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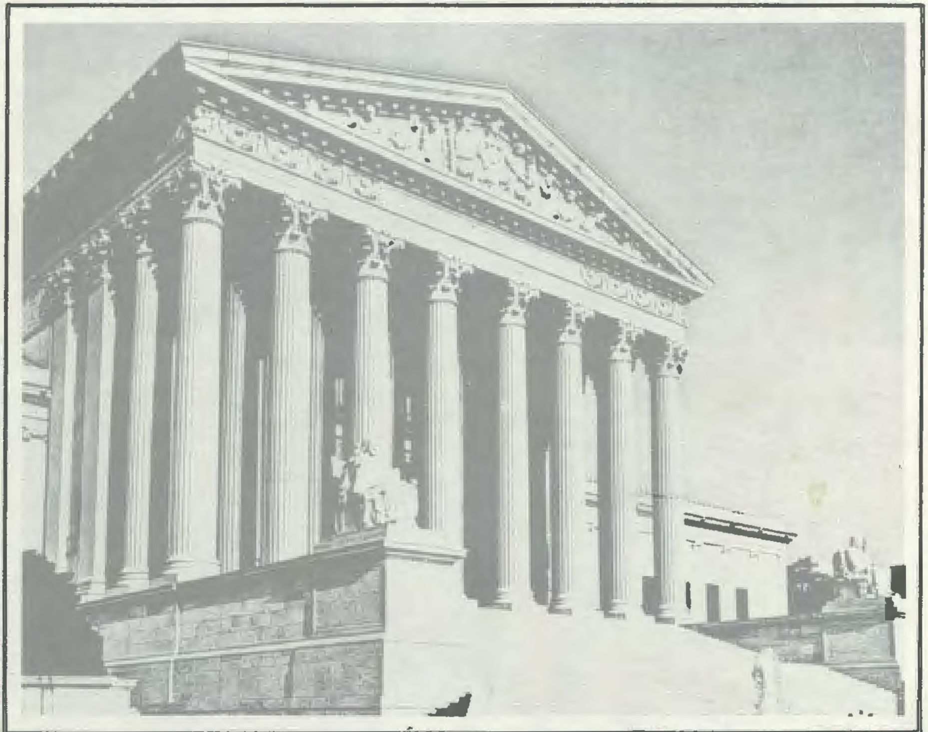

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REVISED ARTICLES 3 AND 4: SUBSTANTIAL CHANGES IN THE UCC

by

Arthur M. Magaldi*
Ivan Fox**

One of the principal purposes for the passage of the UCC was to make uniform the laws that people involved in business transactions would encounter in every state in the United States. A second important purpose of the UCC was to update or "fine tune" the common law principles that had existed for many years, since some of these principles no longer seemed relevant or beneficial in the latter years of the twentieth century. Few would dispute the success of the Code in achieving the twin objectives of fostering uniformity and updating the common law.

The UCC, now in effect for over a quarter century, has also been the subject of study and scrutiny. The American Law Institute and the National Conference of Commissioners on Uniform State Laws have decided that it is again time to update and change laws governing commercial transactions. They have revised Articles 3 and 4 of the UCC. Article 3 has been renamed simply, "Negotiable Instruments."

Our paper will discuss some of the major changes of this revision.[1] As of October, 1992, nineteen states have enacted the revisions as law.

Negotiability

It has been an article of faith that an instrument must be issued payable to order or to bearer if it is to be classified as a negotiable instrument.[2] The order or bearer terminology has frequently been referred to as the magic words of negotiability. An instrument which is made payable to order or bearer indicates the drawer's or maker's intention not to limit payment to the named payee and is therefore one of the bases for protecting later holders in due course. The traditional rule has held that an instrument not issued

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payable to order or to bearer which is later transferred to a good faith purchaser for value cannot result in the later holder becoming a holder in due course. It is well established that there can only be a holder in due course of a negotiable instrument. A transferee from the payee of a non-negotiable instrument is considered merely an assignee of the contract rights of the payee who receives no greater rights than the payee enjoyed. If the issuer, i.e., the maker or drawer, has a defense which can be asserted against the payee, the defense can be asserted against later transferees of a non-negotiable instrument since such transferees can enjoy no greater rights than the original payee.

Revised Article 3 to a large extent continues to require that the traditional ingredients be present in an instrument for it to be considered negotiable. A substantial change has been made, however, in the requirements for negotiability of checks. The revision provides that a check which otherwise meets the requirements for negotiability will not be rendered non-negotiable because it is not issued payable to order or to bearer.[3] The official comments to Section 3-104(c) provide the reasons for the change. "Subsection (c) is based on the belief that it is good policy to treat checks, which are payment instruments, as negotiable instruments whether or not they contain the words 'to the order of.' These words are almost always pre-printed on the check form. Occasionally, the drawer of a check may strike out these words before issuing the check. In the past, some credit unions used check forms that did not contain the quoted words. Absence of the quoted words can easily be overlooked and should not affect the rights of holders who pay money or give credit for a check without being aware that it is not in the conventional form." Based on the official comments to the revised legislation, it is clear that the intention of the revision is to protect unsuspecting transferees of instruments which would in all other respects be considered checks but which lack the "order of" terminology. Inasmuch as this is generally pre-printed on checks, the revision recognizes the fact that a transferee would generally not be examining the instrument for this element and could easily overlook the fact that it is missing. The exception applies solely to checks and other instruments must contain the order or bearer terminology to be considered negotiable.[4]

Under the traditional view, if a buyer paid for goods with a check which was non-negotiable because the check was not issued payable to the order of the payee or to the bearer, and payment of the check was stopped because of a breach of warranty concerning the goods, a subsequent good faith transferee of the check could not be considered a holder in due course. If the later holder sued the buyer, the original issuer of the check, the holder would be subject to the defense of breach of warranty and would be treated as an assignee of the original payee-seller's rights. Under Revised

Section 3-104(c), the lack of order or bearer terminology would not make the instrument non-negotiable, and later holders could be protected as holders in due course.

It should be noted that a bank money order is treated as a check even though it bears the words "money order."[5] Accordingly, the order or bearer terminology is not essential for a bank money order to be considered negotiable.

Particular Fund Doctrine

The new Article 3 changes the particular fund rule as it affects the negotiability of all instruments governed by Article 3, i.e., promissory notes, checks, and drafts. It is well established that only instruments that contain unconditional promises or orders to pay money are considered to be negotiable. The traditional rule holds that an instrument must be based on the general credit of the maker or drawer and payment must not be limited or restricted to a particular source or fund.[6] An instrument in which the promise or order to pay is limited to payment only from a particular fund or source is considered to be conditional and therefore non-negotiable. For example, an instrument which states that it is payable only from the funds in a certain account or only from the proceeds from a particular sale is non-negotiable. The traditional theory is that, when one orders or promises to pay only from a particular fund and from no other source, the instrument is inherently conditional because if there are not funds available in that particular fund then there exists no promise or order to utilize other funds. Therefore, the payment is conditioned upon there being a sufficient sum to provide payment for the instrument from that source alone.

Revised Section 3-106(b)(ii) provides that a promise or order is not made conditional and the instrument rendered non-negotiable because payment is limited to a particular fund or source. "This reverses the result of former Section 3-105(2)(b). There is no cogent reason why the general credit of a legal entity must be pledged to have a negotiable instrument. Market forces determine the marketability of instruments of this kind. If potential buyers don't want promises or orders that are payable only from a particular source or fund, they won't take them, but Article 3 should apply."[7]

Promises or orders which are subject to express conditions or subject to or governed by another writing continue to be non-negotiable under the revised Article 3. Similarly, if the rights or obligations with respect to the promise or order are stated in another writing, the instrument is non-negotiable.

Restrictive Indorsements

Revised Section 3-206(b) changes the rule concerning restrictive indorsements and the manner in which they must be treated by those paying an instrument. The revision provides: "An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled." Prior to revision, an indorsement on a note, "Pay A if A delivers 10 bales of hay pursuant to contract", would impose on the maker the duty to ascertain whether A in fact delivered 10 bales of hay before the instrument can safely be paid. The revision frees the maker from the duty of ascertaining whether the condition had been fulfilled.

Where the revision is not in effect, conditional indorsements on checks make them virtually uncollectible at banks since the latter will not want to undertake the risk of determining whether the condition has been fulfilled. Revised Section 3-206(b) relieves makers of notes and drawees of checks and drafts of the responsibility of determining whether conditions contained in indorsements have been fulfilled. In the example above, the note could be paid by the maker without inquiry into whether the bales of hay had been delivered. In the event the note was negotiated by A to a subsequent holder, the subsequent holder's rights are not affected by the conditional indorsement, i.e., the subsequent holder is entitled to payment irrespective of whether the bales of hay had been delivered. The rule that conditional indorsements do not prevent further transfer or negotiation of an instrument remains unchanged.

Accord and Satisfaction

The revised UCC clarifies the rules concerning the contract theory of accord and satisfaction in regard to part payment checks. Where the amount due on a contract or obligation is unliquidated or in dispute and a check is tendered marked "paid in full", cashing the check by the creditor-payee has typically been held to be a full satisfaction of the claim barring further litigation to recover any additional sum on that claim. Of course, the matter has to be the subject of a legitimate, good faith dispute. The perceived difficulty with the accord and satisfaction concerns the vulnerability of unsuspecting parties, particularly organizations, who unwittingly cash checks marked payment in full when the creditor in fact had no desire to accept the payment as full and final payment.

Revised Article 3 continues to hold that there can be no accord and satisfaction unless the claim is unliquidated or in dispute, the "paid in full" designation is made in good faith, and the creditor cashed the check. Revised Section 3-311 provides protection to organizations who may unwittingly accept full payment checks. Revised Section 1-201(28) defines an organization to include virtually any entity other than an individual or individual proprietor. If the claimant is an organization and before the tender sends a communication that full satisfaction instruments are to be sent to a designated person or place, a party who wishes to tender a full satisfaction instrument must comply. Checks sent to another party or part of the organization will be ineffective to create an accord and satisfaction despite the fact they are cashed by the creditor and bear a conspicuous "paid in full" designation.

An additional protection is accorded organizations which do not designate a particular person or location to receive checks tendered as full payment. The organization may avoid the result of an accord and satisfaction within 90 days of the payment of the check by tendering repayment of the check to the party who sought the accord and satisfaction.[8] In the event, however, it is demonstrated that the claimant or an appropriate agent of the claimant had advance knowledge that the check was tendered to create an accord and satisfaction, cashing the check fully discharges the obligation and re-tendering payment within 90 days is ineffective.[9]

Post-Dated Checks

The rule concerning post-dated checks has also been revised. Prior to revision, a post-dated check was considered an instrument payable at a future time similar to a time draft. Post-dated checks were burdensome to banks which had the duty not to pay them before the date stated on the check. In light of modern check handling of the huge numbers of checks processed daily, the revisors have deemed this to be an unreasonable burden. Revised Section 4-401 provides that a check may be post-dated, but a bank is not liable for making payment on the check before the date stated unless the drawer had given the bank prior notice. This notice must inform the bank that a post-dated check may be presented for payment and advise the bank not to make payment until the stated date. The effect of this is to put the depositor under the obligation to issue something in the nature of a stop payment order.

Secondary Liability of Indorsers

The revisors of the UCC have removed a technical requirement concerning the responsibility of holders of commercial paper who may wish to hold secondary parties liable. The traditional rule requires that an instrument be presented for payment on the due date to the maker, unless an appropriate excuse for non-presentment or delayed presentment exists. Failure to properly present on the due date discharges the secondary liability of the indorser. This

rule, in existence for many years, fails to recognize that there is little actual personal presentation of instruments in the modern business world. Revised Article 3 eliminates the requirement of presenting instruments on the due date in order to have the opportunity of holding an indorser liable in the event of non-payment. "In the great majority of cases presentment and notice of dishonor are waived with respect to notes. In most cases a formal demand for payment to the maker of the note is not contemplated. Rather, the maker is expected to send payment to the holder of the note on the date or dates on which payment is due. If payment is not made when due, the holder usually makes a demand for payment, but in the normal case in which presentment is waived, demand is irrelevant and the holder can proceed against indorsers when payment is not received. Under former Article 3, in the small minority of cases in which presentment and dishonor were not waived with respect to notes, the indorser was discharged from liability (former Section 3-502(1)(a)) unless the holder made presentment on the exact day the note was due (former Section 3-503(1)(c)) and gave notice of dishonor to the indorser before midnight of the third business day after dishonor (former Section 3-508(2)). These provisions are omitted from Article 3 as inconsistent with practice which seldom involves face-to-face dealings."[10] It should be noted that the requirement of giving notice of dishonor has been retained, but the holder has 30 days to give notice of dishonor to the indorser instead of the 3 days previously allowed.[11]

Reporting Forged Drawer's Signature(s)

Another change concerns the amount of time a customer has to report forgeries of the customer's name as the drawer of a check. Prior to the revision, a customer that did not report a forgery of his/her name as drawer, i.e., a signature apparently issuing a check, within 14 days from the receipt of a statement showing such a forgery bore the loss for any subsequent forgeries by the same wrongdoer. The theory, of course, was that the customer's negligence in failing to warn the bank contributed to the loss.

Revised UCC Section 3-406(d)(2) expands the time for the customer to alert the bank to 30 days. This change recognizes the greater number of checks issued today by all kinds of depositors and the practical problems those depositors face in reconciling their accounts. In addition, in the event the depositor fails to alert the bank in the appropriate period of time, the depositor may still not bear the entire loss. The revisors have established a standard of comparative negligence to be applied in such cases.[12]

The changes in the UCC described above are not of the same quantity or magnitude as those contained in the original UCC. Nevertheless, the changes are substantial. The revisors have continued to modernize and "fine tune" the law for the

last portion of the twentieth century and beyond. In general, the revisions seem reasonable and based on sound business practices.

FOOTNOTES

1. See also Anderson on the U.C.C., Vol. 6, 1991, Clark, Boardman, Callaghan & Co. and Quinn's UCC Commentary and Law Digest, 2d edit., Warren, Gorham & Lamont, Inc. (1992).
2. UCC Sec. 3-104(1)(d).
3. Revised UCC Sec. 3-104(c).
4. Revised UCC Sec. 3-104(a)(1).
5. Revised UCC Sec. 3-104(f).
6. UCC Sec. 3-105(1)(g).
7. Official Comment 1 to Revised UCC Sec. 3-106.
8. Revised UCC Sec. 3-311(c)(2).
9. Revised UCC Sec. 3-311(d).
10. Official Comment 2 to Revised UCC Sec. 3-502.
11. Revised UCC Sec. 3-503(c).
12. Revised UCC Sec. 3-406(b).

STRESS IN THE WORKPLACE: JUDICIAL DEVELOPMENTS AND LEGISLATIVE AND BUSINESS RESPONSES

by

Anthony Libertella *
and
George Barbero **

Introduction

In 1989 stress related workers' compensation cases accounted for 15% of all occupational disease claims.(1) Although most stress claims are currently litigated within the workers' compensation system, with average payments of $15,000, the dollar amount and volume of claims is projected to increase dramatically.(2) Stress currently ranks as one of the top ten work-related problems.(3) The Northwestern National Life Insurance Company study of 1991 indicates that the incidence of stress claims has doubled in the past ten years,(4) and the number of employees experiencing stress also has doubled during the same time period.(5) Currently seven out of ten employees surveyed claim to experience work-related stress symptoms.(6)

The factors most commonly cited by employees as causing stress-related illnesses are: reduction of employee benefits, lack of personal control over one's job, mergers and acquisitions or change in business ownership resulting in termination, major departmental reorganizations causing job changes and frequent overtime.(7) It appears that the corporate culture fosters unhealthy and too stressful environments, with unrealistic demands frequently burdening the employees. Of the population surveyed the Northwestern study found that 34% of employees expect to burnout on the job and 72% of all workers experience three or more stress related illnesses on a frequent basis.(8) If the number of stress-related illnesses continues to expand as projected by this study, stress claims are anticipated to lead all other workers' compensation claims in the 1990's.

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The purpose of this article is to explore the judicial developments and the legislative and business responses as they relate to the increasing number of employees seeking compensation for job-related stress illnesses. This article first examines workers' compensation claims where mental or psychic stress causes a mental or psychological disability. Selected cases, including the most recent holdings, are reviewed to demonstrate the criteria laid down by various state courts in denying or permitting recovery for such claims. Next, consideration is given to situations where employees have gone outside of the workers' compensation field to pursue their job-stress claims either under human rights legislation or common law tort. The article then describes the responses of various state legislative bodies and the business community to the flood of work-related stress claims. Lastly, the newly emerging trends in job-related stress illnesses and claims will be discussed, with a brief commentary on the necessity of a careful balancing of the interest by employers, employees and society at large in resolving this emerging crisis in the workplace.

Workers' Compensation Stress Claims

Under the great majority of workers' compensation statutes it is not any workplace injury that entitles an employee to compensation benefits, but only those that are determined to be accidental.(9) Most statutes define "injury" and "personal injury" to mean "only accidental injuries arising out of and in the course of employment." (10) Prior to recent statutory amendments in some states, the statutes typically did not specify any particular injury nor was any reference made to stress claims. From a historical point of view, whether a so-called stress or mental injury claim was compensable, depended upon case law within each state.

Workers' compensation claims involving mental stress are often classified as follows: mental-physical claims in which mental stress causes physical disability (anxiety induced coronary attack), physical-mental claims in which physical injury causes a mental disability (conversion hysteria following traumatic injury), and mental-mental claims in which mental stress causes mental disability (nervous breakdown caused by emotional stress).(11)

Traditionally, the workers' compensation boards and courts are most likely to grant awards in the physical-mental and mental-physical cases; all fifty states regard such claims as compensable.(12) However, in the new and somewhat uncharted territory of mental-mental cases, which is the focus of this paper, there are several difficult issues for determination by the courts. Since there is no physical corroboration for the disability, it is extremely difficult to prove that a mental disability was caused by work. The uncertainties inherent in psychiatry make it difficult to determine whether there was a pre-existing mental illness. Additionally, it is difficult to determine if work-related stress is an aggravating factor to a pre-existing condition, and if so, whether this should be compensable under workers' compensation.(13) In the resolution of these

issues the state courts differ in the criteria to be applied as an examination of selected cases below will demonstrate.

The manner in which state courts have viewed the complex issue of mental-mental claims can be broken into four categories: (1) those denying recovery for mental-mental claims; (2) those allowing recovery where the mental stress involves sudden shock; (3) those allowing recovery when the mental stress is unusual; (4) those allowing recovery where the mental stress is not unusual.(14)

State Courts Denying Recovery for Mental-Mental Claims

The states of Alabama, Florida, Georgia, Kansas, Minnesota, Montana, Nebraska, Ohio, Oklahoma, and South Dakota are among the minority, and do not permit compensation for mental-mental stress cases under any circumstances.(15)

The following two cases exemplify this minority view. The Supreme Court of Oklahoma in 1990 addressed the issue of the compensability of a mental-mental claim in Fenwich v. Oklahoma State Penitentiary.(16) In this case, a state penitentiary employee's claim for mental disability resulting from an incident in which he was held hostage for a few hours was denied. The court concluded that mental injury caused by work-related stress without physical trauma is not compensable under the Oklahoma Workers' Compensation Act.(17)

In a fairly recent South Dakota Supreme Court case, Lather v. Huron College,(18) the issue of mental-mental compensability was considered for the first time. Here, the employee left his position as a college basketball coach because of work-related stress. Subsequently, he was treated for a psychological disorder which ultimately led to his suicide. The court, in denying the claim, held that mental disability caused by a mental stimulus was not compensable.(19)

State Courts that Permit Recovery in Mental Injury Caused by Sudden Shock

The second category is composed of states that permit compensation if the source of the mental stress is caused by a sudden or shocking event. These states are: Illinois, Maryland, Mississippi, Tennessee, Texas and Virginia.(20)

An example where the courts applied this somewhat stringent criterion is found in Transportation Insurance Company v. Maksyn,(21) where the Supreme Court of Texas held that *gradual* mental stress is not compensable, and that recovery for mental injury was limited to those claimants who had suffered sudden injury. In this particular case the claimant, an employee of a publishing company, was subjected to an excessive work load that required constant and excessive overtime, and therefore, because of the ongoing nature of the injury it was not deemed compensable.(22)

Other courts, however, have not only allowed recovery for mental-mental claims caused by sudden or shocking stimuli, but also allowed recovery for mental injuries stemming from gradual and extraordinary stress as well, as shown in the recent Mississippi Supreme Court case of Borden v. Eskridge,(23) where the court upheld the disability claim based upon severe depression. Here, the claimant alleged maltreatment by his supervisor causing him to live in a state of anxiety and depression. The court held that a worker seeking benefits for psychological injury must show extraordinary causes, not those usually associated with the workplace.(24)

State Courts that Permit Recovery in Cases of Unusual Mental Stress

The third category of states includes Arizona, Arkansas, Maine, Massachusetts, New Mexico, New York, Rhode Island, South Carolina, Colorado, Delaware, Indiana, Louisiana, Washington, Wisconsin and Wyoming, all of which allow compensation for mental-mental claims if the source of the mental stress is considered to be unusual and in excess of the amount of stress normally associated with everyday employment.(25)

New York is one state that has adopted the majority view, after its highest court resisted ruling on mental-mental claims for years. In 1975, in the landmark case of Wolfe v. Sibley, Lindsay & Curr Co.,(26) the New York Court of Appeals for the first time considered the question of whether psychic trauma is a readily identifiable cause of psychological or nervous injury. Having earlier decided in Klimas v. Trans Caribbean Airways (27) that an injury caused by emotional stress or shock may be accidental within the purview of the compensation law, and having uniformly sustained awards previously where physical impact resulted in nervous or psychological disorders,(28) the court in Wolfe, by a four to two decision, and despite a vigorous dissent, reversed the Appellate Division's denial of the award, and held that the psychological or nervous injury precipitated by psychic trauma is compensable to the same extent as physical injury.(29) The claimant, employed as a secretary, worked for a department store security director who was suffering from a nervous condition. The supervisor relied heavily on the claimant who not only assumed some of her supervisor's duties, but became his confidante on the subject of his increasing anxiety and nervous condition. After calling the police in response to her supervisor's request and failing to reach him on the intercom, she entered his office and found him lying in a pool of blood caused by a self-inflicted gunshot wound in the head. She became extremely upset, lost time from work, and received psychiatric care with hospitalization. Her condition was diagnosed as acute depressive disorder.(30)

The court, in reinstating the compensation award, noted that, having recognized the reliability of identifying psychic trauma as a cause of physical injury in some cases (mental-physical), and psychological injury as a resultant factor in other cases (physical-mental), it saw no reason for limiting recovery in the latter instance to cases involving physical impact.(31) Citing Battalia v. State of New York(32) which eliminated the "impact" doctrine in the field of torts, the court stated: "There is nothing

talismanic about physical impact."[33] In passing, the court also noted that its analysis reflected the majority of decisions in this country.[34]

Apparently, in an effort to restrict the application of its holding and to distinguish the instant case from its holding in Tobin v. Grossman,[35] which refused to extend to third parties a cause of action in torts for psychic injury incurred without impact, the court pointed out that the claimant here was not a third party merely witnessing an injury to another, *but was an active participant in being involved in her supervisor's nervous condition.*[36] In addition, not only did she consider his suicide a personal failure, but she was an integral part of the tragedy by virtue of his last communication and her discovery of his lifeless body.[37]

Following Wolfe, the appellate courts in New York have affirmed a number of awards to claimants where psychological injury was attributable to psychic trauma. In Gamble v. New York State Narcotics Addict Control Commission,[38] an award for death benefits was affirmed where the claimant suffered psychic trauma resulting from a job change. The court held that the claimant's resulting psychosis and mental derangement caused his suicide and thereby constituted an accidental injury.[39]

In another very recent New York case, Friedman v. NBC, Inc,[40] the court held that a widow of an NBC-TV employee was entitled to compensation due to her husband's work-related suicide. The court unanimously ruled that although the deceased suffered from undiagnosed depression for twenty years prior to his suicide, that his suicide was a result of the depressed condition that was related to stress in his employment. A reorganization of NBC in 1978 led to deceased's being forced to carry a beeper, and work extensive overtime during the nights and weekends. In 1980, he was given a new title and additional responsibilities as manager of the company's video tape library, an area that had long suffered from operational problems. In his final letters to his wife and supervisor, he stated that he could no longer face what he saw as his inevitable failure in this newly assigned capacity. The court held that workers' compensation death benefits may be awarded if work-related stress causes insanity or a pattern of mental deterioration.[41] It further noted that the "casual relationship" between an industrial accident and a resulting mental condition need not be direct and immediate rather, "it is sufficient that the work related stress be a contributing cause of the psychic injury."[42]

In some cases the New York appellate courts have denied awards to claimants in mental injury claims. In Everett v. A.S. Steel Rule Die Corporation,[43] the court held the claimant did not sustain an industrial accident within the meaning of the Workers' Compensation Act where he became incapacitated due to a mental condition causally related to his observation of a bloody bandage on the hand of a coworker. Relying on the holding in Wolfe, where the claimant was an active participant, the court stated that it does not extend compensability to mental-mental injury sustained by a claimant who merely observes an injured coworker.[44]

An example of how the appellate courts in New York have differed in the application of Wolfe is seen in Wood v. Laidlaw Transit, Inc.,[45] where the claimant, a school bus driver, came upon the scene of a gruesome automobile accident in which two young children, known to her, died. She thereafter developed symptoms of a psychological nature requiring hospitalization and treatment for a condition diagnosed as a post-traumatic stress disorder. Relying on the "active participant" criterion in Wolfe, the Appellate Division reversed the decision of the Workers' Compensation Board awarding benefits. On further appeal, the Court of Appeals, also relying on Wolfe, reversed the Appellate Division and affirmed the decision of the Board on the grounds that the claimant was "an active participant in the tragedy."[46]

Subsequent to Wolfe, other states in responding to the increase in workplace stress have placed themselves in the mainstream of workers' compensation jurisprudence by accepting mental-mental claims. Stokes v. First National Bank,[47] a South Carolina case is just such an example. Here, a bank employee suffered a nervous breakdown as a result of a greatly increased work load and job responsibility, a by-product of a corporate merger.[48] The South Carolina Court of Appeals, in accepting mental-mental claims for the first time, held that the claimants prolonged increase in work hours, combined with additional job duties constituted "unusual and extraordinary conditions of employment" which resulted in a compensable accidental injury.[49]

In Candelaria v. General Electric Co.,[50] a New Mexico case, the claimant suffered anxiety attacks with several hospitalizations resulting from personality conflicts with his supervisor. The court held that psychological injury resulting from a sudden or gradual emotional stimulus "arises out of" employment when it is causally related to job performance.[51]

Until Sparks v. Tulane Medical Center Hospital & Clinic,[52] the Supreme Court of Louisiana had never considered the issue of the compensability of a mental-mental claim. Here, the employee claimed that she had been continually harassed and threatened by co-employees causing her to suffer a disabling mental condition.[53] The court noted that mental health is an intrinsic component of the physical structure of the body and that the circumstances here satisfied the requirement of an accidental injury.[54]

State Courts that Permit Recovery if the Source of the Mental Stress is Not Unusual

The final category of states, which have accepted mental-mental compensation claims, includes Alaska, California, Hawaii, Kentucky, Michigan, New Jersey, Oregon, Pennsylvania and West Virginia, all of which have allowed such claims even if the cause of the mental stress is not deemed to be unusual or excessive.[55]

Carter v. General Motors,[56] was one of the earliest cases to recognize the compensability of claims where mental injury results in the absence of physical impact

or physical stimulus. Here, the claimant developed a paranoid schizophrenia condition and required hospitalization after being unable to keep up with the pace of work demanded by his supervisor, although such work was shown not to be unusual. The Supreme Court of Michigan held that "emotional disabilities are compensable under the Workers' Compensation Act regardless of whether the cause was a direct physical injury or mental shock."(57)

Following Carter, the Michigan courts affirmed awards in mental-mental cases, including those based upon workers' subjective perceptions of stress.(58) However, following a 1980 amendment to the Michigan Compensation Law,(59) in 1991 the Court of Appeals in Iloyan v. General Motors Corp.(60) clearly rejected the subjective standard test applied in earlier cases. Here, the plaintiff alleged having "major depression" with the onset emotional disorder occurring in relationship to the stress he allegedly experienced in his workplace, where he described himself as "feeling mistreated, pressured and demeaned."(61) In reversing an award by the Workers' Compensation Board, the court held that the Board mistakenly applied the invalidated Deziel subjective standard and that the correct legal standard to be applied was that of *an actual, precipitating, work-related trauma, event, or events and not just an unfounded perception thereof.*(62)

Human Rights Cases and Job-Related Stress

While the greater number of job-related stress claims are made under workers' compensation, in some instances, employees have been able to successfully pursue such claims outside of the workers' compensation area. In New York City Transit Authority v. State Division of Human Rights (Adrienne Nash)(63) the New York State Court of Appeals reversed an appellate court ordered reduction of a $450,0000 award for mental anguish in a sex discrimination case, and remitted the matter to the Appellate Division for reconsideration. The high court noted that, "Mental suffering is not only compensable, but also a frequent sometimes sole, consequence of unlawful discriminatory condition."(64)

Another recent case from New York's highest court, exemplifying its willingness to compensate employees for mental anguish and humiliation in discrimination cases, is Consolidated Edison Company of New York, Inc. v. New York State Division of Human Rights (Pamela Easton).(65) The court held that there was substantial evidence supporting the finding of the State Commissioner of Human Rights, that Consolidated Edison discriminated against Pamela Easton, a black woman, on the basis of sex and race, by promoting two white males to supervisory positions, both of whom lacked her experience level. In upholding the Commissioner's award of $10,000 for hurt, humiliation, and mental anguish suffered, the court noted "the effects of discrimination were perceived everyday when the complainant reported to white males, petitioners had promoted over her."(66)

Tort Cases and Job-Related Stress

Workers' compensation acts typically provide the sole or exclusive means for injured workers to receive compensation benefits, with recovery unaffected by any negligence on the part of the employer. Yet because workers' compensation limits the recovery, attorneys frequently search for alternatives to employer's exclusivity of remedy protection. In recent years we have seen instances in which appellate courts have carved exceptions to these exclusive remedy provisions of workers' compensation law, particularly with respect to non-physical employee tortious acts, such as intentional infliction of emotional distress, sexual harassment, and discrimination.

In some work-related mental stress claims pursued under state discrimination statutes, employers have raised the issue of the "exclusive remedy" provisions of the state workers' compensation laws. This issue was squarely faced in Boscaglia v. Michigan Bell Telephone Co.,(67) where the claimant brought an action for damages alleging violation of her civil rights and sought recovery for physical and mental or emotional injury. Here, the court held that the exclusive remedy provision of the Workers' Compensation Act did not bar such an action where the employee was alleging a violation of the Fair Employment Practice Act or the Michigan Civil Rights Act.(68)

In Rojo v. Kliger,(69) where an employee brought an action against her employer and co-employees for sexual harassment under the Fair Employment and Housing Acts and intentional infliction of emotional distress, the California Supreme Court held that an employee need not seek remedy through the Fair Employment and Housing Acts before filing suit on common law grounds of sexual discrimination. This decision lends support to the argument that civil and workers' compensation remedies should be cumulative rather than mutually exclusive. The California Labor Code allows tort damages to be awarded against coworkers guilty of sexual harassment, without a reduction of workers' compensation benefit awards.(70)

In Levinson v. Prentice Hall, Inc.(71), the United States District Court permitted a handicapped employee to first prove that the employer violated state fair employment practice and then to receive back pay, compensation damages and reinstatement. The court then permitted the employee to apply common law principles to seek punitive damages. This case demonstrated how common law employment rights can be used to obtain large punitive awards on top of those awards already granted by state and federal civil rights law. Levinson claimed he had been denied several promotions and had been repeatedly subjected to ridicule and mimicked for his uneven walk. Levinson claimed that the ridicule emotionally hurt, resulting in his crying in bed to his wife, apologizing for not getting the promotion and for being less of a man for not receiving a promotion. Levinson, who suffered from multiple sclerosis, sued for punitive and

compensatory damages for emotional distress. The court awarded him $100,000 for mental suffering due to discrimination and 2.3 million dollars in punitive damages[72].

In Pikop v. Burlington Northern Railroad Company,[73] a railroad employee filed suit for intentional infliction of emotional distress alleging that she was constantly insulted by her supervisor, forced to observe as her coworkers tortured and killed rats and birds, and the company refused to listen to her complaints.[74] The Supreme Court of Minnesota held that claims of employees against the railroad for intentional infliction of emotional distress did not necessitate the showing of physical injury under state tort law and, thereby, were not preempted by either the Railway Labor Act or the Federal Employers Liability Act, which limit recovery to intentional torts that cause physical injury.[75]

Legislative Responses to Stress-Related Claims

State legislative bodies have responded to the flood of stress-related claims and to the liberal and expansive judicial interpretation of compensation statutes, which has broadened the application of the concepts of "accident" and "injury" to include mental-mental claims. Some legislative amendments to workers' compensation statutes narrowly redefine "accident" and "injury" to expressly prohibit mental stress claims. Other amendments establish new criteria in the determination of mental injury claims, and some create more demanding standards of proof.

It appears that Montana has taken an extreme position in excluding all mental stress claims when it amended its definition of "injury" under its compensation act by excluding physical and mental conditions arising from emotional or mental stress or non-physical stimulus or activity.[76] Thus, workers who suffer heart attacks from job-related stress are no longer covered (mental-physical claims), nor are workers who suffer a disabling nervous breakdown or any psychological disorder resulting from emotional or mental stress (mental-mental claims).[77]

On the other hand, Massachusetts and New York have taken a more modest position in excluding job-related mental stress claims that arise out of bona fide personnel actions. The Massachusetts legislature amended its compensation laws, and in effect overruled the decision in Kelly's Case,[78] by adding the following: "No mental or emotional disability arising principally out of a bona fide, personnel action including a transfer, promotion, demotion, or termination except such action which is the intentional infliction of emotional harm shall be deemed to be a personal injury within the meaning of this chapter."[79] Strikingly similar language is found in the New York amendment which states that the "terms 'injury' and 'personal injury' shall not include an injury that is solely mental and is based on work-related stress, if such mental injury is a direct consequence of a lawful personnel decision, involving a disciplinary action, work evaluation, job transfer, demotion, or termination taken in good faith by the employer."[80] It appears that this amendment in effect reverses the holding in Gamble.[81]

The recent legislative enactments regarding mental-mental claims in other states vary in the degree of complexity. The amendments in Louisiana, Oregon, Michigan, Colorado, California and New Mexico are good examples.

Apparently, in a direct response to Sparks,[82] Louisiana's Workers' Compensation Act was amended to provide a new definition of "injury" as follows: "Mental injury or illness resulting from work-related stress shall not be considered a personal injury by accident arising out of and in the course of employment and is not compensable ... unless the mental injury was the result of a *sudden, unexpected, and extraordinary* stress related to employment and is demonstrated by clear and convincing evidence."[83] Furthermore, a new subsection for mental injury or illness requires a diagnosis by a licensed psychiatrist or psychologist and the diagnosis must meet the criteria of the American Psychiatric Association.[84] This would appear to rule out an employee's subjective allegation as to the appearance of symptoms of mental injury such as anxiety, and that the mental injury must be precipitated by an "accident". In addition, the requirement of "clear and convincing evidence" creates a new element of proof, more demanding than previously required.[85] Oregon, similar to Louisiana in complexity, and in establishing new criteria for mental injury claims, amended its statute providing for a strict set of standards for the compensability of such claims. First, the claimant must now establish that the work conditions creating the mental disorder exist in an objective sense; second, the employment conditions establishing the mental disorder are not conditions inherent in everyday work situations, such as disciplinary actions, job performance evaluations, and termination of employment; third, the diagnosis of the emotional disorder must be acceptable in the medical community; finally, the claimant must present clear and convincing evidence that the mental disorder arose out of and in the course of employment.[86]

Michigan's legislature limited mental injury claims by amending its compensation statute to read that "mental disabilities and conditions of the aging process, including but not limited to heart and cardiovascular conditions shall be compensable if contributed to or aggravated or accelerated by the employment in a *significant manner.* Mental disabilities shall be compensable *when arising out of actual events of employment, not unfounded perceptions thereof.*"[87] (italics supplied) In requiring that the mental disability be related to employment in a significant manner creates a stricter standard than that found in Carter.[88] Moreover, this amendment clearly invalidates the subjective "honest perception" test found in Deziel.[89]

Colorado's amendment now defines "accident", "injury", and "occupational disease" as not including "disability or death caused by or resulting from mental or emotional stress unless it is shown by competent evidence that such mental or emotional stress is proximately caused solely by hazards to which the worker would not have been equally exposed outside the employment."[90]

California by amendment has established a new and higher threshold of compensability for psychiatric injury by requiring a diagnosis of mental injury or

disorder meeting the criteria of the American Psychiatry Association or criteria generally approved and accepted nationally by practitioners in the field of psychiatric medicine.[91] Additionally, the employee must demonstrate by a preponderance of evidence that actual events of employment were responsible for at least 10% of the total causation from all sources contributing to the psychiatric injury.[92]

Governor Pete Wilson proposed an amendment that would require workers to prove that their mental disability came from their employment, not their families or personal lives.[93] Although, the legislature did not agree to this reform, they did enact a requirement that workers must be employed six months prior to their claim.[94]

Finally, the New Mexico legislature, in response to Candelaria[95] amended its compensation act by redefining primary mental impairment "to mean a mental illness arising from an accidental injury involving not physical injury and consists of a psychologically traumatic event that is generally outside of a worker's usual experience ... but is not an event in connection with disciplinary, corrective or job evaluation action or cessation of the worker's employment."[96]

Business Responses to Stress-Related Claims

A variety of actions have been undertaken by employers to prevent the sources of stress that are precipitating mental stress claims, such as making use of diagnostic stress systems, providing individual counseling, and creating stress-reduction and control programs.[97] Employees from companies that offer stress reduction programs are 50% less likely to miss work or quit their jobs due to stress, according to the Northwestern Life Insurance survey.[98] Researchers calculated the average cost of rehabilitating stress disabled employees at $1925 and, if not rehabilitated, the cost would be an average of $73,270.[99] The survey also showed that the employers who offered stress-reduction programs have more healthful employees, with higher rates of productivity, lower turnover and less absenteeism.[100] Due to the increase of mental-mental claims, and the frequently ensuing likelihood of litigation, it has become essential for employers to learn to protect themselves.

The optimal strategy appears to be one of teaching employees to effectively handle the pressure of their jobs, and thus reduce the occurrence of work-related stress injuries. For example, Texas Instruments Inc. has initiated a holistic stress management philosophy that encompasses a wide range of programs.[101] The National Employee Services and Records Association, a non-profit organization with over 15 million members nation-wide, cited Texas Instruments Inc. as the Employer of the Year in 1991, based largely on their employee services and recognition programs along with their organizational structure that places a high value on people.[102] Texas Instruments sees stress as a useful and positive force in the workplace and attempts to educate employees through their wellness program, Lifetrack.[103] This program is available at three major United States facilities, and includes health assessments and recommendations for participation in company-sponsored wellness programs.[104] The

Lifetrack materials cover a wide range of topics and provide explanations of the mechanism of stress in the workplace; the materials are family-oriented and promote a balanced life style for employees. Within the past three years, employees participating in Lifetrack health assessments have shown a 7% improvement in how they cope with stress.[105]

In companies throughout the United States increasing numbers of professionals and managers are rejecting grueling work loads, much of which leads to stress despite the frequent high salaries that accompany these positions. Employees are reconsidering their priorities and are seemingly willing to accept salary reductions in exchange for time they need for their personal lives. John P. Robinson, Director of Americans Use of Time Project for the University of Maryland, claims that leisure time not money, will be the status symbol of the 1990's.[106] In a study Robinson conducted for the Hilton Hotel Corporation, 50% of all workers surveyed were willing to forego one day's pay per week for the additional day of rest time.[107] Over three quarters of the respondents place "more time to spend with friends and family" as their top priority, whereas only 61% chose "making more money" as their primary goal.[108] Similar concerns for a balanced lifestyle in reducing stress have been addressed by Texas Instruments, Inc. which has established part-time work-pilot programs. [109]

Developing Trends in Job-Related Stress

The number of stress claims in the 1990's is expected to increase as a result of a changing work environment, namely, work-place technology becoming more sophisticated (the use of VDT terminals, computers, and electronic monitoring), the increased presence of workers with AIDS and HIV positive, the employment of disabled persons, and the perceptions of workers being sexually harassed and discriminated.

In ILC Data Device v. County of Suffolk[110] a New York appellate court recently heard arguments in an attempt to resurrect a 1988 law regarding the use of video display terminals in companies with over 20 terminal users. The law was voided in late 1989 by the New York State Supreme Court, which ruled the county was barred by the State Home Rule law from enacting laws affecting employee/employer relations.[111] The 1988 law required employers with more than 20 video display terminal users to provide equipment meeting standards for stress reduction, specified lighting and noise reduction devices, as well as 15-minute breaks for every three hours of employee work time.[112] A similar law was struck down in California as being overridden by the State's Occupational Safety and Health law; the issues being raised challenge whether these statutes directed at workplace stress conflict with the federal OSHA Act of 1970.[113]

At the 1991 annual meeting of the Human Factors Society commentators indicated that the effect of technostress was an area that required increased research. Thomas Sheridan, a professor of Man-Machines Laboratory at MIT, asserted that

computers and automation have alienated workers, and the use of computer networks has led to a blurring of the lines of work responsibility and accountability.[114] Lawrence Schleiter, a research psychologist with the Stress Reduction Laboratory at the National Institute for Occupational Safety and Health, is concerned by the findings of his investigation regarding electronic performance monitoring.[115] Although Schleiter believes technology can contribute to positive changes in the workplace, he fears that it also brings with it an interference into the dynamics of interaction in the workplace.[116]

Researchers have found that employees who are electronically monitored by their supervisors report higher levels of stress and repetitive strain illnesses. Dr. Michael Smith, head of Industrial Energy Department of the University of Wisconsin, in his study of seven regional telephone companies,[117] found that monitored workers reported greater work load dissatisfaction, and a perception of less control over their jobs and greater levels of anxiety and tension. Smith's study concluded that electronic monitoring had a negative effect on employee perceptions of their work.[118]

Another area of growing concern for potential increase of stress claims is the increase of AIDS in the workplace.[119] William Donnelly, Public Education Coordinator for the AIDS Foundation, citing statistics on the impact of AIDS in the workplace, projected that at least one million HIV positive employees are currently in the workplace and forecasts a dramatic increase in stress-related claims from employees working closely with HIV positive coworkers.[120] The stresses related to those working in high risk professions (public health, medical, public safety) have shown the need to minimize the risk and stress through educational programs. Work-related stress can also become a contributing factor in accelerating the HIV virus for an HIV positive employee. It is believed that stress hastens the disease's progress and companies might eventually have to deal with claims based on this factor.[121]. For example, in a recent New York decision, Castro v. New Life Insurance Company,[122] the court upheld a claim for negligent infliction of distress in an AIDS phobia case. Here, the claimant, a cleaning woman, developed AIDS phobia after being struck by a negligently disposed hypodermic needle.

The employment of disabled persons poses another area of concern for employers. California workers' compensation attorney, Richard H. Jordan, recommended that congress should amend the Americans with Disabilities Act (ADA), or the EEO Commission should issue new regulations to avoid the difficulties employers are now facing from employees claiming emotional stress caused by personnel actions.[123] In many states, employees currently have the right to seek workers' compensation benefits and ADA remedies when they are suffering from emotional disorders and are denied employment opportunities by the employer they worked for at the time of their injury.[124] Jordan recommends eliminating job stress claims based on personnel actions from workers' compensation, establishing a new grievance system, and prohibiting employees from using decisions from workers' compensation tribunals to support claims of mental impairments under the ADA; he believes these changes would free employers from a fear of unlimited and unrestricted

liability for mental injuries and would further the intention of the workers' compensation law and the ADA.[125]

Another developing trend relating to job stress is found in the area of sex discrimination and sexual harassment, where victims report difficulty in sleeping, listlessness, depression, deep feelings of worthlessness and self-blame.[126] Some estimate the stress-related sexual harassment claims are costing American companies a staggering $11 billion annually.[127] Under a 1986 Supreme Court decision sexual harassment was determined to be a form of discrimination, for which the employer is held liable.[128] Studies show 90% of the women in the work force see sexual harassment as a major problem.[129] Companies with stringent sexual harassment policies report improved productivity and morale.[130] According to a survey conducted by Training magazine 74% of all companies have sexual harassment policies.[131] The key to a successful sexual harassment prohibition policy appears to be a combination of commitment by management, education and intervention. Companies who choose not to deal effectively with this problem, may one day find themselves paying vast sums in discrimination suits.

Conclusion

Stress induced psychological disorders are becoming the fastest developing segment of occupational ills, with the number of mental-mental claims continuing to grow each year. This growth can be attributed to a number of economic, psychological, and sociological reasons, including technological advances in society and overall work environment situations. In addition, the courts liberal interpretation of workers' compensation laws, human rights law and common law torts, to embrace work-related stress claims, have contributed to the growth of such claims. There can be little doubt that mental claims caused by workplace stress will continue to increase with more litigation in the workers' compensation and state court systems, with the resultant high cost to employers, employees and society at large.

While employers have in some measure met with success in lobbying state legislatures for changes in workers' compensation laws in order to reduce mental-mental claims, it is questionable whether this will be an effective solution to the emerging crisis in society engendered by stress related disability claims. While the legislatures, and to a lesser degree, the courts, are faced with the difficult and delicate task of balancing the interest of employers, workers, and society at large, the pervasive nature of work-place stress and its resultant disability cannot be ignored. As one court noted, "undue anxiety, strain and mental stress from work are frequently more devastating than a mere physical injury ...".[132]

Perhaps a better solution would be for employers to adopt a holistic stress management philosophy which would focus more on the value of workers as persons and take into account critical human needs.[133] Employers might develop programs promoting a balanced life style and allowing time for their employees' personal and

family lives. Other stress reduction and stress control programs could be instituted by employers. These might include educating employees to effectively handle stress, providing individual and group counseling, and adopting new policies designed to foster better work environments and better relationships between employers and employees. These initiatives will go a long way toward the resolution of this emerging crisis.

Footnotes

1. La Van, Katz, Hochwarter, *Employee Stress Swamps Workers' Comp.*, PERSONNEL, May 1990, at 61.
2. Id.
3. *Job-Related Mental Stress Claims Expected to Pass All Others in '90's*, THE PSYCHIATRIC TIMES, November 1990, at 1.
4. See generally, *Employee Burnout: America's Newest Epidemic*, NORTHWESTERN NATIONAL LIFE INSURANCE SURVEY, 1991.
5. Id.
6. Id.
7. Id.; see also, *Why Workplace Stress Claims are Increasing*, STRESS MANAGEMENT ADVISOR, May 1992, 1-2.
8. Id.
9. 1B A. Larson, THE LAW OF WORKMEN'S COMPENSATION, §37.10 (1991).
10. See, e.g., NEW YORK COMP. LAW §2(7) (McKinney 1991); see generally, DE CARLO AND MINKOWITZ, WORKERS' COMPENSATION INSURANCE AND LAW PRACTICE: THE NEXT GENERATION, Appendix 10A, pp. 271-78 (1989).
11. See generally, IB A. Larson, supra note 9, §42.21-42.23.
12. Id.
13. La Van, supra note 1, at 62.
14. See generally, IB A. Larson, supra note 9, §42.25 (c).
15. Id.
16. 792 P.2d 60 (OKL. 1990).
17. Id., at 63.
18. 413 N.W.2d 369 (S.D. 1987).
19. Id.
20. See generally, IB A. Larson, supra note 9, §42.25 (e).
21. 580 S.W. 2d 334 (Texas 1979).
22. Id., at 338-39.
23. Supreme Court of Mississippi, No. 89-CC-0787, decided Nov. 20, 1991.
24. Id.
25. IB A. Larson, supra note 9, §42-25 (f).
26. 36 N.Y. 2d 505, 330 N.E. 2d 603, 369 N.Y.S. 2d 637 (1975); See commentary, *Compensability of Mental Injury*, 21 N.Y.L.F. 465-76 (1976); *Workmen's Compensation - New York Court of Apeals Holds Mental Injury Precipitated by Psychic Trauma Is Compensable*, 44 FORDHAM L. REV. 204-13 (1975); *New York's Workmen's Compensation Law and the Concept of Accidental Injury: Gradual Injuries, Psychological Disabilities, and Common Sense*, 28 SYRACUSE L. REV. 664-99 (1977).
27. 10 N.Y. 2d 209, 176 N.E. 2d 714, 219 N.Y.S. 2d 14 (1961).
28. Supra, note 26, at 509, 330 N.E. 2d at 605, 369 N.Y.S. 2d at 640.
29. Id., at 510, 330 N.E. 2d at 606, 369 N.Y.S. 2d at 641.
30. Id., at 510, 330 N.E. 2d at 606, 369 N.Y.S. 2d at 642.
31. Id.
32. 10 N.Y. 2d 237, 176 N.E. 2d 729, 219 N.Y.S. 2d 34 (1961).
33. Supra note 26, at 510, 330 N.E. 2d at 606, 369 N.Y.S. 2d 642.
34. Id. at 510-511 (citing Bailey v. American Gen. Ins. Co., 154 Texas 430, 279 S.W. 2d 315; Carter v. General Motors Corp., 361 Mich. 577, 106 N.W. 2d 105; Burlington Mills Corp. v. Hagood, 177 Va. 204, 13 S.E. 2d 291.
35. 24 N.Y. 2d 609, 249 N.E. 2d 419, 301 N.Y.S. 2d 554 (1969).
36. Supra, note 26, 36 N.Y. 2d at 511, 330 N.E. 2d at 607, 369 N.Y.S. 2d at 642.
37. Id.
38. 60 A.D. 2d 703, 400 N.Y.S. 2d 599 (1977).
39. Id., 400 N.Y.S. 2d at 600.
40. 577 N.Y.S. 2d. 517 (A.D.3 Dept.1991), _______ A.D. 2d _______.
41. Id., at 518.
42. Id., at 519.
43. 106 A.D. 2d 181, 484 N.Y.S. 2d 972 (1985).
44. Id., at 183, 484 N.Y.S. 2d at 973.
45. 77 N.Y. 2d 79, 565 N.E. 2d 1255, 564 N.Y.S. 2d 704 (Ct. App. 1990), reversing 152 A.D. 2d 769, 543 N.Y.S. 2d 547 (A.D. 3 Dept. 1989).
46. 77 N.Y. 2d at 85, 565 N.E. 2d at 1258, 564 N.Y.S. 2d at 707.
47. 298 S.C. 13, 377 S.E. 2d 922 (S.C. App. 1988); see note, *Mental Injuries Held Compensable Under Workers' Compensation Act*, 41 SOUTH CAROLINA L. REV. 234, 237 (1989) where the commentator concludes Stokes is a "sensible extention of existing South Carolina law."
48. Id., at 15-16, 377 S.E. 2d at 923.
49. Id., at 21-22, 377 S.E. 2d at 926-27.
50. 105 N.M. 167 (App.), 730 P.2d 470 (N.M. App. 1986).
51. Id., at 174, 730 P. 2d at 477.
52. 546 So. 2d 138 (La.1989); see *Sparks v. Tulane Medical Center: An Expansive Interpretation of Louisiana's Workers' Compensation Law*, 64 TUL. L. REV. 970-76 (1990) where one commentator felt that the court in Sparks incorrectly construed the term of the Workers' Compensation Act as not covering such injuries.
53. Id. at 141.
54. Id., at 149.
55. 1B A. Larson, supra note 25, §42.25 (c).
56. 361 Mich. 577, 106 N.W. 2d 105 (1960).
57. Id., at 581, 106 N.W. 2d at 109.

58. Deziel v. Difco Laboratories, Inc. 403 Mich. 1; 268 N.W. 2d 1 (1978); see MacKenzie v. General Motors Corporation 403 Mich. 1, 268 N.W. 2d 1 (1978)..
59. see infra, note 87.
60. 187 Mich. App. 595,468 N.W. 2d 302 (1991); Lv. App. Den. 437 Mich. 1055 (1991)..
61. Id., at 600, 468 N.W. 2d at 305.
62. Id. at 601-2, 468 N.W. 2d 304-305.
63. 78 N.Y. 2d 207, 577 N.E. 2d 40, 573 N.Y.S. 2d 49, (1991).
64. Id., at 217, 577 N.E. 2d at 44, 573 N.Y.S. 2d at 53.
65. 77 N.Y. 2d 411, 570 N.E. 2d 217, 568, N.Y.S. 2d 569 (1991).
66. Id., at 421, 570 N.E. 2d at 222, 568 N.Y.S. 2d at 574.
67. 420 Mich. 308, 362 N.W. 2d 642 (Mich. 1984).
68. Id., at 309, 362 N.W. 2d at 643.
69. 52 Cal. 3d. 65, 801 P. 2d 373, 276 Cal. Rptr. 130 (1990).
70. See Jordan, *Is Sexual Harassment a Workers' Comp. Issue?* STRESS CLAIMS ADVISOR, December 1991, 1.
71. 868 F. 2d 558 (3rd. Cir. 1989).
72. Id., at 565.
73. 390 N.W. 743 (Minn. 1986).
74. Id., at 747.
75. Id., at 745.
76. MONT. CODE ANN. Sec. 39-71-119(3) (1987); see Kazda, *The Definition of Injury Under the Workers' Compensation Act: Revisited and Redefined*, 49 MONTANA L. REV. 341-51 (1988).
77. Id.
78. 394 MASS. 684, 477 N.E. 2d 582 (Mass 1985). In Kelley, the claimant was told she would be laid off, and later told she could transfer to another department; this caused depression and emotional disability. By a 4-3 decision the Supreme Court ruled for the first time that mental disability resulting from a termination notice was compensable.
79. ANN. L. of MASS. Ch. 152 97A) (1985).
80. NEW YORK WORK LAW, §2 (7) (McKinney 1991).
81. 60 A.D. 703, 400 N.Y.S. 2d 599 (1977).
82. 546 So. 2d 138 (La. 1989).
83. LA. REV. STAT. ANN. §23.1021 (7) (b) (1990); see commentary in *Workers' Compensation Act: The Legislatures' Attempt to Reinstate - or Retip - the Careful Balance of Interests Upset By Judicial Interpretation,* 36 LOY. L. REV. 158, (1990) where it is suggested that the enlarged definition of "injury" under Louisiana's amendment may not have altered the Sparks holding.
84 Id., (7) (d).
85. Id., (7) (b) (c).
86. OR. REV. STAT. §656.802 (2) (3) (a) (b) (c) (d) (1991).
87. MICH. COMP. L. ANN., §418.301 (2) (1980).
88. 361 Mich. 577, 106 N.W. 2d 105 (1960).

89. See, e.g., Greenwood v. Pontiac Bd of Ed., 186 MICH. APP. 389, 465 N.W. 2d 362 (Mich. App. 1990); Hurd v. Ford Motor Company 423 MICH. 531, 377 N.W. 2d 300 (Mich. 1985)
90. COLO. REV. STAT. §8-41-108 (2.2) (1986).
91. WEST'S ANN. CAL. LABOR CODE, §3208.3 (a) (1990).
92. Id., at §3208.3 (b).
93. *Boss, I Feel Lousy Where's My Check?* U.S. NEWS AND WORLD REPORT, July 1991, at 26.
94. WEST'S ANN. CAL. LABOR CODE, at §3208.3 (d) (1991).
95. 105 N.M. 167 (App.), 730 P. 2d 470 (N.M. App. 1986).
96. N.M. STAT. ANN. 52-1-24 B. (1991). Based upon the new criteria relating to a "psychologically traumatic event," compensation benefits were denied by the New Mexico Courts in the following cases: Jensen v. New Mexico State Police 109 N.M. 626; 788 P. 2d 382 (N.M. App. 1990). Douglas v. State of New Mexico Regulation and Licensing Department, 112 N.M. 183, 812 P.2d 1331 (N.M. App. 1991).
97. Supra, note 4.
98. Id.,
99. Brody, *Personal Health,* N.Y. TIMES July 10, 1991, at D6, col.1.
100. Supra, note 4, for a discussion of IBM "Wellness Programs", developed to meet the needs of employee stress, see *A Plan For Life: How IBMers Handle Stress,* STRESS MANAGEMENT ADVISOR, May, 1992, 4-5.
101. *Stress Management Program Switches Focus From Symptoms to Causes,* STRESS CLAIMS ADVISOR, November, 1991, p. 4.
102. Id.
103. Id.
104. Id.
105. Id. at 5.
106. Hymowitz, *Trading Fat Paychecks for Free Time*, THE WALL STREET JOURNAL, August 5, 1991, at B1.
107. Id.
108. Id.
109. Supra, note 101, at 5.
110. 207 New York Law Journal 1, col. 4, (March 26, 1992).
111. Id.; the N.Y. Supreme Court decision was recently unanimously affirmed by the Appellate Division (2d Dept.) 208 New York Law Journal 1, col. 4, (September 18, 1992).
112. Id.
113. Id., at 2, col. 6.
114. *Technostress: fact or fallacy?*, STRESS CLAIMS ADVISOR, October 1991, at 1.
115. Id. at 2.
116. Id.
117. *Electronic Supervision of the Workplace Tied to Stress Related Illnesses*, STRESS CLAIMS ADVISOR, January 1992, 1.

118. Id.
119. *AIDS in the Workplace Will Increase Job Stress*, STRESS MANAGEMENT ADVISOR, March 1992, 1.
120. Id.
121. Id., at 1,2.
122. Davis, J., Supreme Court New York County, 91 New York Law Journal 23, col. 4 (Aug. 5, 1991); for general discussion of AIDS phobia in the workplace by noted trial attorney Harry Lipsig see, H. Lipsig, *AIDS Phobia and Negligent Infliction of Emotional Distress*, 207 New York Law Journal 3, col. 1, March 26, 1992.
123. *ADA May Increase Stress Claims*, STRESS CLAIMS ADVISOR, February 1992, at 8.
124. Id.
125. Id.
126. L. Kram, *Why Have a Sexual Harassment Prevention Program*, STRESS CLAIMS ADVISOR, February 1992, p.7.
127. *Preventing Sexual Harassment in the Workplace Begins with Employer*, STRESS CLAIMS ADVISOR, November 1991, at 1.
128. Meritor Savings Bank v. Vinson, 477 U.S. 57 (1986), 106 S. Ct. 2399.
129. Supra, note 127, 1-2.
130. Id.
131. Id.
132. Klimas V. Trans-Caribbean Airways, 10 N.Y. 2d 209, at 213, 176 N.E. 2d 716, at 717, 219 N.Y.S. 2d 14, at 16.
133. See generally, DeMaria, *Values, Decision-Making, and the Rich Life*, INT. J. VALUE BASED MANAGEMENT, Vol. 1. No. 2, 1988, pp.33-37.

COMPARATIVE ASPECTS OF ANTITRUST LAW BETWEEN JAPAN AND THE UNITED STATES

By
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Antitrust law in the Unites States and in Japan are fundamentally similar. There are, however, significant and minor differences. Both aspects will be explored in this paper. We will first summarily examine the nature of antitrust law in the United States and then compare its common and dissimilar characteristics with that of Japan.

There are three basic statutes which together with their amendments define antitrust prohibitions and sanctions in the United States. They are: the Sherman Antitrust Act of 1890, the Clayton Act of 1914 and the Federal Trade Commission Act to 1914.

The Sherman Antitrust Act of 1890[1]

The act as amended states:

> Section 1 "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. Every person who shall make any such contract or engage in any such combination or conspiracy shall be guilty of a felony...
>
> Section 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..."

Jurisdiction The constitutional basis for Congressional intervention in antitrust activities is

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its power under Article I, Section 8 to regulate interstate commerce. Although the U.S. Supreme Court initially interpreted the commerce clause as excluding manufacturing as well as service industries,[2] the Court found activity to be in interstate commerce if it actually involves multi-state transactions or <u>affects</u> persons in other states in little more than a minimal way. In addition to interstate commerce, the prohibitions also affect foreign commerce. Activities by companies abroad which if domestic would violate the statute and cause an effect within the United States, come also within the constitutional power to regulate commerce.[3]

<u>Conspiracy</u> The Sherman Act, Section 1, prohibits agreements or conspiracies to restrain trade. As in the entire field of antitrust litigations, the wording of the statute, though simple in appearance, is enormously complex. This section is concerned with "horizontal" restraints. The activity must involve more than one legal person. Generally, a corporation cannot "conspire" or contract with its officers, directors or employees to violate the statute even though such persons are affiliated with a subsidiary company.[4]

<u>Conscious parallelism</u> An expressed agreement between competitors clearly comes within the purview of the statute. The difficulty arises when there is no such agreement but the <u>conduct</u> of the parties exhibit behavior which the courts may prohibit. In one case, <u>Interstate Circuit, Inc. v. United States</u>[5], the United States Supreme Court held that a conspiracy contract or combination may be formed without direct proof of such an agreement. It would be sufficient to show that participants acted in a substantially similar manner, possessed the motive for so acting and had knowledge of the actions which would be taken by the other parties.

<u>"Rule of reason" v. per se" illegality</u>. The statute forbids conduct which restrains trade. Although the Supreme Court initially gave literal application to the statutory wording so as to forbid all conduct having any restraint on trade, it later modified its ruling so as to provide that only <u>unreasonable</u> restraints would be banned.[6] Under the rule of reason, the Court would determine whether or not conduct was illegal by examining a variety of factors such as the nature of the restraint, its purpose, possible benefits to the public, harmful effects and other factors. Nevertheless, there were certain types of conduct which were by their very nature (per se) violative of the Sherman Act. These include:

(1) <u>Price fixing</u> Any agreement between competitors whose purpose is to raise, depress or stabilize prices in interstate or foreign commerce is <u>per se</u> unlawful.[7]

(2) <u>Division of markets.</u> Any arrangement by competitors on the same distributive level which explicitly or implicitly divides territories is wrongful.[8] Even indirect divisions of markets which affect interstate or foreign commerce is prohibited.[9]

(3) <u>Boycotts</u> Agreements between competitors which prohibit them from dealing with certain other competitors or trades are <u>per se</u> illegal.

(4) <u>Resale price maintenance</u> It is useful for a seller to dictate the price at which a buyer of the goods may resell them. Once a seller has disposed of the goods, they may be resold at whatever price the distributor or retailer desires.

<u>"Rule of reason"</u> Not all restraints are automatically invalid under Sherman (1). In most cases the "Rule of reason" applies, i.e., only unreasonable restraints are prohibited. Examples include:

(1) <u>Agreement to exchange data</u> such as price information.[10] tendency to stabilize prices rather than allowing market forces to determine the price structure.

(2) <u>Self-regulation</u> by associations.

(3) <u>Joint ventures</u> in themselves are legal, i.e., two or more companies banding together to perform a particular project (e.g., the construction of a dam, building of a pipeline, etc.). The problem arises when two or more competitors join together for unlawful ends.

<u>Monopolies</u>. Section 2 of the Sherman Act forbids monopolizing or attempts to monopolize. It does not forbid monopolies in and of themselves. There are two elements necessary to establish an offense: "(1) the possession of monopoly power in the relevant market and (2) the wilful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen or historical accident."[11]

Monopoly power is the power to control prices or exclude competition. Crucial to an understanding of monopolizing is the determination of the relevant geographic or product market. Product market refers to possible substitutes or reasonable interchangeability of products.

<u>Geographic market</u> is the area in which a particular company and its competition operate. The area may be nationwide, regional or local. Whether or not a company appears to be monopolistic often depends upon

the geographical area which the court determines to be the relevant market.

Wilful act. In addition to possessing power which alone is not sufficient to be violative of the statute, a company must commit an act to acquire or enhance its monopoly power. If a company becomes a monopoly simply because others fail to enter the market or because of an exclusive product, there is no violation of Sherman.

Attempts and conspiracies to monopolize are also prohibited by Sherman (1). Attempt relates to the effort made by a party to accomplish the goal of monopolizing, intending to and committing an overt act in so doing. The conduct required is similar to the conduct described above for monopolizing.

Conspiracy to monopolize is the attempt to monopolize in unison with at least another person with intent to monopolize.

Sanctions for violations The Sherman Act is the only statute of the three major antitrust laws which imposes criminal as well as civil penalties. Individuals who violate the Sherman Act can be imprisoned up to three years and issued a fine up to $100,000.00. Corporations can be fined up to $1,000,000.00. Corporate officers acting on behalf of the company can be fined up to $5,000.00 and/or one year in prison. It is more likely, however, that the federal government will utilize the equitable powers of the court, i.e., the prosecution will generally ask the Court to issue an injunction to prevent and restrain the offending conduct, divide the assets of a company, compel a divestiture of subsidiaries of a company, grant licenses to competitors, cancel contracts and other court-fashioned remedies.

THE CLAYTON ACT OF 1914[12]

After a decade of antitrust experience, many of the abuses which previously existed continued to prevail in a variety of forms. They were due in part to experienced corporation counsel who devised a multitude of techniques to avoid Sherman Act restraints. Congress attempted to close these loopholes in 1914 by the enactment of two major statutes, namely, the Clayton Act and the Federal Trade Commission Act. These statutes, as amended, cover a variety of abuses of which corporate and other business persons should be aware.

Price Discrimination Section 2 of the Clayton Act

as substantially modified by and known as the "Robinson-Patman Act of 1936, "provided in subsection (a) that it is unlawful to engage in price discrimination "between different purchases of commodities of like grade and quality...where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce..." The statute thus requires a number of prerequisites before a violation will be found, namely:

(a) The persons involved must be engaged in interstate commerce;

(b) There must be at least two sales between different purchases at a discriminatory price. There must be two distinct sales, not merely a lease, license, consignment or other like arrangement;

(c) The sales must be fairly contemporaneous.

(d) Sales "of commodities of like goods and quality" must be involved. Only tangible rather than intangible products are within the statute.

(e) There must be a "discrimination in price." "Price" is not merely the charge for the goods but includes terms of sale such as credit and preferential allowances. Allowing some buyers preferential credit treatment may violate the statute.

Defenses A person charged with a Robinson-Patman price discrimination offense may defend against liability by interposing a number of defenses specifically authorized by the Act. These defenses include:

(a) Cost differential Section 2(a) says that the statute does not "prevent differentials which make only due allowance for differences in the cost to manufacture, sale or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered..." A seller can classify an average customer into various groups provided they are relatively homogenous.

(b) Changing conditions Another defense which a person may interpose is proof that price variations took place in response to a change in conditions such as "actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the good concerned." The most common example is the lowering of prices for outdated or seasonal items.

(c) Meeting competition Section 2(b) states that a seller can justify price differentiation by "showing that his lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of

a competitor, or the services or facilities furnished by a competitor."[13]

Indirect price discrimination-broker allowances Section 2(c) makes it unlawful "to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered..."

Compensation for services and promotions Section 2(d) makes it unlawful for a seller to pay for services or facilities rendered or furnished by a buyer unless such compensation is available on a proportionate basis to all other customers of competing products. Section 2(e) forbids a seller from furnishing services or facilities to buyers unless they are rendered to all buyers on a proportionate basis.

Tying arrangements Section 3 of the Clayton Act forbids a seller or lessor of a commodity from conditioning or tying its sale or lease to the purchase or lease of another product. There must be at least two separate products: the tying and the tied product. A second requirement is that the seller or lessor have substantial market power so as to be able to lessen competition substantially.[14]

Mergers The first paragraph of Section 7 of the Clayton Act, amended in 1950 and 1980, sets forth the merger provision:

> "No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity effecting commerce where in any line of commerce or in any activity affecting 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."

The merger involves the combining of previously separate firms into one having a common ownership and

control. Originally, the Clayton Act forbade the acquisition of stock in another corporation which tended to lessen competition. The Cellar-Kefauver Act of 1950 amended Section 7 to include asset acquisitions as well as stock mergers.[15]

Remedies The Clayton Act provides only for civil remedies as distinguished from criminal penalties. The United States Government acts through the Justice Department and the Federal Trade Commission in its administrative hearings. Private parties have broad remedies for statutory violations directly affecting them. Equitable remedies allowable to the government include actions to: (1) enjoin or stop the defendant from committing the offending act; (2) cause a divestiture or severing of relationship if an action such as a completed merger has taken place; (3) preliminarily enjoin a present activity pending determination of the outcome; (4) compel a company to license or give permission to others to use its patents, trademarks or copyrights; and (5) divide the assets of a company. In addition, the parties may be induced to enter into consent decrees whereby the parties settle under certain terms and conditions. Approximately 85 percent of all cases are resolved in this manner.

The most potent private remedy is an action for treble damages. A private party is able to collect three times its provable damages plus a reasonable attorney's fee for loss of profits, added costs attributable to the forbidden activity and decrease in value, if any, of the injured party's investment. The litigant, however, must establish a causal relationship between its damages and the action of the offending party.

Exceptions Exempted from the prohibitions of the Clayton Act include labor unions and business concerns controlled by other governmental agencies, such as banks, railroads, airlines and stock exchanges.

THE FEDERAL TRADE COMMISSION ACT OF 1914[16]

The third major piece of legislation governing antitrust activities is the Federal Trade Commission Act enacted at the same time as the Clayton Act. The Act created the Federal Trade Commission. Section 5(a)(1) grants antitrust jurisdiction to the FTC by providing: "Uniform methods of competition in commerce, and unfair or deceptive acts or practices in commerce, and unfair or deceptive acts or practices in commerce, are hereby declared unlawful." Section 5(a)(6) provides: "The Commission is hereby empowered and directed to prevent persons, partnerships or corporations...from using

unfair methods of competition in commerce and unfair or deceptive acts or practices on commerce."

The FTC is solely empowered to enforce Section 5(a)(1) above and to enforce, together with the Attorney General, the Sherman and Clayton Acts. Section 5(a)(1) is so broad that virtually all conduct prohibited by the Sherman and Clayton Acts comes within its purview. For example, conspiracy or attempts to monopolize, price fixing, vertical and horizontal restraints are "unfair methods of competition." The provision is broader than the Sherman and Clayton prohibitions. Thus, certain conduct not forbidden under these laws may be proscribed under the Act.

The FTC is empowered to protect the consumer against deceptive and unfair acts or practices such as false and misleading advertising, deceptive claims, nondisclosure of hazardous products and deceptive warranty representations. It has the power to conduct broad investigations of possible antitrust violations, including the issuance of subpoenas. It may issue guidelines, advisory opinions and enter into consent decrees with persons who may be violating the laws within FTC jurisdiction. It may sue in Federal Courts for the issuance of an injunction and can issue cease and desist orders directly, Violations of its orders can result in civil penalties of up to $10,000.00 per day.

We will now review the manner in which Japan promulgates and enforces its antitrust laws.

Japanese Antitrust Law

The historical development of Japan's policy with respect ot cartels may be divided into three major eras, namely, the Tokugawa Shogunate Era (1603-1868); the post Meiji Restoration of 1868 and the post World War II Era. Prior to 1868, the Tokugawa governments were essentially feudalistic in nature with emphasis upon the concept of "wa" or social harmony which mandated that commercial disputes be resolved without litigation. Individual rights were subsumed to that of society.[17]

The Tokugawa government was overthrown in 1868 and replaced by a government under the Emperor known as the Meiji Restoration of 1868. The Restoration brought about a transition of the feudal based society into the modern world with a reformed monetary, educational and industrial system. Government worked closely with private industry to create a unique form of Japanese capitalism. As in the U.S., various cartels formed known

as the Zaibatsu combines, led by a number of families. Unlike the U.S. which passed the several antitrust laws referred to in this paper, the government virtually fostered cartels and monopolies which it found easier to control than a more pluralistic industrial complex.[18] The four major Zaibatsu families of Missui, Mitsubishi, Sumitomo and Yasuda controlled 544 companies which constituted almost half of the financial sector and a third of heavy industry.

The allied victory over Japan led to a dissolution of the Zaibatsu groups. President Harry S. Truman's directive of September 6, 1945 to General Douglas MacArthur mandated the development of democratic organizations in labor, industry and agriculture directed to peaceful ends, It stated:

> "To this end it shall be the policy of the Supreme Commander
> (a) to prohibit the retention in or selection of places of importance in the economic field of individuals who do not direct future Japanese economic effort solely toward peaceful ends; and
> (b) To favor a program for the dissolution of the large industrial and banking combinations which have exercised control for a great part of Japan's trade and industry.

MacArthur issued a Directive calling for the dissolution of the Zaibatsu and other combinations of enterprise, the abolition of private monopolization and the establishment of a competitive system.[19] Ultimately, the statute, which was an enactment of these goals, was passed and made effective on July 20, 1947 and was known as the "Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade."[20] The Act was modeled upon the three major U.S. antitrust enactments, namely the Sherman Act, the Clayton Act and the Federal Trade Commission Act.

The Japanese Antimonopoly Act of 1947[21]

The purpose of the Act is set forth in Section 1:

> "This Act, by prohibiting private monopolization, unreasonable restraint of trade and unfair business practices, by preventing the excessive concentration of

> economic power and by eliminating unreasonable restraint of production, sale, price, technology, and the like and all other undue restoration of business activities through combination agreements and otherwise, aims to promote free and fair competition, to stimulate the initiative of entrepreneurs, to encourage business activities of enterprises, to heighten the level of employment and people's real income and thereby to prevent the domestic and wholesome development of the national economy as well as to assure the interest of consumers in general."

The purpose clause clearly is reflective of the goods of the U.S. statutes outlined above. The substantive requirements are set forth in Section 3 of Chapter II which states that "No entrepreneurs shall effect private monopolization of any unreasonable restraint of trade." The section is a summary of the two substantive sections of the Sherman Anti-Trust Act. Section 19 reflects Section 5 of the Federal Trade Commission Act by forbidding an entrepreneur from employing unfair business practices. The Federal Trade Commission Act created the Federal Trade Commission to enforce the provisions for the Act. Enforcement of the Japanese Antimonopoly statute is by the Fair Trade Commission. The similarity in nomenclature is not coincidental.

Section 2 of the Antimonopoly Act defines each of the key words of Section 3. "Entrepreneur" is any person who carries on a commercial, industrial, financial or other business including officers, employers or agents or thereof. "Private monopolization" refers to business activities by any person acting alone or in combination or conspiracy with other entrepreneurs [almost identical to Sherman Act, Section 2. "Every person who shall monopolize....or combine or conspire with any other person"] which excludes or controls business activities of other entrepreneurs causing a substantial restraint of competition in any particular field or trade [Sherman: "Every contract combination....or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations is declared to be illegal."] "Unreasonable restraint of trade" is defined as business activities by contract or concerted activities which mutually restrict their business

practice so as to fix, maintain, or enhance prices, or to limit production, technology, products, facilities or customers or suppliers causing a substantial restraint of competition [Section 2(6)] This definition is very similar to Section 2 of the Robinson-Patman Act.

<u>Fair Business Practices</u> The prohibition against monopolization extends to international agreements or contracts containing subject matter which constitutes unreasonable restraint of trade or unfair business practices [Section 6(1)]. Unfair business practices refers to any act which tends to impede fair competition and which: (1)unduly discriminates against other entrepreneurs; (2) deals at undue prices; (3) unreasonably induces or coerces customers of a competition to deal with oneself; (4) trading with another party so as to unjustly restrict the business activities of the latter; (5) abusing one's bargaining position; or (6) unjustly interfering with a transaction between a competitor and its customer or causing an officer or shareholder to act against the interest of his/her company. The definition again is reflective of U.S. law particularly, the Robinson-Patman Act, with respect to price discrimination and predatory pricing practices (Section 2,3) as well as Clayton's prohibition of tying and boycott (Section 3). The last aspect of the definition is similar to U.S. Common law injunction against interference with contracts. (Pennsoil litigation).

The Fair Trade Commission further elaborated upon the meaning of "unfair business practices" in its notifications of 1953 and 1982.[22] Among the specific prohibitions were:

Unduly refusing to deal with a certain entrepreneur or restricting the quality or a substance of a commodity or causing another to so refuse service [U.S. - boycott provision of Clayton];

Price discrimination [Compare Robinson-Patman];

Affording favorable or unfavorable treatment of and entrepreneur [Robinson-Patman 2(d)];

Unjustly excluding an entrepreneur from a trade association or unjust discrimination against it; without proper justification, supplying a commodity or service excessively below cost or at a low cost on a continuous basis so as to cause difficulties to other entrepreneurs;

Unjustly purchasing a commodity or service at a high price as to cause difficulties to other entrepreneurs;

Wrongful inducement to customers of a competitor to

deal with oneself by alleged unsubstantial claims that one's commodity or service is better then competitor or by offering unjust benefits in the light of normal business practices;

Unjustly causing a purchaser to purchase a commodity or service by tying it with another purchase or otherwise coercing the party to deal with oneself;

Unjustly dealing with a party on condition that it does not deal with a competitor;

Imposing resale price restriction without proper justification upon the purchaser of one's commodities;

Abusing one's dominant bargaining position by unfairly compelling the other party to purchase a commodity or service not involved in the transaction or causing it to provide money, service or other economic benefit not warranted under the circumstances, setting or changing terms of the transaction in a disadvantageous way to the other party or otherwise imposing a disadvantage upon the other party regarding execution of the agreement;

Interfering with the formation of a contract or inducing a breach of contract by a competitor;

Interfering with the internal operation of a competitor by wrongful inducement of a shareholder in its exercise of voting rights divulgences of secrets or by any other means.

Filing Section 6(2) of the Act mandated that any entrepreneur entering into a international transaction which the Fair Trade Commission finds a tendency towards unfair business practice or unreasonable restraint of trade, shall file a report within 30 days with the FTC together with a copy of the contract or agreement or a memorandum of the substance of an oral agreement. Forms are provided by the FTC in accordance with the nature of the agreement. Failure to file such a report would subject the entrepreneur to a fine of up to 2 million yen and further subjects the offending officer, agents or employees committing the violation to a similar fine.[23] No such comparable statute or regulation exists in the U.S.[24]

Trade Association The act specifically addresses activities of trade association. Section 8(1) states:

> "No trade association shall engage in any one of the following acts:
> i) Substantially restricting competition in any particular field of trade;
> ii) Entering into an international agreement or an international contract as provided for in Section 6(1) [Contracts which unreasonably restrain trade or unfair business practices;
> iii) Limiting the present or future number of entrepreneurs in any particular field of business;
> iv) Unduly restricting the functions or activities of the constituent entrepreneurs (meaning an entrepreneur who is a member of the trade association; hereinafter the same);
> v) Causing entrepreneurs to do acts as constitutes unfair business practices."

The reason why trade associations are specifically addressed is because historically these associations were meeting grounds for the formation of cartels. Every trade association is given 30 days to file a report with the FTC of its formation (Sec. 8(2)) as well as for any changes or termination thereof (Sec. 8(3)(4)).

The FTC guideline formulated in August, 1979 elaborated upon the statutory prohibition. Generally they prohibit price fixing of every nature, enforcement of resale prices maintenance, restriction of output, restriction of governing sales territory, and competition, restriction concerning development or use of technology, defamation of non-members and other restrictions.

The remedy provided is similar to the remedy set forth above but in addition thereto. The FTC is empowered to issue a dissolution of the trade association and take any measure to carry out the statute.

Monopolistic Situations If the FTC determines that a monopolistic situation exists, it may order the entrepreneur to transform a part of its business or take any other measures necessary to restore competitiveness with respect to such goods and services.[25] The statute

does place some limitations upon the FTC by foregoing statutory injunction if such action by the FTC reduces the business of the entrepreneurs to such an extent that the cash required for the sale of goods or services will rise sharply, undermines the financial position of the entrepreneur or makes it difficult for it to maintain its international competitiveness.[26]

The FTC in making its determination is to consider the entrepreneur's (1) assets, means of expenditures; (2) officers and employees; (3) location of factories, workyards and offices; (4) business facilities and equipment; (5) the substance of intellectual property rights; (6) capacity of production and sales and for obtaining funds and materials and (7) aspects of supply and distribution of supply and distribution of goods or services.[27]

A "monopolistic situation" is defined at length in the Act in terms of market structure and market performance such the situation occurs whenever such structure or performance exists in an area of business where the total amount of prices of goods of the same description and those of other goods essentially similar thereto are supplied in Japan or the total amount of prices of service supplied in Japan is in excess of 50 billion yen for a one year period and; (a) the market share of one entrepreneur exceeds 50% or the combined share of entrepreneurs exceeds 75%; or (b) conditions exist which make new entrants very unlikely; or (c) where the increase in price for the goods or service or the decrease therein is slight considering the charges in the market place; and where the entrepreneur has earned for excessive profit rate or is expending for cost and administrative expenses far in excess of the norm.[28]

In such event the FTC shall notify the appropriate governmental ministry of the monopolistic situation who shall render his view regarding the existence or non-existence of such a monopolistic situation as well as his recommendation as to which measures should be taken if such situation does exist.[29] A public hearing is then held by the FTC to obtain the public's views.[30] The FTC will then issue a complaint but only after it consults with such minister.[31] The complaint must be in writing outlining the case. After the hearing in which all parties present their position, the commission renders its decision which may include the remedies heretofore stated.[32]

STOCKHOLDING, INTERLOCKING DIRECTORATES,

MERGER AND TRANSFER OF BUSINESS

The Act addresses the prohibitions addressed by President Truman to General MacArthur. To eliminate the pre-war Zaibatsu combines, the Act specifically prohibits the formation of a holding company. A "holding company" is defined as: "a company whose principal business is to control the business activities of a company or companies in Japan by means of holding of stock (including shares of partnership..."[33] It applies only to Japan and not to holding companies possessing the shares of a foreign company.

<u>Giant Company</u> Giant companies also face restriction in stockholdings. Any stock company, other than one engaged in financial services (banks, insurance, securities), whose capital is larger than 10 billion yen or whose net assets are larger than 30 billion yen is not allowed to acquire stock in Japanese companies in excess of its capital or its net assets whichever is larger. Exceptions include governmental corporations, corporations engaged in development of industries as permitted by a Cabinet Order and companies involved in international business or foreign investments.[34] Companies engaged in financial service have much stricter limitations (limit purchases to 5% of stock of mother company; 10% of insurance companies).[35]

The Act prohibits the purchase of any stock of a company in Japan where the effect is to substantially restrain competition in any field of trade.[36] Compare Section 7 of the Clayton Act which forbids the acquisition of stock or other share capital of assets of another corporation where the effect is to substantially lesser competition or tends to create a monopoly. The Japanese FTC, like the U.S. FTC has guidelines with respect to mergers.

The FTC will closely examine all stockholdings where the combined market share is 25% or more; the combined market share is one-third and the combined share of the top three companies is 50% or more where there are seven or few competitors; and where the total assets of one corporation is 100 billion yen and the other party is 10 billion yen or more.[37]

<u>Financial Company</u> The Act restricts stockholding by a financial company by forbidding the acquisition of shares by a company engaged in the financial sector from acquiring or holding stock of another company in Japan to the extent of greater than 5 percent or 10 percent if the purchase is of insurance company stock. The FTC is

given the authority to grant exceptions with consultation with the Minister of Finance if the acquisition was the result of enforcement of a lien, pledges, mortgage or payment of an indebtedness or purchase was of shares in a securities firm or it was acquisition of stock in the form of trust property or securities trust.[38]

Interlocking directorates The Act forbids an officer or employee of a company from holding a similar portion in another company in Japan where the effect is to substantially lessen competition in a field or trade. A company in Japan cannot compel a competing company to hire one of its officers or employees to act as an officer in such other company. If an officer or employee does possess such status and the total assets of either company exceeds 2 billion yen, s/he must file a report with the FTC within 30 days of assumption of such office.[39] Compare Section 8 of Clayton Act which provides that "No person at the same time shall be a director in any tow or more corporations, any one of which has capital, surplus, and individual profits aggregating more than $1,000,000..."

Restriction on purchase of shares by an individual The Act forbids a person other than a company from acquiring or holding stock of another company which such acquisition may restrain competition in such acquisition is accomplished by unfair business practice. If a purchase of shares in mutual competing companies exceeds 10 percent of the second companys he must file a report with the FTC within 30 days of acquisition.[40]

Restriction on mergers The Act forbids mergers or consolidation (a) where the effect may be to substantially restrain competition in any field or trade or (b) when unfair business practices have been employed in the course of such merger or consolidation.[41] All mergers or consolidations must be done by filing a report with the FTC and must wait for the expiration of a 30 day waiting period from date of filing. The FTC may extend the period to 60 days with consent of the companies or shorten the said period. The FTC must file its complaint or recommendation within the said waiting period unless there has been false statements made in the filing with respect to important matters.[42]

Restrictions on acquisition of assets De facto mergers are also subject to the preceding section where a company acquires the business or fixed assets of a competing company or leases most of the business of another company or enters into a join profit and loss

account arrangement with another company.[43]

It should be noted that the prohibition of this and preceding section are applicable only within Japan. It is not unlawful to merge or acquire assets in competing companies beyond its borders.

Parallel Price Increases Historically, U.S. courts have applied the concept of "conscious parallelism" where direct proof of concerted price fixing or other wrongful conduct has not been established but where conduct has occurred and the parties had knowledge, motive and substantial unanimity with respect to each other's actions.[44] The Antimonopoly Act addressed similar parallelism with respect to price increases. The FTC may inquire and compel a report from entrepreneurs requesting reasons for the in price of goods and services where the total price of goods or services of the same type is in excess of 30 billion yen and the rises by the largest entrepreneur with an aggregate market share in excess of 70 percent is almost identical within a 3 month period.[45]

Exemptions The U.S. exempts certain entities from the antitrust laws. They include air carriers, agricultural organizations, motor, rail and interstate water carriers, export trade associations, stock exchanges and labor union. Similarly, exemptions are granted under the Antimonopoly laws to persons engaged in a rail way, electricity, gas and other enterprises which by nature are monopolies. Other exemptions include those permitted by law, monopolies arising under intellectual property right enactments (patents, copyright, trademark), acts of cooperative and statutory exception for agriculture, consumer coops, labor unions, forestry cooperative and public service mutual aid association.[46]

Enforcement of the Antimonopoly Law Violations of the Antimonopoly laws are enforced against in four ways: (1) administrative guidance; (2) formal action by the FTC; (3) criminal procedure initiated by the FTC; and (4) private litigation.[47] The FTC is given broad powers under the Antimonopoly laws to initiate both civil and criminal proceedings. Any person is allowed to file a complaint with the FTC which may undertake an investigation. The FTC then determines what action if any, to undertake. A report of its investigation is given to the complainant. If action is mandated, the FTC then initiates the appropriate procedure which varies depending upon the nature of the violation.[48]

In its investigation, the FTC may order persons

affect or witnesses to appear for interrogation. It may further order experts to appear and give expert testimony, order submission of accounting books and records and enter upon any place of business being investigated to inspect conditions of its operations as well as its books and records.[49] A record of its investigation must be maintained.

The FTC upon a finding of a violation of monopolization of unreasonable restraint of trade, trade association violation and other violations, may recommend that the persons affected take appropriate measure to cure the violations. If the person accepts the recommendation, a decision is rendered without a formal hearing. If the FTC finds a violation of Section 7 of the Act (private monopolization or restraint of trade), it may order the entrepreneur to pay the Japanese Treasury a surcharge. If the person objects timely, a hearing procedure will be commenced.[50]

A formal hearing is initiated by the issuance by the FTC of a complaint which is in writing and which outlines the case. The respondent submits an answer. Generally a hearing examiner then conducts the proceeding in which both sides submit their evidence. The hearing is public unless it is necessary to protect trade secrets. The commission then makes a determination, based upon the hearing, whether a violation has taken place. A certified copy of the written decision is served upon the respondent. The respondent may bring on a lawsuit in Court to grant a decision of the FTC; however, the findings of fact by the FTC shall, if supported by substantial evidence, be binding upon the Court. The Court may grant the decision if the decision is not supported by substantial evidence or is inconsistent with the constitution or other laws or orders.[51]

<u>General Considerations</u> American companies wishing to do business in Japan must be attentive to the above stated statutory prohibitions. A U.S. company must be careful no to become designated as a holding company, i.e., where its principal business is to control business activities of other companies. The exception are: (1) where the holding company is engaged in the same line of business and (2) a foreign holding corporations and its related companies may control <u>one</u> Japanese corporation even if it is not in the same line of business.

Like the U.S., the Antimonopoly Law has extraterritorial reach. In order to be affected by the statute, a presence is necessary either by way of a U.S.

corporation's acquisition of a Japanese corporation or its assets or at least "close contracts" with Japan. Service of process however, must be accomplished by service upon a place of business or office in Japan.[52]

CONCLUSIONS

The Antitrust laws of Japan and the U.S. have a great deal of similarity. It appears initially that the Japanese legislation may be stricter than the U.S. but enforcement tends to be relatively lax. Nevertheless, companies doing business in Japan must conform to the statutory requirements to avoid conflict with local authorities.

FOOTNOTES

1. 15 USC sections 1-7.

2. <u>United States v. E.C. Knight Co.</u>, 156 U.S. 1, 15 S. Ct. 249, 39 L. Ed. 325 (1895).

3. <u>United States v. Aluminum Co. of America</u>, 148 F. 2d 416 (2d Cir. 1945).

4. <u>Copperweld Corporation, et al., Petitioners v. Independence Tube Corporation</u>, 52 LW 4821 (June 19, 1984).

5. 306 U.S. 208, 59 S.Ct. 467, 83 L. Ed., 610 (1939).

6. <u>Standard Oil Co. of New Jersey v. United States</u>, 221 U.S. 1, 31 S.Ct. 502, 55 L. Ed. 1129 (1911).

7. <u>United States v. Socony-Vacuum Oil Co., Inc.</u>, 310 U.S. 150, 60 S.Ct. 811, 84 L. Ed. 1129 (1940).

8. <u>United States v. Topco Associates</u>, 405 U.S. 596, 92 S.Ct. 1126, 31 L. Ed. 2d 515 (1972); <u>United States v. Addyston Pipe & Steel Co.</u>, 85 F. 271 (6th Cir. 1898), modified and aff'd 175 U.S. 211, 20 S.Ct. 96, 44 L.Ed. 136 (1899).

9. <u>United Stated v. Sealy, Inc.</u>, 388 U.S. 350, 87 S.Ct. 1847, 18 L. Ed. 2d 1238 (1967).

10. <u>United States v. Container Corp. of America</u>, 393 U.S. 333, 89 S.Ct. 510, 21 L. Ed. 2d 526 (1969).

11. <u>United States v. Grinnell Corp.</u>, 384 U.S. 563, 86 S.Ct. 1698, 16 L. Ed. 2d 778 (1966).

12. 15 USC sections 12-27.

13.Standard Oil Co. v. FTC, 340 U.S. 231, 71 S.Ct. 240, 95 L. Ed. 239 (1951).

14.International Salt Co. v. United States, 332 U.S. 393, 68 S.Ct. 12, 92 L. Ed. 20 (1947).

15.353 U.S. 586, 77 S.Ct. 892, 1 L. Ed. 2d 1057 (1957).

16.15 USC sections 41-51.

17.Elliott J Hahn, Japanese Business Law and the Legal System. pp. 9-10

18.Hiroshi Iyori and Akinori Uesugi, The Antimonopoly Laws of Japan. pp. 2-3.

19.Directive No. 244 of the Supreme Commander of the Allied Powers. For an excellent discussion of the Zaibatsu family groups, see Eleanor H. Hadley, Antitrust in Japan (Princeton: Princeton University Press, 1970).

20.No. 54 of April, 1947.

21.As amended on July 23, 1982 including amendments of June 18, 1949 (Act No. 214), September 1, 1953 (Act No. 259) and June 3, 1977 (Act No. 63).

22.Fair Trade Commission Notification No. 11 of 1953 and Fair Trade Notification No. 15 of 1982.

23.Sections 92-2(i) and 95.

24.The Hart-Scott Improvements Act does impose a pre-merger notification requirement but only wish respect to large mergers and acquisitions.

25.Section 8-4(1).

26.Ibid

27.Sect. 8-4(2)(i-viii).

28.Section 2(7)

29.Section 45-2(1)(2).

30.Section 22-2.

31.Section 49.

32.Section 54.

33.Section 9.

34.Section 9-2.

35.Section 11.

36.Section 10(1).

37. FTC, "Administrative Procedure Standards for Examining Stockholdings by Companies;" September, 1981.

38. Section 11.

39.Section 13.

40.Section 14.

41.Sections 21-24.

42.Section 15(2)(3)(4)

43.Section 16.

44.See Interstate Circuit Inc v. U.S., 306 U.S. 208, 1939.

45.Section 18-2.

46.Section 21-24.

47.See article by Mrs. Michiko Ariga, "Antitrust and Trade Regulation Laws and Practice," Current Legal Aspects of Doing Business in the Far East, ed. by Richard C. Allison, American Bar Association 1972.

48.Section 45.

49.Section 46.

50.Section 48-2.

51.Sect. 49-52. A text of the Antimonopoly laws and other statutory enactments may be found in Hiroshi Iyori and Akinori Uesugi, The Antimonopoly Laws of Japan, Milwaukee: Federal Legal Publications Inc., 1983.

52.Toshiro Nishimura, "Acquisition in Japan," Legal ASpects of Doing Business with Japan, Isaaac Shapiroch., (New York: Practicing Law Institute, 1981) pp. 91-148, esp. 129-13.

DISCRIMINATION IN EMPLOYMENT AND EDUCATION

BECAUSE OF DYSLEXIA

by

Dr. Sharlene A. McEvoy*

ABSTRACT

Despite advances in medical science in the area of brain studies, the identification of some causes of learning disabilities and instructions to sufferers on how to cope with them, the law has lagged behind and dyslexics remain victims of discrimination in employment and education. This paper analyzes cases in which dyslexics have sued to gain their rights, under the Rehabilitation Act of 1973 and the Education of All Handicapped Children Act of 1975 and The Americans With Disabilities Act.

INTRODUCTION

See spot nur
Spot likes to dlay
in the bark
with other gods
There are many animals in
the dark. There are dirbs
and squirrels and fish in
a bond.[1]

This is the world of the dyslexic, which, despite some popular misconceptions, is not an illness or a form of mental retardation. It is a complex learning disability that often runs in families. It does not only cause a person to see letters backward like

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"p" for "g" or "b" for "d." People with dyslexia do not process information well and it often becomes confused in the brain.[2] In addition to having difficulties with reading, a dyslexic may have irregular handwriting, math difficulties, organizational problems, and a poor sense of direction and time. Some dyslexics may have difficulty performing simple tasks, following instructions or conducting casual conversations.[3]

Dyslexia was recognized as long ago as 1887 as a form of word blindness but for decades it was thought to be caused by a disease, the effect of an injury, or upbringing.[4] While some researchers believe that dyslexia is a case of differently wired-circuits in the brain, a recent study published in the Proceedings of the National Academy of Science states that the cause of dyslexia might indeed be a failure of visual system circuits to keep proper timing caused by an autoimmune disease before or after birth. Abnormally processed sights and sounds might begin to shape the infant's brain and cause it to be wired differently from the start.[5]

Whatever the cause, studies have shown that dyslexia affects boys more than girls, that it may run in families, and that it affects 4-5 percent of the population or some 12 million Americans.[6]

Although dyslexia affects a significant number of Americans, the number of research dollars allocated to it is low, and many academics are unwilling to recognize dyslexia's role in this country's illiteracy problem.[7] If children were properly tested for dyslexia when young and offered appropriate education, the problem related to the disability could begin to be remedied.

Since this is not the case, the educational system must deal with students who suffer from this problem and later employers must deal with testing them for jobs. When dyslexics have problems that cannot be resolved with employers and educators, the courts must get involved. This article discusses several cases in which dyslexics have been forced to bring actions to fight discrimination against them involving important laws the Education of All Handicapped Children Act, (EAHCA) which makes learning disabilities a legally recognized handicap and entitles afflicted students to a range of services in elementary and secondary school, and Section 504 of the Rehabilitation Act which covers certain employers and causes public and private colleges and universities to lose federal assistance if they discriminate against qualified learning disabled students as well as the Americans with Disabilities Act. Clearly dyslexics have rights under these laws. It is unfortunate that they have had to resort to the courts on so many occasions to enforce them with mixed success.

II EMPLOYMENT DISCRIMINATION AGAINST DYSLEXICS

There are three cases in the area of employment discrimination that underscore the difficulty that dyslexics have in obtaining jobs: Stutts v. Freeman,[8] Fitzgerald v. Green Valley Area

Education Agency,[9] and DiPompo v. West Point Military Academy.[10]

In Stutts v. Freeman, Stutts was hired in 1971 by the Tennessee Valley Authority as a temporary laborer at the TVA's Colbert Steam Plant in Colbert County, Alabama and then hired permanently in 1973.[11] In 1979, Stutts applied for an opening in the apprenticeship training program to become a heavy equipment operator but his application was denied because of a low score on the GATB, a test used by the TVA to predict the probability of success of applicants in the training program.

Stutts had been diagnosed as a dyslexic, which impaired his ability to read. In fact, the record showed that Stutts could not read beyond the elementary level and that this was the reason for his poor performance on the GATB.[12]

Stutts was subsequently evaluated by a doctor and given non-written tests. He was judged to be of above-average intelligence, coordination, and aptitude for a position of heavy equipment operator.[13]

Attempts to persuade the testing service to give Stutts an oral GATB were unsuccessful because the scoring on the test is based on standardized and uniform testing conditions which could not be accurately translated from an oral test. Thus Stutt's non-selection was based solely on his low score on the GATB.

Stutts argued that he was the victim of discrimination under the Rehabilitation Act of 1973.[14] The policy of the law is to promote and expand employment opportunities in the public and private sectors for persons with handicaps. Even the TVA agreed that Stutts was handicapped and that the GATB could not accurately reflect Stutt's abilities.[15]

The Court found considerable evidence that Stutts was fully capable of performing the job of equipment operator and that there was a genuine issue as to whether he could complete the training program with the help of a reader or by other means.

The Court noted that Congress has clearly directed that employers make efforts to expand opportunities for handicapped persons,[16] but that TVA did not satisfy its obligation under the Rehabilitation Act by merely asking for the results of Stutt's oral tests and then accepting a rejection.[17]

The Court did not state that Stutts had to be given a position as a heavy equipment operator or that he had to be admitted to a training program, but it did hold that "when the TVA uses a test which cannot and does not accurately reflect the abilities of a handicapped person as a matter of law, they must do more to accommodate that individual than the TVA has done in regard to Stutts."[18]

Despite the TVA's protestation that it sought to give Stutts

a non-written GATB test and get the results of his oral examinations, the fact remained that the TVA was not successful and it made its employment decision based on the GATB. The Court said, "TVA's unsuccessful efforts do not amount to a reasonable accommodation of the handicapped as required by 45 C.F.R. 84.12 (1981)."[19]

The Appeals Court concluded that the district court's reliance on the GATB test results was in error saying, "when an employer like the TVA chooses a test that discriminates against handicapped persons as its sole hiring criterion and makes no meaningful accommodation for a handicapped applicant, it violates the Rehabilitation Act of 1973."[20]

Although the landmark case in the area of handicapped discrimination is Southeastern Community College v. Davis,[21] the Court held that it did not apply to Stutts. In Southeastern, the Supreme Court held that a nursing school was not compelled by the Rehabilitation Act to admit an applicant with a serious hearing disability because evidence showed that the ability to hear speech was a necessary qualification for a nurse. The Court refused to order the school to hire a person to follow Davis around every day to interpret speech whenever necessary.[22] The Appeals Court said that the TVA had not shown that the ability to read was a necessary physical qualification for the job or that if Stutts needed accommodation it would be an unreasonable burden on TVA to provide it. The Court stated that the ultimate test is whether, with reasonable accommodation, an individual is able to perform the functions of the job without endangering the health or safety of the individual or others. The Court was convinced that Stutts could perform competently as a heavy equipment operator and that if he had trouble with the outside reading requirement, that obstacle could be overcome by obtaining a professional or family member to act as a reader.[23]

In DiPompo v. West Point Military Academy, DiPompo also suffered from dyslexia which, like Stutts, hampered his ability to read. When DiPompo was calm, he could read about as well as an advanced first grader, but when under stress, evidence showed that he was illiterate.[24]

DiPompo was a mason's helper at West Point and a volunteer firefighter in the Beacon, New York fire department. In September 1980 and June 1982, DiPompo applied to work as a fire fighter at West Point but on both occasions his applications were rejected. In January, 1984, DiPompo even sought a temporary summer fire fighter position but was denied.

After mediation efforts failed in June, 1984, DiPompo filed an Equal Employment Opportunity complaint alleging that West Point's decision not to hire him temporarily was illegal based on his handicap.[25]

While this claim was being investigated, DiPompo applied to

become a structural fire fighter, took a physical examination and was required to read from a fire fighters manual. Because West Point requires its firefighters to read at a twelfth grade level in order to be accepted, DiPompo was rejected and in January, 1985 filed a second EEO complaint against asserting that West Point illegally discriminated against him because of his handicap.

In April and July, 1986, the Army determined that DiPompo was a victim of discrimination and issued him two right to sue letters.[26]

DiPompo sued, claiming violation of the Rehabilitation Act of 1973, and sought relief for violation of section 503 of the New York Human Rights Law.[27] He also sought damages from individual defendants for the intentional infliction of emotional distress for aiding and abetting West Point to violate the latter.

DiPompo asserted two different theories of liability under Section 501 of the Rehabilitation Act[28]: disparate impact and surmountable barrier discrimination.[29]

Once a prime facie case of handicap discrimination had been established, the Army secretary had to show that persons who could read at a twelfth grade level could not efficiently perform the position of structural fire fighter, said the Court.

DiPompo also raised the issue of surmountable barriers, so the secretary was required to show that no accommodation could reasonably be made that would enable DiPompo to perform the duties of the job safely and efficiently,[30] because it would impose an undue hardship on the fire fighting program. The criteria for determining undue hardship included:

1. The overall size of the program, number of employees and facilities and size of the budget.
2. The composition and structure of the fire fighting unit.
3. The cost of accommodating DiPompo.[31]

The court found that the West Point fire department was a small force that worked out of three scattered fire stations, with small crews and that the fire fighters are often required to work without much supervision. Also, because there are not many fire fighters, each one had to be able to do every task, including those that required reading at the twelfth grade level. Thus, the Court found in favor of the Army.[32]

Despite DiPompo's attempt to bring his claim under the ambit of Section 504 of the Rehabilitation Act, the Court held that his suit was limited to Section 501 because the legislative history of the Act makes it clear that that section is the federal employee's exclusive remedy for employment discrimination based on handicap.[33]

Fitzgerald v. Green Valley Area Education Agency posed another challenge under the Rehabilitation Act, Section 504. Fitzgerald was a multiply-handicapped individual. While he suffered from dyslexia, he also had left side hemiplegia due to cerebral palsy and nocturnal epilepsy which he controlled by medication. Fitzgerald's dyslexia caused him to read between a third and sixth grade level.[34]

Despite this disability, Fitzgerald was able to earn a bachelor's degree in sociology and psychology and master's degree in education by using tape, records, and readers and also managed to work as a teacher's aide or substitute teacher for children whose reading skills were less than his. Upon completion of his masters in 1979, Fitzgerald responded to an advertisement placed by Green Valley, seeking a pre-school teacher of the handicapped and a special education instructor but did not mention his handicap.[35]

When the Director of Special Education for Green Valley, one Steen called Fitzgerald to arrange an interview, the latter told Steen of his disabilities and learned that pre-school handicapped teachers had to be able to drive a school bus. Fitzgerald said that he had a license to transport students in New York. When Steen called the Iowa Department of Public Transportation, he learned that Iowa law required a bus driver permit holder to have full and normal use of both hands, arms, feet and legs, and due to his hemiplegia, Fitzgerald could not qualify.[36]

Steen then called Fitzgerald to tell him it would not be worth his while to travel to Iowa. But Steen had expressed no reservations to Fitzgerald about his qualifications for the teaching portion of the job.

Fitzgerald felt a combination of inadequacy, anger, rejection and bitterness because he had worked hard to gain his degree and to overcome his handicap. Because he was married with a family, he also feared for his ability to provide for them and felt embarrassment and humiliation.[37]

Based on the evidence presented at trial, the District Court concluded that Fitzgerald was better qualified in terms of education and experience to teach pre-school handicapped children than the person who was hired. The court also found that were it not for his hemiplegia and bus driving problem, Fitzgerald would have gotten the job.[38]

The Court said that in order to come under the coverage of Section 504 of the Act, Fitzgerald had to prove to a preponderance of the evidence:

1. He was handicapped due to his nocturnal epilepsy, dyslexia and cerebral palsy with left side hemiplegia.
2. He was qualified due to education and experience.

3. He was excluded from the program solely because of his handicap.
4. The program received federal financial assistance.[39]

The court found it puzzling that, as a recipient for Education for All Handicapped Children Act (EAHCA) funds, Green Valley could not have been unaware of its duty "to take positive steps" to employ qualified handicapped persons in its programs.

The Court also noted that Green Valley failed to consider alternatives that would have eliminated the bus driving requirement, and so failed to fulfill its "special obligation" to accommodate Fitzgerald's handicap.[40]

The Court found it particularly objectionable that Steen gave Fitzgerald the impression that coming to Iowa would have been futile and that Green Valley did not consider whether accommodation was possible. Thus, the Court concluded that Fitzgerald had met his burden of establishing all four elements of a 504 claim and proved violation of Iowa law.[41]

The Court found that Fitzgerald was entitled to damages for mental anguish ($1,000.00) and $5,150.00 in loss earnings, attorney fees, but not punitive damages. Noting that there is a split of authority as to whether damages are available under 504, this court concluded it was "the better view that the full panoply of remedies is available to Fitzgerald under 504."[42]

III. EDUCATIONAL DISCRIMINATION AGAINST DYSLEXICS

There are four cases that are representative of the problems that dyslexics have experienced in education. They are Wynne v. Tufts University School of Medicine,[43] Jaworski v. Rhode Island Board of Regents for Education [44] Riley v. Ambach, [45] and Koeppel v. Wachtler.[46]

In Wynne, a medical student was dismissed from the Tufts University School of Medicine after failing several courses during two attempts to complete his first year program. Wynne alleged that he failed the multiple choice examinations because of his dyslexia and argued that Tufts could have reasonably accommodated his handicap by offering him another form of examination.

The U.S. District Court granted summary judgment to Tufts because it found that Wynne was unable to show that he could meet the school's requirements.[47]

Wynne appealed, relying on Section 504 of the Rehabilitation Act, and the issue was whether the university could make a reasonable accommodation to Wynne's disability to give him meaningful access to Tuft's education.[48]

The Court admitted that on the surface, it appeared that a

medical student who failed half of his classes - some after multiple attempts - had demonstrated his inability to get a medical education. But Wynne attributed his failure to Tuft's "unwarranted" refusal to test him in courses by any means other than written multiple choice exams.[49]

He offered as proof of his ability his substantially higher scores in Practicum, a type of examination which required him to apply his knowledge to a problem, which he described as being "closer to the actual practice of medicine than a multiple choice examination."[50]

Tufts claimed that Wynne's problem with the multiple choice format was "an inability to process complex information, a necessary requirement for a medical degree at Tufts."[51] The school maintained that the decision to administer written multiple choice examinations was a matter that a court or jury should not be permitted to second guess.

The Court stated that it subscribed to the principle of academic decision making, but that Section 504 required it to examine academic decisions to determine if they "mask even unintended discrimination against the handicapped."[52] The court found Tufts offered no evidence to explain why multiple choice examinations as distinguished from all other types of examinations were better tests of a student's ability "to assimilate, interpret, and analyze complex material."[53]

The Court believed that essay examinations would accomplish the same objective, and moreover, Tufts did not respond to Wynne's claim that the Practicum Exam is a more appropriate method for him to evaluate a medical student's ability to synthesize complex data.[54]

The Court concluded that the record failed to show that a different testing method would fundamentally alter the program or that Wynne inevitably would fail if freed of the burden of taking multiple choice exams. The Court noted that Section 504 does not require a recipient of federal funds to disregard the disabilities of the handicapped, but it does require that decisions be based on actual abilities, not on assumptions that the handicapped are less capable than others.[55]

Koeppel v. Wachtler was a case that also dealt with an advanced student who had a problem with an examination - the New York State Bar Exam. Koeppel was a law student who also suffered from dyslexia. In July, 1984, Koeppel took the exam as required by N.Y.C.R.R. 22 CRR 520.6.[56]

To accommodate his disability, the New York State Board of Law Examiners allowed Koeppel an additional nine hours to take the exam and to mark his answers to the multiple choice questions on the question sheet than the computer scored answer sheet.[57]

Despite these adjustments, Koeppel failed the bar examination and sought a waiver of the requirement of passing a written bar exam. The Board responded that it had neither the power nor the discretion to modify the requirements of 22 N.Y.C.R.R. 520.6 to permit a restructured or oral examination.

Koeppel's petition was also reviewed by an Associate Justice of the Court of Appeals who determined that it should be denied.[58]

Koeppel appealed the ruling claiming that he was denied equal protection of the law in violation of the Fourteenth Amendment to the U. S. Constitution, the New York Constitution Article I, Section II. He also argued that the failure of the Board to certify Koeppel's name to the Appellate Division's Second Department violated a right conferred upon him by Executive Law 296 (1) (a).[59] The Court found the first two claims to be barred by the Statute of Limitations but not the third. The case was remanded for further proceedings.[60]

In Weintraub v. Board of Bar Examiners[61], Richard P. Weintraub won an order from the Massachusetts Supreme Judicial Court that granted him twice the generally alloted time to take the July, 1992 Massachusetts Bar Examination. The court ruled that the American With Disabilities Act applies to the Board of Bar Examiners and that Weintraub was entitled to accommodations prescribed by the Act because of his dyslexia and attention-deficit disorder. Weintraub, a B student at Boston University Law School, graduated in 1991 and failed both the July, 1991 and February 1992 bar exams by small margins. On these occasions he was given 30 extra and 45 extra minutes per each three hour segments respectively. Weintraub and his attorney Ernie Katz argued that the Board of Bar Examiners' 45 minute per segment limit violated the ADA's provision that each person's individual needs should be addressed. The court's order allowed Weintraub to take the July 1992 exam over a four day period in a private room during the same week others took the exam. Although the order deals with one case in Massachusetts, it effectively delivers a signal to bar examiners around the country and to other agencies within the state that certify professions to take note about how they accommodate the disabled. Stephen Fedo, a Chicago lawyer, who advises the National Conference of Bar Examiners said that the ADA opens the door for a greater number of more specialized or individualized accommodations at examinations which could pose numerous problems for bar examiners in terms of cost and practicality.

Not only do students from professional schools have problems with regard to acceptance of the limits of their dyslexic condition but so also do younger students and their parents. There are two cases that explore the issues of the Rehabilitation Act and the Education of All Handicapped Children Act (EAHCA).[62]

In Riley v. Ambach, the facts involved an action brought by eighteen handicapped children and their parents to enjoin regulations made by the New York Commissioner of Education, Ambach, with regard to their education of learning disabled children. Ambach made a rule that required such children to exhibit a discrepancy of 50% or more between expected and actual achievement based on intellectual ability in order to qualify as a handicapped child" under the appropriate federal and state laws.[63]

The parents alleged that Ambach violated the Rehabilitation Act and the Education of All Handicapped Children Act of 1975, which established federal and state programs to secure "free appropriate public education for all handicapped children and expanded federal funding of state educational efforts for that purpose."[64]

The Court discussed at length the legislative history and said that children with specific learning disabilities and their parents have a right to expect that individually designed instruction to meet their children's specific needs is available.[65]

In order to participate, states have to meet eligibility requirements and must submit plans to meet the educational needs of the handicapped.[66]

The parents argued that the 50% discrepancy rule violated federal statutory requirements because it excluded from identification as handicapped those severely learning disabled children who did not meet the 50% cut-off.[67]

One student, John Riley had been classified as handicapped by Levittown School District Committee on the Handicapped (COH) because of his dyslexia. The Committee recommended that he be placed at Landmark, a residential school in Massachusetts that was on the Commissioner's approved list. But Landmark had been removed from the approved list so Riley's tuition would not be paid by the state. In the wake of the rule change, the COH recommended placement in the Levittown Memorial Junior High School with special education classes. Riley's parents viewed the placement as unsatisfactory and put their son at Landmark at their own expense.[68] Similar things happened to other students who joined the suit.

The parents argued that the 50% rule is inconsistent with federal standards which require that a child exhibit a severe discrepancy between expected and actual achievement because it is a more restrictive criterion and that implementation of the 50% rule caused the number of learning disabled children in New York schools to drop from 28,172 to 12,167 from 1977-1979. Expert witnesses testified as to the inappropriateness of the 50% standard to determine if a child is learning disabled.[69]

The Court concluded that the 50% standard interfered with the proper identification of learning disabled children since it operated to eliminate consideration of factors and the use of techniques which "do not, given the present state of the art, lend themselves to quantification."[70]

The Court was troubled because no evidence had been presented to show that the 50% rule is interpreted by local COHs in a flexible way. In fact, the school districts reached decisions "primarily if not exclusively on the basis of quantitative tests and grade scores which lend themselves to quantification."[71] Even the Assistant Commissioner admitted that testing procedures were very poor. The Court stated that Congress was concerned about the inadequacy of testing procedures used to evaluate students for special education programs, and noted "the usefulness and mechanistic ease of testing should not become so paramount in the educational process that its negative effects are overlooked."[72]

Thus, the Court concluded that the 50% rule and the elimination of residential schools by the Commissioner violated federal law. The Court ordered restoration of the residential schools to the approved list and reimbursement of the cost of the current year's placement costs.[73]

A similar struggle took place in Jaworski v. Rhode Island Board of Regents for Education, in which James Jaworski's parent sued under the EAHCA seeking an injunction requiring the Pawtucket School Committee to fund his placement in a private school and other procedural safeguards.[74]

The issue in the case was whether the Pawtucket School Committee should be required to reimburse James' parents for money they were required to spend because of the Committee's failure to provide him with a free appropriate education within the school system.[75]

James began his checkered educational career in the Pawtucket School System in 1967. During his early school years, he had considerable difficulty in reading, writing and arithmetic. But it was not until December, 1973 that an examination revealed that he suffered from dyslexia. Jame's parents decided in June, 1974 to place him in a private school, Eagle Hill. Mr. Jaworski approached the Pawtucket Director of Special Education, Leo Dolan, to seek funding for such a placement and was informed that there was a program for dyslexia with the school system.[76]

The Jaworskis filed a petition seeking reimbursement for costs in keeping James at Eagle Hill, but after an evaluation by a doctor, school psychologist and, on recommendation of Dolan, the School Committee notified the Jaworski's that the school system could provide an appropriate education. The Jaworskis then appealed to the Commissioner of Education who found that the school's program was appropriate, a decision affirmed by the Board of Regents for Education.[77]

The case became moot once James graduated but the Court had to consider if a retrospective award of compensatory damages was available under the EAHCA. The judge concluded that while there were cases on both sides of the issue, the term "relief" meant injunctive relief and not damages.[78]

The Jaworskis also claimed damages under Section 504 of the Rehabilitation Act of 1973 but the judge found that this issue was not raised in a timely fashion.

The Jaworskis also argued that the Pawtucket School Board denied them a hearing which would have allowed them to rebut the information the Committee relied upon in reaching its decision. The Court found that the denial of a hearing violated the regulations of the Board of Regents Governing the Special Education of Handicapped Children, which specifically provided an opportunity to appeal to the School Committee if the decision of the Superintendent was not acceptable to the parents. But the court found that the Jaworskis failed to show in any way that, if they had been given a second hearing a different decision would have been reached or they would have been spared an injury. The Court only awarded the Jaworskis nominal damages of $1.00.[79]

CONCLUSION

As the cases discussed in this article have shown, it is no easy task for dyslexics to achieve their rights in this society. In each of these cases, dyslexic employees, students and their parents faced a long struggle to achieve justice due to the presence of this learning disability.

There has been a greater awareness of learning disabilities in the last few years and activity in developing programs for the learning disabled at all levels of education. Colleges have even displayed more willingness to allow untimed admission tests in undergraduate and graduate programs and help in taking SATs and GREs. But only about 150 two and four year colleges offer comprehensive programs to provide intensive support to the learning disabled while they earn their degrees.[80]

In addition to the Rehabilitation Acts and the Education of All Handicapped Children Act, protection is afforded dyslexics was in 1992 by the Americans With Disabilities Act which affect employers with 25 or more employees. The ADA takes a different tack from the Americans With Disabilities Act which should provide even more opportunities for the learning disabled to gain employment opportunities.[81] The focus is on what handicapped people can do. Under the law, if a qualified applicant or employee with disabilities cannot perform essential work functions or fully participate in employment programs because of their impairment, he or she is entitled to have barriers removed through reasonable accommodation.

Experts agree that dyslexia is an incurable malady. Dyslexics can learn and work but special steps must be taken to help them achieve these goals. It is unjust that a society allows discrimination against persons with immutable characteristics like race, sex, and handicap. Dyslexia is a neurological impairment. As two authors have put it, despite advance in many areas of neurology, psychology and linguistics, dyslexia remains an

enigma."[82]

NOTES

1. "The Bright Idea of Dyslexic Minds," University of California at Irvine Journal U.C.I. Journal Apr-May 1986 at 10. (hereinafter "The Bright Idea of Dyslexic Minds.)

2. Callahan, "Here Dyslexics Meet Success," The Boston Globe, June 2, 1991 at B-19.

3. "The Bright Idea of Dyslexic Minds," supra note 1 at 10.

4. Id. at 11.

5. Blakeslee, "Study Ties Dyslexia To Brain Flaws Affecting Vision and Other Senses, The New York Times, Sept. 15, 1991 at A-1, A-30.

6. Id. at A-1. The term "dyslexia" comes from the Greek dys (difficult) and lexikos (having to do with words). Erens "The Scrambled World of Dyslexia," Connecticut Magazine, Nov. 1987 at 103.

7. "Dyslexic Teacher Helps Others," The New Haven Register, Oct. 4, 1985 at A-35.

8. 694 F. 2d 666 (1983).

9. 589 F. Supp 1130 (S.D. Iowa 1984).

10. 708 F. Supp 540 (S.D. N.Y. 1989).

11. 694 F. 2d 666, 668.

12. Id.

13. According to testimony, the TVA tried to get the results of these non-verbal tests but was unable to do so. Id.

14. 29 U.S.C. 701 (8). The Rehabilitation Act of 1973 says in part:

    No otherwise handicapped individual in the United States shall solely, by reason of his handicap be excluded from participation in or be denied the benefits or be subjected to discrimination under any program or activity receiving federal financial assistance or under any program or activity conducted by any Executive Agency or U.S. Postal Service.

    A handicapped individual is defined as an individual who:

    1. Has a physical or mental disability which, for such individual constitutes or results in a substantial handicap to employment and it can reasonably be expected to benefit in terms of employability from vocational rehabilitation service.
    2. Any person who:
       (i) has a physical or mental impairment which substantially limits one or more of such person's major life activities.
       (ii) has a record of such impairment or
       (iii) is regarded as having such an impairment.

15. 694 F. 2d 666, 668.

16. Id.

17. Id. at 669.

18. Id.

19. Id. at 668.

20. Id. at 669.

21. 442 U.S. 397, 99 S. Ct 2361, 60 L. Ed 2d 980 (1979).

22. 694 F. 2d 666, 669 fn 3.

23. Id. at 669.

24. 708 F. Supp 540, 542.

25. Id.

26. Id.

27. N.Y. Exec. Law 296 (1) (a), McKinney, 1982.

28. Section 501 provides in part:

    "Each department, agency and instrumentality (including the U.S. Postal Service, Postal Rate Commission in the executive branch) shall...submit...an affirmative action program for the hiring, placement, and advancement of handicapped individuals in such department, agency or instrumentality."

29. 708 F. Supp 540, 547.

30. Id. at 550.

31. Id.

32. Id.

33. Id. at 545.

34. 589 F. Supp. 1130, 1132.

35. Id. at 1133.

36. Id. at 1134.

37. Id.

38. Id. at 1135.

39. Id. at 1135.

40. Id. at 1136.

41. Id. The Court found that Green Valley also violated the Iowa Code 601 A 6(1) (1979) which makes it illegal for any person to discriminate in employment against any applicant for employment or any employee because of disability of such applicant or employee unless based on the nature of the occupation. Thus, the employer has a duty to make reasonable accommodation to a handicapped qualified applicant and cannot deny employment opportunity to a qualified handicap person if the basis for denial is the need to make reasonable accommodation for the physical limitation of the employee or applicant. 240 Iowa Admin. Code 6.2 (6) (6) (c) says," An employer can avoid its duty to make reasonable accommodation only if it can show "that the accommodation would impose an undue hardship on the operation of its program."

42. Id.

43. 58 U.S.L.W. 2658-2659 5-15-90 (CA 89-1670) 4-30-90.

44. 530 F. Supp. 60 (1981).

45. 508 F. Supp. 1222 (1980).

46. 529 N.Y.S. 2d 359 (A.D.2 Dept. 1988).

47. 58 U.S.L.W. 2658.

48. Id.

49. Id.

50. Id.

51. Id.

52. Id.

53. Id. at 2659.

54. Id.

55. Id. at 2658. The Court cited Southeastern Community College v. Davis supra fn 21 which held that Section 504 does not require that educational institutions lower their standards or make substantial modifications to their program to accommodate handicapped persons but that reasonable accommodations may be necessary to fulfill the mandate of 504.

56. 529 N.Y.S. 2d 359, 360.

57. Id.

58. Id.

59. Id.

60. Id. But see "Learning Disabled Lawyer Wins Compromise on Bar Exam," Wall St. J Mar. 2, 1993 at B-5. Randi L. Rosenthal, an associate at the New York Law firm, Kaye, Scholes, Fierman, Hays and Handler sued in February, 1992 under the Americans with Disabilities Act asking a federal judge to halt the February New York Bar Exam arguing that she suffers from dyslexia and attention deficity disorder. She was denied special accommodations for the July, 1991 exam and failed. Faced with a possibility that the bar exam for 2300 candidates would have to be postponed, the New York State Board of Law Examiners agreed to allow her to take the February exam over four days instead of two and in a separate room. Nancy Opps, deputy executive secretary of the board said there is "no uniformity throughout the country - some states accommodate the learning disabled, some don't."

61. Kennedy, "U.S. Disability Law Put To The Test," The Boston Globe, Sept. 22, 1992 at 39-54.

62. 20 U.S.C. Section 1401 et. seg. 20 U.S.C. 1401(15) defines children with learning disabilities as follows:

> "... those children who have a disorder in which one or more of the basic psychological processes involved in understanding or in using language spoken or written, which disorder may manifest itself in impact on the ability to listen, think, speak, read, write, spell or do mathematical calculations such disorders include such conditions as peruptual handicaps, brain injury, minimal brain dysfunction, dyslexia and developmental aphasia."

Such term does not include children who have learning problems which are primarily the result of visual, hearing, or motor handicaps of mental retardation, of emotional disturbance, or of environmental, cultural or economic disadvantage 20 U.S.C. 1401 (15).

63. 508 F. Supp. 1222 (1980) at 1225.

64. Id. at 1226.

65. Id. Senate Labor and Public Welfare Committee S. Rep. No 94-168, 94 Cong. 1st. Sess., June 2, 1975 at 10. U.S. Code and Admin. News 1975, pp. 1425, 1430.

66. Id. at 1227.

67. Id. at 1228.

68. Id. at 1236.

69. Id. at 1240.

70. Id. at 1241.

71. Id. at 1242.

72. Id. at 1244. 45 CFR 121 a 302.

73. Id. at 1246.

74. 530 F. Supp. 60, (1981) at 61.

75. Id.

76. Id.

77. Id. at 62.

78. Id. at 63. The court found support for this position in the legislative history and in Anderson v. Thompson, 658 F 2d. 1205 (7th Cir. 1981) affg 495 F. Supp. 1256, 1257 (E.D. Wis. 1980).

79. Id. at 64-65.

80. Van Ness, "As Easy As 1-3-2," New York Times, Education Times, 47-48.

81. Owen, "A Law That Gives the Disabled A Fair Chance," Wall Street J. May 29, 1991, at A-10.

82. Shaywitz and Vaxman, "Dyslexia," New Eng. J. of Medicine, May 14, 1987 Vol. 316, No. 20, at 1269. Tragically the world of the learning disabled child is clouded by frustration and failure in school and often leads to crime. Statistics show that while 15% of the population have learning disabilities, 36% of juvenile delinquents involve such people. The American Bar Association recognized the link between learning disabilities and crime in 1983. In New York, studies show that 10-40% of inmates in states county jail system may have some learning or developmental disability. Johnson, "Help of Court Sought for Learning Disabled," New York Times, Nov. 16, 1986 at B-2.

MORAL TURPITUDE AND THE TENURED TEACHER: DISCHARGE OF COLLEGE AND UNIVERSITY FACULTY

by

Robert S. Wiener*

INTRODUCTION

Although college and university faculty often see tenure contracts as iron-clad, there are a number of ways by which we can lose the protection tenure affords. This paper explores the path of moral turpitude.

I. HISTORY

The history of tenure is a long one, going back to the Middle Ages.[1] More recently, representatives of the American Association of University Professors (AAUP) and of the Association of American Colleges, in a series of conferences begun in 1934, discussed tenure. On 7-8 November 1940 they agreed to the 1940 *Statement of Principles on Academic Freedom and Tenure and Interpretive Comments*. "Institutions of higher education are conducted for the common good . . . . [which] depends upon the free search for truth and its free exposition. Tenure is a means to: "(1) Freedom of teaching and research and of extramural activities and (2) a sufficient degree of economic security to make the profession attractive to men and women of ability." The service of teachers who "have permanent or continuous tenure . . . should be terminated only for adequate cause, except in the case of retirement for age, or under extraordinary circumstances because of financial exigencies." Examples of cause referred to in passing are "incompetence" and "moral turpitude". The reference to "moral turpitude" suggests that "[t]eachers on continuous appointment who are dismissed for reasons . . . involving moral turpitude [need not] receive their salaries

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for at least a year from the date of notification of dismissal . . . ."

Additional interpretive comments on the 1940 Statement, drafted by a 1969 Joint Committee of the AAUP and the Association of American Colleges, were endorsed by the AAUP in 1970. They note "relevant developments in the law itself reflecting a growing insistence by the courts on due process within the academic community which parallels the essential concepts of the 1940 Statement; particularly relevant is the identification by the Supreme Court of academic freedom as a right protected by the First Amendment."[2] These comments also elaborate on moral turpitude.

II. FACULTY QUALIFICATIONS

As the cases show, courts typically defer to the judgment of school administrators when teachers are dismissed. Legislative language establishing the foundation for dismissal for cause is often quite broad, such as "evident unfitness for service"[3] and is interpreted broadly by judges.

> [T]he calling [of a teacher] is so intimate, its duties so delicate, the things in which a teacher might prove unworthy of fail are so numerous that they are in capable of enumeration in any legislative enactment.... His habits, his speech, his good name, his cleanliness, the wisdom and propriety of his official utterances, his associations, all are involved. His ability to inspire children and to govern them, his power as a teacher, and the character for which he stands are matters of major concern in a teacher's selection and retention.[4]

With standards such as these and discretion placed in the hands of the colleges and universities, teachers may well find it difficult to prove their fitness.

At least one case seems to put the burden of proof for discharge on the school.

> [A]n individual can be removed from the teaching profession only upon a showing that his retention in the profession poses a significant danger of harm to either students, school employees, or others who might be affected by actions as a teacher.[5]

III. MORAL TURPITUDE

As observed in 1958, "[o]ne persistent source of difficulty is the definition of adequate cause for the dismissal of a faculty member. Despite the 1940 *Statement of Principles on Academic Freedom and Tenure* and subsequent attempts to build upon it, considerable ambiguity and

misunderstanding persist throughout higher education, especially in the respective conceptions of governing boards, administrative officers, and faculties concerning this matter."[6] This observation is, if anything, more true of moral turpitude than incompetence.

What is moral turpitude? According to the 1970 Interpretive Comments

> The concept of "moral turpitude" identifies the exceptional case in which the professor may be denied a year's teaching or pay in whole or in part. The statement applies to that kind of behavior which goes beyond simply warranting discharge and is so utterly blameworthy as to make it inappropriate to require the offering of a year's teaching or pay. The standard is not that the moral sensibilities of persons in the particular community have been affronted. The standard is behavior that would evoke condemnation by the academic community generally.[7]

This standard differs from the 1973 Miller v. California obscenity test of "whether the 'average person, applying contemporary community standards' would find that the work taken as a whole, appeals to the prurient interest, ..."[8] Here the community is not the average person but the academic community. The comment suggests that this academic community is not local, but national.

The 1966 AAUP *Statement on Professional Ethics* speaks of the enforcement of ethical standards. In this context, it discusses a professor's responsibilities to his subject, students, colleagues, institution, and community. Issues of possible moral turpitude raised are sexual misconduct, a professor "avoids any exploitation of students for his private advantage . . . ." and plagiarism, a professor "acknowledges his academic debts".[9]

Standards for dismissal include: "(1)incompetence (including inefficiency); (2)immorality (including dishonesty); (3) neglect of duty (such as violating institutional rules and missing classes); and (4)insubordination (including excessively disruptive behavior)."[10] Although several of these standards are often used together, this paper investigates immorality.

What does a teacher's morality have to do with teaching? "One of the prerequisites of a teacher is good moral character.... It need not be found in the Education Law. It is found in the nature of the teaching profession. Teachers are supposed not only to impart instruction in the classroom but by their example to teach students."[11] "If adherence to a code of proper personal conduct is not essential in all callings, it is in the teaching profession."[12]

A. Sexual Misconduct

1. With a current student

A case of sexual misconduct by a male teacher to a female student is Cockburn v. Santa Monica Community College Dist. Personnel Comm'n.[13] Donald Cockburn, a physical sciences laboratory technician and instructor for about 17 years, was responsible for hiring and supervising laboratory assistants.

> Duria Suncar, an 18 year old Oriental student at the college asked [Cockburn] about employment as a lab assistant.... [She] was interviewed by [Cockburn who] met her and put her to work immediately washing beakers. He then asked her to come with him to the basement to do some work. In the basement he held her hand, asking how her hands felt washing all those dishes. He then grabbed her, holding her tightly. He kissed her on the cheek then on the mouth, saying afterwards, 'o.k., go to work.' Five or ten minutes later he tried to embrace her again. [Suncar] said 'no, I don't want to.'[14]

Cockburn was confronted with the incident and was eventually told that he would need to have an evaluation by a psychologist independent of the college before the president of the college decided on Cockburn's employment. The psychologist, as a condition of his employment, insisted that Cockburn tell his wife. Cockburn rejected that condition, and submitted a request for retirement which was granted. Even so, the college retained the psychologist for 12 therapy sessions with a now amenable Cockburn. In the psychologist's opinion, "the possibility of a recurrence of the above behavior appears to be very minimal given ongoing therapy and monitoring."[15] Cockburn unsuccessfully attempted to withdraw his resignation request and brought this case on grounds of a lack of procedural due process, an issue outside the scope of this paper. No mention was made of Cockburn's tenure status. The court noted the "grave responsibility" both it and the Santa Monica Community College District Personnel Commission have "to the [Santa Monica Community College] and their personnel, the professors, instructors and students they embrace and to the general public."[16]

Joseph William Stubblefield, a teacher at Compton Junior College in Los Angeles County, after teaching a night class on 28 January 1969, drove a female student to a secluded location. A patrolling police officer flashed a light on the couple who were in a state of undress: he with his pants unzipped and penis exposed, she nude above the waist and unzipped below. The court observed that, "[i]t would seem that, as a minimum, responsible conduct upon the part of a teacher, even at the college level, excludes meretricious[17]

relationships with his students ...."[18]

Manuel Loera's discharge by the Oregon State Board of Higher Edication was upheld, based, in part, on his entry into women's dormitories against orders allegedly for room checks, conversations with sexual overtones with female students, and sexual advances toward a female resident assistant.[19]

On 26 February 1992 the Supreme Court ruled 9-0 that students may sue for monetary damages for sexual harassment based on Title IX of a 1972 federal education act.[20] The law banned sex discrimination in any "education program or activity receiving Federal financial assistance", that is, all public and many private schools and colleges. Justice Byron R. White, who wrote the opinion of the Court joined by five other justices, "presumed the availability of all appropriate remedies" when none are specified by Congress, as in this law. Clarence Thomas and Chief Justice William H. Rehnquist concurred with Antonin Scalia's opinion that a 1979 decision that private individuals have a right to sue under the act was incorrect, but that because Congress had endorsed that decision (and apparently on principles of stare decisis), "it is too late in the day" to deny damages. The case was brought in 1988 by Christine Franklin's who claimed that one of her high school teachers in Gwinnett County, Georgia forced sexual relations on her School officials were informed and investigated but took no action other than to discourage her from pressing criminal charges against the teacher. The teacher resigned and the investigation was ended.[21]

A recent case is that of Dr. Margaret Bean-Bayog, a Harvard Medical School psychiatrist. She has been accused of seducing Paul Lozano, a student at the school whom she counseled from July 1986 to June 1990. In April 1991 Mr. Lozano committed suicide. Court papers filed in a medical malpractice and wrongful death action allege that Dr. Bean-Bayog led Mr. Lozano "into a dangerous cycle of regression and transference wherein the patient was caused to become completely dependent, as a 3-year-old child, on Dr. Bean-Bayog as his mother." Also, that she caused him to "participate in vivid sadomasochistic sexual fantasies" resulting in sexual intercourse. Harvard placed Dr. Bean-Bayog on leave as of May 1991.[22]

2. With a former student

A 1966 California case deals with a relationship between a male teacher and a female student from the previous school year. Eugene Clarence Hartman was a permanent teacher dismissed by the Board of Trustees of Mount San Antonio Junior College District of Los Angeles County[23] for immoral conduct and evident unfitness for service.[24] The principal grounds for dismissal was Hartman's relationship with a woman (designated by the court as Patricia).

> Beginning about 12 December 1961 and for much of 1962, Hartman cohabited with Patricia who was married to a[nother] man ..., that such relationship commenced on the day that Patricia left her husband, that the defendant's wife had died less than 30 days prior thereto, and that Patricia had been a student of [Hartman] at Mount San Antonio Junior College [in 1960-61 school year][25]. [N]either Patricia nor defendant "believed in good faith that their activities in Tijuana, Mexico, on December 19, 1961, had resulted in that day or at any later time in a valid diforce [sic] between Patricia ... and her husband, or in a valid marriage between [Hartman] and Patricia...."[26]

The California appellate court considered this to be adequate grounds for dismissal as a result of immoral conduct. Cohabitation raises the presumption of sexual relations, but even had there been none, "the evil [target of the statute] ... is the harmful impression on others, particularly students, arising from the fact of a teacher and a woman to whom he is not married living together openly as man and wife."[27] The appeal was largely based on procedural issues and failed by a 3-0 vote.

3. With a non-student

The trial court in the Hartman case also determined that, in the fall of 1960, while married to Barbara Jean Hartman, Mr. Hartman lived in an apartment with a woman designated as Frances under the name of Mr. and Mrs. Hartman. This was considered sufficient grounds for dismissal on the grounds of immoral conduct.[28] The appellate court apparently agreed. This case is probably even more dated now. I have found no more recent cases of discharge based extramarital relations with a non-student.[29]

Homosexuality has also been considered a matter of immorality.[30] However, one of the few cases won by a teacher, evidence of a single "undescribed but noncriminal private act "of a homosexual nature" with a consenting adult three years earlier was not considered sufficient cause for discharge as a result of moral turpitude.[31]

B. Language

One case deals with a teacher who used graphic language sometimes combined with descriptive actions. William Hensey, a permanent junior college philosophy teacher in Palo Verde, California was dismissed for "evident unfitness for service and immoral conduct."[32] The trial findings included the following:

[That Hensey]
(2) ... stated the bell system of the college "sounded like a worn out phonograph in a whorehouse" and made numerous references during the semester to "whore" and "whorehouses" and, following a reprimand for this conduct, submitted to the president of the college a thesis on the justification of his of these terms in his class.
(3) ... directed himself to several Mexican-American students seated in the rear of the classroom and stated, "I understand you have been to San Luis; I understand they have super-syphilis there, and you know that they don't have drugs to cure that. Be careful when you're there." This statement was made in a tone loud enough to be heard by all of the students in the class, both male and female.
(4) ... advised his philosophy class that the district superintendent ... "... spends too much time ... (at this point in the statement he stepped over to the wall and simulated licking the wall with his tongue in an up and down manner and then continued speaking) ... licking up the Board."
(5) ... derogatorily referred to the walls of the high school and on one occasion he referred to them as looking as though "someone had peed on them and then smeared them with baby crap."

As to the bell characterization (incident 2), the court opined that teaching fitness standards applied to elementary and high schools may well be different than those applied to college and university faculty.[33] "[W]hile the use of the words may have shown bad taste and vulgarity (footnote: On one occasion he referred to the public address system as sounding like a constipated elephant.) we cannot find that these charges constitute or are evidence of immorality."[34]

For the safe sex warning (incident 3), "[a]gain, while we find this incident to be in bad taste, we can find in it no evidence of immorality."[35] Venereal diseases was apparently not a subject in the course and I believe that a current court, more sensitive to issues of demographic diversity, would respond more strenuously.

Concerning wall licking (incident 4) the court states,

> [h]ere, we have passed the limits of bad taste and vulgarity. The defendant's contention that he was imitating a deaf mute ordering an ice cream cone was an insult to the intelligence of the trial judge. Rather, it is obviously a gesture which was intended to describe a person who would rather curry favor with his superiors than to do his duty and was specifically directed to the County Superintendent of Schools. The defendant's explanation that, in this context, he meant "face licking" was obviously not accepted by the trial court nor do we so accept it. Quite to the contrary, this expression means in common parlance licking in an entirely different portion of the anatomy. It was obviously so intended by the defendant and so understood by his college-age students. This obscene incident indicates both "immorality" and "evident unfitness."[36]

Hensey's speech is considered "far outside the protection of the First Amendment ...."[37]

The court's response to the wall description (incident 5) implies that language acceptable to males is unacceptable to females. The courts notes that "this was a class made up of both males and females. We assume that each of them at that age was familiar with the words used.... Nevertheless a teacher has a responsibility to respect the feelings and sensitivities of the members of his class and to conduct himself with a certain degree of rectitude. His behavior in this incident is inexcusable in the presence of his students."[38] The characterization of the depiction as "barrack's language" may be another observation relating to gender specific language reflecting a time before females were in the barracks. The court does "not consider the language used to be immoral, [however] its obvious vulgarity was evidence of "evident unfitness."[39]

Of the six points considered by the court, only the wall licking was deemed immoral, but "[a]ll of the incidents taken in the aggregate serve as substantial basis for the trial court's determination that the charges of "immoral conduct" and "evident unfitness for service" were true and constituted cause for dismissal."[40]

C. Course Content

Despite the Bertrand Russell case, the best argument against dismissal for cause based on moral turpitude is probably a claim of academic freedom to determine course content. One of the rare faculty winners was Deena Metzger, a permanent teacher at Los Angeles Valley College.[41] The approved textbook in her first-year junior college English class was Girvetz's "Contemporary Moral Issues". In conjunction with a unit on obscenity, Metzger distributed her poem "Jehovah's Child", "liberally sprinkled with Anglo-Saxon obscenities, slang references to male and female sexual organs and to sexual activity, and profane references to Jehovah and Christ."[42] Supplementing a propaganda section, a brochure

"You Can Become a Sexual Superman" and advertisement for "The Picture Book of Sexual Love" were used. Even so, widespread support from her peers and students was apparently quite helpful to Metzger and the court warned the they were not granted a carte blanche to obscenity and pornography.[43]

It remains to be seen if Professors Jeffries and Levin of City College will withstand attacks against them based on the alleged immorality of their teachings.

D. Teachings

A particularly noteworthy case is that of Kay v. Board of Higher Education of City of New York.[44] This is the case against the appointment of Bertrand Russell to chair of philosophy at City College by the New York City Board of Higher Education. Despite the defense of the Corporation Counsel of New York City and the filing of three amici curiae briefs on his behalf, Russell's appointment was revoked. This case again reflects the judicial understanding of the potential impact of a teacher on college students. Even if Mr. Russell were to teach mathematics,

> his very presence as a teacher will cause the students to look up to him, seek to know more about him, and the more he is able to charm them and impress them with his personal presence, the more potent will grow his influence in all spheres of their lives, causing the students in many instances to emulate him in every respect.[45]

The argument the court found "most compelling" was that "the appointment of Bertrand Russell has violated the public policy of the state and of the nation because of the notorious immoral and salacious teachings of Bertrand Russell and because [Jean Kay] contends he is a man not of good moral character."[46] "The contention ... that Mr. Russell has taught in his books immoral and salacious doctrines, is amply sustained by the books conceded to be the writings of Bertrand Russell ...."[47] The writings quoted recommend "childless marriages"[48] and pre-marital sex[49] and do not condemn infantile masturbation[50] and homosexuality.[51] The court sees Russell's hiring as an "expenditure that seeks to encourage the violation of the provisions of the Penal Law."[52]

The scathing denunciation of Bertrand Russell by Justice McGeehan of the New York County Supreme Court deserves lengthy quotation.

> The appointment of Dr. Russell is an insult to the people of the City of New York and to the thousands of teachers who were obligated upon their appointment to establish good moral character and to maintain it in order to keep their positions. Considering the instances in which immorality alone has been held sufficient basis for removal of a teacher and mindful of the aphorism "As a man thinking in his heart, so he is," the court holds that the acts of the Board of Higher Education of the City of New York in appointing Dr. Russell to the Department of Philosophy of the City College of the City of New York, to be paid by public funds, is in effect establishing a chair of indecency and in doing so has acted arbitrarily, capriciously and in direct violation to the public health, safety and morals of the people .....[53]

CONCLUSIONS

Conventional legal research is particularly difficult in this area of law. From my discussions with college and university faculty and administration it is clear that in most cases of moral turpitude neither teachers nor schools want the publicity litigation brings. Teachers want to avoid the stain even a charge of moral turpitude brings. Schools do not want it known that such teachers taught at their institutions.

The future of moral turpitude cases is hard to predict. On the one hand, cases upholding dismissal of tenured college and university faculty for moral turpitude often require a sense of violated community values. Therefore, as our society seems to have become one of permissiveness based on concepts of relative ethics, the number of cases has decreased.

On the other hand, a new player may appear on the scene, students, the purported victims of moral turpitude. Especially after Anita Hill's testimony, and the William Kennedy Smith and Mike Tyson rape cases, victims of sexual offenses may be somewhat less reluctant to bring cases. The case provides a monetary incentive to bring cases against schools. At the same time, we appear to be more sensitive to such women's rights issues as sexual harassment. Therefore, the number of litigated moral turpitude cases will probably rise, at least for sexual misconduct cases brought by students against colleges and universities that do not take adequate preventive and corrective measures against sexual misconduct.

ENDNOTES

1. AAUP Statement on Procedural Standards in Faculty Dismissal Proceedings, Introductory Comments (1958).

2. "Our Nation is deeply committed to safeguarding academic freedom, which is of transcendent value to all of us and not merely to the teachers concerned. That freedom is therefore a special concern of the First Amendment, which does not tolerate laws that cast a pall of orthodoxy over the classroom." Keyishian v. Board of Regents, 385 U.S. 589 (1967).

3. California Education Code Section 13403.

4. Goldsmith v. Board of Education, 66 Cal. App. 157, 178, 225 P. 783 (1924).

5. Morrison v. State Board of Education, 1 Cal. 3d 214, 235, 82 Cal. Rptr. 175, 461 P.2d 375 (1969).

6. "The present statement assumes that individual institutions will have formulated their own definitions of adequate cause for dismissal, bearing in mind the 1940 Statement and standards which have developed in the experience of academic institutions." AAUP Statement on Procedurals in Faculty Dismissal Proceedings, Introductory Comments (1958).

7. 1970 Interpretive Comment 9.

8. Miller v. California, 413 U.S. 15, 22 (1973).

9. AAUP Statement on Professional Ethics, The Statement (1966).

10. Lovan, *Grounds for Dismissing Tenured Postsecondary Faculty for Cause*, 10 J. of Coll. and U.Law 419, 422 (1983-84).

11. Kay v. Board of Higher Education of City of New York, 18 N.Y.S. 2d 821, 826, 173 Misc. 943 (New York County 1940).

12. Board of Trustees of Mount San Antonio Junior College Dist. of Los Angeles County v. Hartman, 246 Cal. App. 756, 763, 55 Cal. Rptr. 144 (1966).

13. 161 Cal. App. 3d 734, 207 Cal. Rptr. 589 (1984).

14. Id. at 737.

15. Id. at 744.

16. Id. at 748.

17. It is unclear what the judge means by use of this word. Perhaps he intends "having the nature of prostitution (meretricious relationship)" (Webster's Ninth New Collegiate Dictionary, 1989), but there is no evidence of a quid pro quo in the case.

18. Board of Trustees v. Stubblefield, 16 Cal. App. 3d 820, 825, 94 Cal. Rptr. 318 (1971).

19. Loera v. State Bd. of Higher Educ., 45 Or. App. 715, 609 P.2d 826, 828 (1980).

20. Franklin v. Gwinnett County Public Schools, No. 90-918 (U.S. Feb. 26, 1992).

21. The New York Times, Feb. 27, 1992.

22. The New York Times, March 31, 1992.

23. Board of Trustees of Mount San Antonio Junior College Dist. of Los Angeles County v. Hartman, 246 Cal. App. 756, Cal. Rptr. 144 (1966).

24. Education Code, Section 13403.

25. Id. at 767.

26. Id. at 759-760.

27. Id. at 763.

28. Id. at 760.

29. See Kay, *supra* note 11.

30. Id.

31. Morrison, *supra note 5,* at 217.

32. Palo Verde Unified School Dist. of Riverside County v. Hensey 9 Cal. App. 3d 967, 970, 88 Cal. Rptr. 570 (1970).

33. "Were this an elementary school, these charges might bear more careful scrutiny. However, the defendant was teaching at a junior college level ...." Id. at 973.

34. Id.

35. Id.

36. Id. at 974.

37. Id.

38. Id. at 975.

39. Id.

40. Id. at 976.

41. Board of Trustees of Los Angeles Junior College v. Metzger, 104 Cal. Rptr. 452, 501 P.2d 1172 (1972).

42. Id. at 1173.

43. "[O]ur ruling should not be viewed as insulating permanent teachers from discipline on account of their classroom use of indecent or profane works or writings. Id. at 1176.

44. *Supra* note 11.

45. Id. at 830.

46. Id. at 826. It seems that had he been teaching only mathematics, his private life and writings would have been considered less relevant to his fitness. "It has also been argued that he is going to teach mathematics. His appointment, however, is to the department of philosophy ...."

47. Id. at 827.

48. Id. "It is not necessary to detail here the filth which is contained in the books. It is sufficient to record the following: from "Education and the Modern World," pages 119 and 120: "I am sure that university life would be better, both intellectually and morally, if most university students had temporary childless marriages. This would afford a solution of the sexual urge neither restless nor surreptitious neither mercenary nor casual, and of such a nature that it need not take up time which ought to be given to work."

49. Id. "From "Marriage and Morals," pages 165 and 166: "For my part, while I am quite convinced that companionate marriage would be a step in the right direction, and would do a great deal of good, I do not think that it goes far enough. I think that all sex relations which do not involve children should be regarded as a purely private affair, and that if a man and a woman choose to live together without having children, that should be no one's business but their own. I should not hold it desirable that either a man or a woman should enter upon the serious business of a marriage intended to lead to children without having had previous sexual experience." ("The peculiar importance attached, at the present, to adultery, is quite irrational." From "What I Believe," page 50.)

50. Id. at 830.

51. Id. at 831. "[W]e are confronted with Dr. Russell's utterances as to the damnable felony of homosexualism, which warrants imprisonment for not more than twenty years in New York State, and concerning which degenerate practice Dr. Russell has this to say in his book entitled "Education and the Modern World," at page 119, "It is possible that homosexual relations with other boys would not be very harmful if they were tolerated, but even then there is danger lest they should interfere with the growth of normal sexual life later on."

52. Id. at 828-29.

53. Id. at 831.

FAMILY AND PARENTAL LEAVE STATUTES: A STATUS REPORT

by

Rosemarie Feuerbach Twomey*

INTRODUCTION

Congress was unable to override President Bush's veto of legislation that would have provided mandated leave, upon request, to employees of private companies for "family related" purposes--birth of a child, adoption of a child, or to care for sick or disabled family members. However, nineteen states and the District of Columbia have passed such legislation. Of that number, nine states and the District of Columbia have passed laws mandating leave for both parental and family reasons, and ten states require leave for birth and/or adoption of a child only (parental leave). Congress has vowed to revisit the issue at its next opportunity, and it is highly probable that a federal family leave bill will be passed into law during the Clinton administration.

A comparison of the states' parental and family leave statutes reveals wide variations in provisions. This gives rise to a number of questions. Should the federal government pass a family or parental leave law to insure uniform protection to employees and avoid the problems of wide differences between the laws of one state and the laws of another? Would a Uniform Family Leave Act accomplish the major objectives of a federal statute while still allowing states some discretion to consider the impact of such laws on their unique business environments? Should employers be free of the requirements of any such legislation and, in lieu of those laws, be encouraged through tax benefits or other governmental assistance to provide leave to employees for family related purposes? In light of demographic trends indicating higher percentages of women, minorities, and disabled persons entering into the workforce [1], employers might prefer to offer cafeteria style benefits to their diverse workforces (including, as an option, parental or family leave) rather than be required by law to grant one type of benefit at the risk of having to forego others [2].

The primary focus of this paper is on parental and/or family leave laws, although maternity and pregnancy leave laws

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will also be addressed. Since there are inconsistencies in the labelling of the various types of leaves, it is suggested here that uniform labels be adopted as described below.

The passage of Title VII of the Civil Rights Act of 1964 as amended by the Pregnancy Disability Act led many states to enact statutes requiring that leave be granted to an employee who gives birth. Such leave may or may not include a period of time for the care of the newborn as distinguished from time to heal and recuperate from the act of giving birth. These leaves are usually called "maternity" or "pregnancy" leaves, but are sometimes referred to as "medical," "disability," "parental," "child care," or "family" leaves.

It is recommended here that those labels be refined and used as follows: "Maternity" and "pregnancy" leave should refer to leave for a female employee in relation to the birth of that employee's child. To be in compliance with federal law, such leave should be equal to or greater than, but not less than, leave made available to employees for other temporary disabilities [3]. "Parental" leave should refer to leave which is granted to care for a newborn or newly adopted child. The EEOC uses the term "parental leave" to refer to leave which is taken "to care for a child of any age, or to develop a healthy parent-child relationship, or to help a family adjust to the presence of a newborn or adopted child" [4]. "Family" leave should refer to leave for the purpose of caring for a sick or disabled family member, or for some other family-related reason. "Medical" and "disability" leave should refer to leave for the employee who cannot work due to his or her own temporary disability or illness.

The states' parental and family leave statutes ride a continuum from minimum to maximum concern for employer needs. The statutory provisions of the several family/parental leave laws are presented below with comments indicating which are the most and the least favorable to employers. Also addressed is whether the provisions of the laws pose any significant legal problems; and, where appropriate, comparisons are made with the federal bill which was vetoed by President Bush. The paper concludes with a discussion comparing the advantages and disadvantages of enacting federal law on the subject, formulating a Uniform Parental/Family Leave Act, leaving the matter completely to the states' legislators, or, conversely, discouraging passage of more legislation in this area at either the state or federal level.

The twenty statutes which provide for mandated parental and/or family leave for private sector employees have been divided into two categories: Section I lists and describes those which provide for both parental and family leave, and Section II lists and describes those which require leave only for birth and/or adoption of a child (including maternity and pregnancy leave laws). Section III describes statutory provisions in four states' laws which provide alternative means of addressing family concerns in employment.

For purposes of this paper, only statutes which apply to private sector employers are included. Laws which pertain only to public sector employers are not covered.

I. COMPREHENSIVE STATUTES MANDATING BOTH PARENTAL AND FAMILY LEAVE.

Nine states and the District of Columbia require both parental and family leave. Those states are California, Connecticut, Hawaii, Maine, New Jersey, Oregon, Rhode Island, Washington, and Wisconsin. In analyzing these laws, the following items were selected for comparison:

A. Provisions as to who is a "child" whose birth or adoption triggers the right to mandated leave.
B. The circumstances under which family leave is to be granted.
C. Provisions indicating what constitutes an illness for purposes of family leave.
D. The number of employees needed to bring an employer within the coverage of the law.
E. Employee's rights and remedies under the act.
F. The employee's right to reinstatement.
G. The employer's right to require notice and/or certification to confirm the need for the leave.
H. Length of the mandated leave period.
I. The employer's right to deny or limit leave.
J. Effects of leave on employee benefits.

A. Provisions as to who is a "child" whose birth or adoption triggers the right to mandated leave.

All the statutes in Section I require employers to grant "parental" leave for both birth and adoption of a child. Leave granted for birth of a child always refers to a natural or biological child. With regard to adoption, the statutes differ. California's [5] definition for purposes of adoption includes a requirement of dependency status. Connecticut's [6] definition of child is limited to one who is under the age of 18 or who is a dependent due to inability to care for him or herself. New Jersey [7] and Wisconsin [8] are similar to Connecticut in their definition of child. The District of Columbia's [9] statute mandates leave for an employee with whom a child is placed--even when such placement is not for purposes of adoption, i.e., as long as the employee permanently assumes and discharges parental responsibilities for such a child. As such, it is the only statute which does not require a legal relationship to establish who is a child for either a leave granted when such child is placed with the employee or leave granted to care for such a child upon his or her illness. Maine [10], Rhode Island [11], and Washington [12] limit the definition of child for purposes of adoption by age: for Maine and Rhode Island the child must be 16 years of age or less, and for Washington, 5 years of age or less. Hawaii [13] neither broadens nor limits its definition of child for adoption purposes.

Oregon [14] provides for both parental and family leave in two separate statutes--one which makes it an unlawful employment practice to refuse to grant an employee's request for a parental leave of absence and one which provides for Family Medical Leave. Although Oregon is unlike the above states which provide the parental and family leave benefits in one comprehensive statute, it is included in Section I. Under Oregon's law a child, for purposes of requesting leave for adoption, is one who is under 6 years of age.

Least Favorable to Employers: The District of Columbia's statute gives broadest protection to employees by requiring leave for the placement of any child with an employee, regardless of the existence of a legal relationship with such a child, as long as the employee "assumes and discharges" parental responsibility for such a child.

The federal bill's definition describes a "son or daughter" as a "biological, adopted, or foster child, a stepchild, a legal ward, or a child of a person standing in loco parentis..." [15]. This definition is similar in scope to D.C.'s statute, and would preempt the state laws which have narrower definitions.

Most Favorable to Employers: Rhode Island and Maine, by omitting definitions of child, could be narrowly construed, and thereby benefit employers. Washington and Oregon limit the definition of child in the case of adoption to children 5 years of age or less, the most restrictive of the statutes which limit the definition of child for adoption purposes.

B. The circumstances under which leave is to be granted.

Family leave, which refers to leave granted in order to enable an employee to care for a sick family member, is mandated in all the statutes included in Section I. However, the definitions of family member, child, spouse, and parent differ; the criteria which constitute an illness which entitles an employee to such leave varies; and the states are not in agreement as to whether family leave (with its guarantees of reinstatement and other benefits) includes the right of an employee to take leave for his or her own illness. The questions of when family leave is to be granted and who is considered a family member are addressed first.

Connecticut [16], Maine [17], Rhode Island [18], and Wisconsin [19] provide family leave for the employee's own illness, a logical extension of the concerns expressed in the objectives of family leave laws.

The federal bill includes a provision for leave to an

employee whose serious health condition makes the employee unable to perform the functions of his or her position [20].

All the statutes, except Washington, indicate that an employee is entitled to family leave to care for a serious health condition or serious illness of a child, spouse, or parent of the employee. Under Washington's law [21] employers must grant leave to employees to take care of a newborn or a newly adopted child under the age of 6 or a child under the age of 18 with a terminal health condition. There is no provision for leave to care for a spouse or parent. Interestingly, the law does provide that an employee's accrued sick leave can be used to care for a child under 18 who simply requires "treatment" or "supervision"--no other statute addresses leave to care for a child who is neither seriously nor terminally ill, but only mildly ill.

The District of Columbia [22] has passed the only statute which includes in its definition of family member a child who lives with the employee and for whom the employee permanently assumes and discharges parental responsibility and a person with whom the employee shares or has shared, within the past year, a mutual residence and with whom the employee maintains a committed relationship.

Least Favorable to Employers: The District of Columbia has the broadest definition of family member. It is the only one which includes a person with whom the employee shares or has shared a mutual residence and with whom the employee maintains a committed relationship. In addition, it includes as a child one who lives with the employee and for whom the employee permanently assumes and discharges parental resonsibility. This could include one who is the child of a live-in companion, whether or not a legal or blood relationship exists.

Most Favorable to Employers: Washington does not require that leave be granted for the illness of family members other than the child of the employee.

C. Provisions indicating what constitutes an illness for purposes of family leave.

California [23], Connecticut [24], the District of Columbia [25], New Jersey [26], and Wisconsin [27] have substantially similar definitions for serious health condition or serious illness: an illness, injury, impairment, or physical or mental condition that involves either inpatient care in a hospital or other health care facility, or continuing treatment or supervision by a health care provider. Wisconsin and Connecticut add the adjective "disabling" to the definition, a word that was found to be ambiguous in a Wisconsin case since it could mean any illness or injury that interferes with performance of daily functions, not necessarily one that is limited to long-term illnesses or

conditions. In the same case, it was decided that the employee who took one day off for bronchitis was not entitled to protection from discharge under this law because the illness did not call for outpatient care with "continuing treatment" by a health care provider [28].

The Rhode Island [29] statute defines a seriously ill person as one who by reason of an accident, disease, or condition is in imminent danger of death, or requires hospitalization involving an organ transplant, limb amputation or other procedure of similar severity. Maine's [30] definition is the same, except that it adds a third possibility: a mental or physical condition that requires constant in-home care. The Washington [31] statute, which limits family leave to care for an ill child only, is further limited to a child with a "terminal health condition" one which is caused by injury, disease, or illness, that is incurable and will produce death within the period of the leave. This very restrictive definition is softened somewhat by the state's law which requires employers to allow employees to use accrued sick leave to care for a child who requires treatment or supervision due to a "health condition." Hawaii [32] defines a serious health condition as "an acute, traumatic or life threatening illness, injury, or impairment that requires a physician's treatment or supervision."

Oregon [33] defines serious health condition in more severe terms, such as a condition which poses an "imminent danger of death, is terminal in prognosis with a reasonable possibility of death in the near future," but also includes in the definition the more general "illness of a child of an employee requiring home care" and "any mental or physical condition that requires constant care."

Least Favorable to Employers: California, Connecticut, D.C., New Jersey, and Wisconsin entitle employees to broad protection with regard to reasons for requesting family leave. However, the California law states that the condition must be one which "warrants the participation of a family member to provide the care." An employer could require evidence that the employee's personal presence is necessary to care for the ill family member.

Most Favorable to Employers: Hawaii and Rhode Island allow employees a right to family leave only in very restricted circumstances involving a terminal prognosis for the ill family member.

D. The number of employees needed to bring the employer within the coverage of the law.

The following list shows the number of employees an employer must have in order to be considered an "employer" under the law. They are in order, from the lowest number of employees to the highest. Some of the statutes staggered the

effectiveness of their laws, making the law applicable to employers with a higher number of employees in the first year, and reducing the number in later years (District of Columbia, New Jersey, and Connecticut). The numbers below represent the lowest final numbers provided in the various states' laws.

District of Columbia [34] - 20 or more.
Maine [35] - 25 or more.
Oregon [36] - 25 or more (for its parental leave law).
50 or more (for its family leave law).
California [37] - 50 or more.
New Jersey [38] - 50 or more.
Rhode Island [39] - 50 or more.
Wisconsin [40] - 50 or more.
Connecticut [41] - 75 or more.
Hawaii [42] - 100 or more.
Washington [43] - 100 or more.

Least Favorable to Employers: The District of Columbia's statute applies to a broader base of employers (those with 20 or more employees) than any of the other states' laws. Also broad is Maine (25 or more employees).

Most Favorable to Employers: Hawaii and Washington are the only ones which exclude businesses with less than 100 employees from the law's requirements, indicating a concern about the impact of the law on small businesses.

The federal bill covers employers of 50 or more [44].

E. Employees' rights and remedies under the act.

The extent to which there is statutory language which grants the benefactors of the laws (the employees) specific remedies with which to enforce the rights established in the laws is an indication of the seriousness of purpose which the legislators brought to their deliberations of these parental and family leave statutes. The statutory provisions range from no mention of remedies (in which case it is presumed the employee can take civil action in a court of general jurisdiction) to several clauses allowing for civil penalties, punitive damages, and other relief.

The New Jersey law [45] attempts to balance the interests of business against the state's acknowledged policy of protecting and promoting the stability and economic security of family units. It provides that, in addition to other relief or affirmative action permitted, a penalty of not more than $2000 for a first offense, and not more than $5000 for second and subsequent offenses will be assessed against violators. Also, punitive damages of up to $10,000 for an individual and $500,000 for a class action (or 1% of the net worth of the employer, whichever is less) can be awarded to plaintiffs, as well as reasonable attorney's fees to the prevailing party. If the employer prevails, however, bad

faith must be shown in order recover attorney's fees.

Other states which provide penalties against violators are Rhode Island [46], Washington [47], and Maine [48]. Rhode Island will assess not more than $1000 for each day of a continuing violation; Washington will fine up to $200 for a first infraction and $1000 for each additional; and Maine provides liquidated damages of $100 per day for each day a violation continues.

The District of Columbia [49], Hawaii [50], Wisconsin [51], and Washington employ administrative processes for parties seeking relief under these laws. Washington alone precludes the right of an employee to take civil action, but allows awards of reinstatement and backpay. Wisconsin requires filing with its agency within 30 days of the violation, and an attempt at conciliation will be made before a hearing will be given. After exhausting the administrative process, an employee may take civil action. In the District of Columbia a successful plaintiff may be awarded backpay plus interest, and up to three times that amount in consequential damages, medical expenses not covered by health insurance, and costs and reasonable attorney's fees. If the agency process goes beyond 150 days, the aggrieved employee may file a civil action.

Least Favorable to Employers: New Jersey specifically provides that an employee may seek punitive damages up to $10,000 for an individual. New Jersey also assesses the highest penalty on employers for violations--$2,000 for the first offense and up to $5,000 for each subsequent offense.

The federal bill contains a provision unlike any of the state statutes. It grants standing to any one or more employees for and in behalf of other employees to take action in any Federal or State court of competent jurisdiction against any employer, including a public agency [52].

Most Favorable to Employers: Washington precludes a private right of action for employees, and assesses only a $200 fine for the first employer infraction, and up to $1,000 for each infraction if violations continue. A successful employee may be limited to reinstatement and backpay.

F. Employee's right to reinstatement.

California [53], Connecticut [54], Rhode Island [55], and Wisconsin [56] simply mandate reinstatement of the employee to

his or her former position, or to a position with equivalent duties, pay, benefits, and other terms and conditions of employment. The remaining states, while acknowledging substantially the same right of reinstatement, qualify the right by recognizing exceptions which operate in favor of employers. Hawaii [57] and New Jersey [58] state that reinstatement can be denied if the employer experiences layoffs or workforce reductions and the employee would have lost the position if not on leave pursuant to a bona fide layoff and recall system.

The District of Columbia [59] allows an employer to deny reinstatement to an employee who is among the highest paid 10% of the employer's workforce if the employer can demonstrate that reinstatement would result in substantial economic injury to its operations. Oregon [60] and Washington [61] have similar language stating that if the employer's circumstances have so changed that the employee cannot be reinstated to the former or equivalent job, the employee shall be reinstated to any other position that is available and suitable. Washington's statute goes on to state that the entitlement to reinstatement does not apply if the position has been eliminated by a bona fide restructuring or reduction-in-force, the workplace has been moved to at least 60 miles away or is permanently or temporarily shut down for at least 30 days, or if the employee takes another job, or does not provide timely notice of his or her intent to take family leave, or did not return on the agreed-on-day.

The broadest right to deny reinstatement is found in Maine's [62] law which states that reinstatement can be denied if the employer proves that the employee was not restored because of conditions unrelated to the employee's exercise of rights under this act.

Least Favorable to Employers: The statutes which are silent as to the right of an employer to deny reinstatement could prove most beneficial to employees. These include California, Connecticut, Rhode Island, and Wisconsin.

Most Favorable to Employers: Those statutes which specifically recognize the employer's right to deny reinstatement in particular circumstances are desirable for employers. In particular, Maine's catch-all exception provides a major loophole operating in favor of employers.

The federal bill contains an exemption for certain highly compensated employees--the highest paid 10 percent of the employees employed by the employer within 75 miles of the facility at which the employee is employed--which allows the employer to deny restoration to such employee if it is necessary to prevent substantial and grievous economic injury to the operations of the employer [63].

G. Employer's right to require notice and/or certification to confirm the need for a leave.

All of the statutes require notice of the intent to take a leave unless the reasons for taking the leave are unforeseeable. Connecticut [64] requires 2 weeks' notice; Maine [65] and Rhode Island [66] require 30 days' notice; and the others require "reasonable" notice. Washington [67] is the only state which requires written notice (30 days for parental leave and 14 days for family leave). All except Maine and Rhode Island state that employees should make reasonable efforts in scheduling leave dates to avoid disrupting the employer's business operations.

All the statutes except Rhode Island specifically permit employers to require certification from a physician or health care provider, and Connecticut alone requires that the employee provide a written certificate from a physician stating the nature of the illness and its probable duration. New Jersey [68], Washington, and Wisconsin [69] permit the employer to obtain a second medical opinion at the employer's expense, with New Jersey and Washington adding that if there is a conflict between the two opinions, a third opinion may be sought--in New Jersey such party is chosen jointly. In Washington the third is chosen by the other health care providers.

Oregon [70] and Washington laws provide that if the employee fails to provide notice as required, the employer may reduce the leave period by 3 weeks.

Least Favorable to Employers: By reason of its limited employee notice requirements and its silence regarding the employer's right to require verification from a physician, Rhode Island shows less concern for employers.

Most Favorable to Employers: Washington has a 30-day written notice requirement, a concern for disrupting the business operations of the employer, an allowance for an employer's demand for confirmation from a health care provider, plus the right of the employer to punish an employee who fails to abide by the notice requirements.

H. Length of mandated leave period.

The length of the mandated leave periods fall between 2 weeks in a 1-year period to 16 weeks in a 2-year period. In order from the shortest to the longest, they are:

Wisconsin [71] - 2 weeks in a 1-year period for family leave.
6 weeks in a 1-year period for parental leave.
8 weeks in a 1-year period for a combination of leaves.

Hawaii [72] - 4 weeks in a 1-year period.

Maine [73] - 10 weeks in a 2-year period.

New Jersey [74] - 12 weeks in a 2-year period.

Washington [75] - 12 weeks in a 2-year period.

Oregon [76] - 12 weeks in a 2-year period for family leave.
12 weeks in a restricted period of time for parental leave.*

Rhode Island [77] - 13 weeks in a 2-year period.

Connecticut [78] - 16 weeks in a 2-year period.

District of Columbia [79] - 16 weeks in a 2-year period.

California [80] - 4 months in a 2-year period.

* Oregon's statute requires an employee to take the parental leave between the birth of the infant and the time the infant reaches 12 weeks of age. If the child was born prematurely, the 12-week period will be extended to the time the child will have reached the developmental stage equavalent to 12 weeks of age. For adoptions, the leave must be within the 12-week period which begins when the employee takes physical custody of the child.

The federal bill provides a total of 12 workweeks of leave during any 12-month period [81].

Least Favorable to Employers: California, Connecticut, and the District of Columbia permit the longest leave periods for employees.

Most Favorable to Employers: Wisconsin provides only 2 weeks in a 1-year period for family leave, by far the shortest leave period of all the statutes.

I. Employer's right to deny leave.

The statutes of California [82], Connecticut [83], the District of Columbia [84], New Jersey [85], Oregon [86], and Washington [87] specifically recognize the right of employers to deny parental and/or family leave to employees in certain situations. The California, Connecticut, Oregon, and Washington laws allow employers to restrict the combined leave of a husband and wife to the maximum leave period provided for one employee (in some states, even though they may work for different employers). In California, if an employee's spouse is unemployed, the employee cannot take a leave. Likewise, in Oregon leave can be denied to an employee if another family member is available to be a caregiver. In Oregon, Washington, and California the employer can deny leave to a husband and wife simultaneously (in some states, whether or not they work for the same employer).

Employers in California, the District of Columbia, New Jersey, and Washington can deny leave to high paid employees when necessary to avoid substantial economic injury to the employer's operations. In California and the District of Columbia this would include an employee who is one of the 5 highest paid or is among the top 10% in gross salary. In New Jersey it means an employee who is salaried and among the highest paid 5% or one of the 7 highest paid employees, whichever is greater. In Washington it includes up to 10% of the workforce who are designated (in writing and displayed in a conspicuous place) as "key personnel," or the highest paid 10% of the employees.

New Jersey has inserted a punitive clause in its parental/family leave statute stating that no employee shall, during the leave period, perform services on a full-time basis for any person for whom the employee did not provide those services immediately prior to taking leave. However, no sanctions are given for violators.

Least Favorable to Employers: Hawaii, Maine, Rhode Island, and Wisconsin have no provisions specifically granting employers the right to deny parental and family leave in given circumstances or to certain classes of employees.

Most Favorable to Employers: California, New Jersey, and Washington recognize at least two types of situations in which employers can deny parental or family leave to employees. Additionally, California has as open-ended provision which would permit an employer to deny leave if it would result in undue hardship to the employer's operations.

J. Effects of leave on employee benefits.

Preservation of rights and benefits which have accrued up to the commencement of a leave period is standard for all the parental/family leave statutes. The laws differ in regard to whether or not they require continuation of benefits during the leave period. The District of Columbia [88], New Jersey [89], Rhode Island [90], and Wisconsin [91] statutes indicate the employers shall continue certain benefits for employees while on leave.

New Jersey's law specifically states that the employer shall maintain coverage under a group health insurance policy, a group subscriber contract, or a health care plan at the level and under the conditions coverage would have been provided if the employee had continued to work. The law was challenged and was found to be pre-empted by the Employee Retirement Income Security Act with regard to any plans which would come within the jurisdiction of the federal

law [92]. The legal issue of pre-emption would apply to several other of the state's statutes with similar provisions.

For the protection of employers, some states have a provision that employees pay to the employer a sum of money equal to the amount of the insurance premiums which will be paid during the time of the leave. Rhode Island makes this payment a statutory requirement, adding that the employer shall return such payment to the employee within 10 days following the employee's return to work. Wisconsin permits employers to require an escrow payment for this purpose.

California [93], Washington [94], and Oregon [95] have provisions which specifically absolve employers from requirements of continuing benefits during leave. California allows employers to refuse to make pension or retirement contributions during the leave. Washington's law states, "Nothing in this act shall be construed to require the employer to grant benefits, including seniority or pension rights, during any period of leave." Both states acknowledge the employees' rights to continue group health insurance plans at the employee's expense. Finally, under Oregon's law benefits are not required to accrue during the leave.

Maine's [96] law requires that employers make it possible for employees to continue benefits at the employee's expense.

Least Favorable to Employers: Statutes which mandate continued benefits during the leave period include those of the District of Columbia, New Jersey, Rhode Island, and Wisconsin.

Most Favorable to Employers: Rhode Island indicates a concern for the employers' protection by requiring employees to make a prior payment to employers for the cost of continuing benefits for the duration of the leave period. California, Washington, and Oregon allow employers to refuse to continue certain benefits during that period.

II. STATES MANDATING LEAVE FOR PREGNANCY, CHILDBIRTH, ADOPTION OR CARE OF A NEWBORN OR NEWLY ADOPTED CHILD ONLY. (These statutes contain no provisions for care of an ill family member.)

The following statutory provisions reflect a deliberate effort to abide by civil rights requirements concerning sex and pregnancy discrimination. It is somewhat ironic that in an attempt to comply with those laws, several states have enacted laws which appear to violate those very laws. Part of the problem stems from the fact that it is legally necessary to treat pregnancy and childbirth the same as other temporary disabilities are treated, and that treating pregnancy more favorably than other temporary disabilities met with approval by the U.S. Supreme Court [97]. Since pregnancy and childbirth are biologically associated only with the female

gender, many of the statutes grant benefits such as leave only to female employees. As long as the benefits are tied to the related medical condition of pregnancy and childbirth, there is no legal problem with granting them only to females. However, as stated earlier, by mixing child care leave with pregnancy and childbirth leave, and granting the benefit only to females, there can be a sex discrimination violation of Title VII as well as a potential constitutional question of equal protection [98].

The following statutes are presented in alphabetical order with code cite accompaniments for reference. Many are part of comprehensive fair employment practice or civil rights statutes. Key words have been highlighted to enable the reader to scan the significant facts.

Iowa: The Iowa Civil Rights Act requires that pregnant employees be given leave for their period of disability or for 8 weeks, whichever is less [99].

Kansas: The state's law against discrimination has been interpreted to require employers to grant a reasonable period of leave to female employees for childbearing and to reinstate her to her original (or like) position after leave [100].

Kentucky: The Fair Employment Practices law requires an employer to grant a reasonable leave up to six 6 weeks to care for an adopted child under the age of 7 [101].

Louisiana: Under a pregnancy discrimination law, an employer is required to grant a reasonable leave up to 4 months for disability for pregnancy or a related medical condition [102].

Massachusetts: Maternity leave shall be granted to a female employee for birth or the adoption of a child under the age of 18, or if the child is physically or mentally disabled, under the age of 23. The employee shall be restored to her original position or a similar position with the same status, pay, length of service credit and seniority. However, this does not apply if there is a layoff [103].

Note: Massachusetts' law is likely to be in violation of the federal Civil Rights Act, Title VII. The EEOC recently warned that leaves granted to females only, which are not limited to pregnancy, childbirth, or related medical conditions, may be in violation of the sex discrimination prohibitions of the law [104]. Clearly, a leave granted to a woman for the purpose of adoption does not involve a medical condition and is only for child care. It therefore should also be made available to male employees in order to be in compliance with federal law.

Minnesota: Leave shall be granted to an employee who is a natural or adoptive parent in conjunction with the birth or adoption of a child. The leave may begin not more than 6

weeks after the birth or adoption [105].

The act covers employers with 21 or more employees at at least one site [106].

The length of the leave period is 6 weeks [107].

In addition to remedies otherwise provided by law, a person may bring a civil action to recover any and all damages recoverable at law, together with cost and disbursements, including reasonable attorney's fees, as well as injunctive and other equitable relief at court's discretion [108].

The employee shall be entitled to return to his or her former position or a position of comparable duties, number of hours, and pay. However, if the employer experiences a layoff and the employee would have lost a position pursuant to a bona fide layoff and recall system, the employee is not entitled to reinstatement, but retains all other rights under the system as if the employee had not taken the leave [109].

The leave shall begin at a time requested by the employee. The employer may adopt reasonable policies governing the timing of requests for unpaid leave [110].

The employer shall continue to make coverage available to the employee, while on leave, under group insurance, group subscriber contract, or health care plan for the employee and dependents. Nothing in this act requires the employer to pay the costs [111].

Montana: Under the state's Fair Employment Practices law, an employer must grant a reasonable leave for pregnancy/maternity, the length to be determined on a case-by-case basis. The employee must be reinstated to her original or equivalent position [112].

New Hampshire: Under the state's law against discrimination, leave is to be granted for temporary disability due to pregnancy, childbirth or a related medical condition and to reinstate the employer to the same or a comparable position unless business necessity makes it impossible or unreasonable [113].

Tennessee: An employer must grant a full-time female employee up to 4 months leave for pregnancy, childbirth, and nursing of her infant and reinstate her to her original or similar position unless the position is so unique it cannot be temporarily filled after reasonable efforts have been made or if the employee has used the leave to pursue other employment or has worked full-time for another employer during the leave. The act specifically excludes male employees from taking "maternity leave" [114].

Vermont: Under the state's pregnancy leave law, an employer must grant up to 1 year to a female employee during pregnancy and following birth and reinstate her to the same or comparable position. An employee may seek relief for violation of the act in a private civil suit [115].

Commentary: Because providing leave for childcare to females and not to males has been ruled as sex discrimination

under federal law [116], states which run the risk of being invalidated include: Kentucky and Massachusetts (both of which mandate leave for female employees for adoption), and Vermont (which mandates leave for female employees for up to a period of 1 year (unless it is clearly granted only when a related medical condition is involved).

III. ALTERNATIVE STATUTORY PROVISIONS ADDRESSING FAMILY CONCERNS IN EMPLOYMENT.

The following statutory provisions are included to illustrate that other possibilities exist for addressing the need for family concerns in the context of employment. Creative legislators should be encouraged to propose statutory schemes which may better address the needs of employees with family obligations than the ones already enacted.

California: Up to 4 hours per year must be granted for visits by an employee to his or her child's school. Employers may require a signed document verifying the visit [117].

Connecticut: In conjunction with its family and parental leave law, the state's Department of Labor shall report on the feasibility of establishing a statewide job bank of replacement employees available to work for temporary periods of time [118].

Oregon: The Oregon family leave law is not applicable if the employer offers to the employee a nondiscriminatory cafeteria plan, as defined by the IRS Code, providing as one of its options a parental leave benefit that is at least equivalent to the benefit required by this act [119].

Nevada: It is a misdemeanor to terminate an employee who is a parent, guardian or custodian of a child and who (1) appears at a conference requested by an administrator of a school or (2) is notified during work of an emergency regarding the child by a school employee [120]. In addition, it is an unlawful employment practice to fail or refuse to grant leave to a pregnant female employee if such a benefit is provided to employees for other medical reasons [121].

COMMENTS AND CONCLUSIONS

The foregoing statutes, with their varied and sometimes conflicting definitions, remedies, and even major provisions, pose a challenge for large, interstate employers who must deal with the numerous requirements relating to their employer-employee relationships. One solution would be for Congress to successfully pass a family/parental leave bill. Proponents of a national policy on parental leave are concerned about balancing the needs of America's young children against the other demands made on their working parents--demands which lead to the need for two-income

families and working mothers [122]. Others recognize a need for a policy to help employees who choose to care for aging parents at a time when costs of health and nursing care are rapidly increasing and people are living longer.

There is reason to believe that a federal law which would provide minimum benefits and/or leave to employees would be acceptable to employers. Many large corporate businesses already make parental/family leave available to their workers and, as women become a larger portion of the workforce, management will respond to their needs in order to retain them. A recent study of 700 firms conducted by the National Chamber Foundation of the U. S. Chamber of Commerce revealed that 77 percent of the firms implemented policies that addressed the parental leave needs of workers [123]. The benefits to employers of making family/parental leave available to the workforce include greater productivity, better quality of job performance, and reductions in absenteeism, tardiness, turnover, and stress.

A federal law would establish uniform regulations to ease the burden on interstate employers. However, although the federal bill contains a preemption provision, it makes clear that states which pass leave laws more favorable to employees shall not be superseded by the federal law. The problem of conflicting statutory requirements would therefore still exist. A Uniform Family/Parental Leave Act may better address this problem. Those states wanting to insure some measure of job security for workers in the face of increasing family responsibilities and rising health costs, could turn to the Uniform Act and select from alternative provisions those which best fit their needs. Although the states may choose different options, there would be a standardization of definitions, remedies, and language which would make both compliance and enforcement more effective.

Although small businesses have voiced opposition to a federal mandatory leave law on the basis of cost, the fact that all the states' leave laws as well as the proposed federal bill require only unpaid leave, leads others to believe that the cost burden is exaggerated. A major argument of small business is that when a business is required by law to offer one type of benefit for its workforce, the effect is to make it more costly to offer varied benefit packages for workers with different needs. It has been suggested that a better alternative to mandated leave is to provide tax credits to employers who provide such leave [124].

The United States has been compared unfavorably to other western industrialized nations regarding its national and state policies on employment security issues, in general, and parental leave, in particular. Most of those nations provide medical care or health insurance for pregnancy, and have maternity leave benefits which include a specified leave before and after childbirth, in addition to replacement of all or some of the wages lost during the leave and a guarantee of

job reinstatement [125]. Although in those countries the burden is shared by the taxpayers rather than by employers, mandated unpaid leave may not be too high a price to pay to preserve the economic and social wellbeing of the American family. Proponents of these laws regard them as reasonable minimum requirements which would secure the jobs of employees whose family responsibilities might otherwise lead to loss of employment, compounding already stressful situations.

In conclusion, the objectives of parental and family leave laws can be met through either a federal statute or through the continued enactment of statutes in the individual states. The present situation can be problematic for large interstate businesses since the statutes present an array of requirements which makes it difficult for such organizations to comply. A Uniform Family/Parental Leave Act is a possible alternative solution to that problem.

Beyond the statutory schemes presented above are other alternatives which could be explored by employers, such as company-provided child care, flexible work schedules for working parents, home work, and job sharing arrangements. Legislators could consider other creative solutions to the problem, such as tax credits to parents for childcare expenses, tax benefits to employers to encourage policies aimed at helping employees who are burdened with family responsibilities which affect their employment, or laws similar to Nevada's and California's which require employers to be flexible in regard to employees who must attend to the educational needs of their children by meeting with school personnel during working hours.

The challenge for legislators at both the national and state level is to fashion laws which can satisfactorily meet the needs of both employees and employers and at the same time accomplish the larger, societal objectives of a productive workforce without compromising the employees' ability to meet family obligations outside of the workplace.

ENDNOTES

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7. N.J. Stat. Ann. Sec. 34:11B-3a and h (West 1990).

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12. Wash. Rev. Code Sec. 49.78.020 (1) and (7) (1989).

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15. H.R. Rep. No. 102-816, 102nd Cong., 2nd Sess. Title I, Sec. 101(13) (1992).

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55. R.I. Gen. Laws Sec. 28-48-3(a) (1990).

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58. N.J. Stat. Ann. Sec. 34:11B-7 (West 1990).

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MAKING SENSE OF RULES 10b-5 AND 14e-3

by

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I. Introduction

Now that the "go-go" eighties are gone and Michael Milken[1] and Ivan Boesky[2] and other high profile securities traders have served time in jail, the relative calm in Wall Street "wheeling and dealing" presents a wonderful opportunity for Congress to finally clarify insider trading law.[3] Although the newspapers have been full of insider trading stories[4] and numbers of highly publicized insider trading cases have come before the courts,[5] Congress has never clarified what insider trading is and what specific behavior should be prohibited. Leaving these "details" to the Securities and Exchange Commission (SEC) and the courts has resulted in wrangling between the former and the latter and in a body of law that does not make much sense.

This article will first discuss the Congressional purpose and methods for prohibiting insider trading. Then, SEC Rules 10b-5 and 14e-3 will be explained and compared. The comparison will show that the statutes authorizing the SEC to promulgate those rules are not identical and, therefore, the letter of the law does not require those rules to be interpreted identically. Nevertheless, there is no policy reason to have rules prohibiting insider trading vary depending on whether or not the securities being traded are the subject of a tender offer. Therefore, this article concludes that Congress, in order to create coherent insider trading law, should explicitly indicate which of the two rules has been properly interpreted by the courts. Application of the rules is difficult enough without having the additional burden of incongruous policy.

II. Prohibiting Insider Trading

Congress has made clear its intention to stop insider trading as well as other market practices it considers abusive in order to maintain public confidence in the fairness of the securities markets.[6] The stock market crash

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of October 19, 1987 magnified the importance of encouraging public confidence in the security markets.[7] That event, together with the dramatic increase in insider trading cases in the 1980's[8] and a public perception that inside traders are not caught,[9] made Congress intent on doing battle against insider trading.[10]

Peculiarly, although legislating against insider trading,[11] Congress has purposefully declined to define statutorily what insider trading is.[12] The House Committee on Energy and Commerce has defined insider trading as "trading in the securities markets while in possession of 'material' information (generally, information that would be important to an investor in making a decision to buy or sell a security) that is not available to the general public."[13] The rationale for refusing to enact into law this or any other definition is to avoid restricting the reach of securities laws and to avoid facilitating schemes designed to circumvent the intent of the laws.[14] Using general antifraud provisions rather than a specific definition has, as noted approvingly by the House Committee, permitted courts to construe the prohibitions broadly and the SEC to use its rulemaking authority creatively.[15] Moreover, according to the House Committee, court decisions and SEC actions have sufficiently clarified principles of insider trading law.[16]

Unfortunately, since that House Committee report in 1984, the law has become more confusing rather than more lucid. This is particularly so because a recent opinion of the United States Court of Appeals for the Second Circuit interpreting Rule 14e-3[17] is at odds with the United States Supreme Court's interpretations of Rule 10b-5.[18]

III. Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934[19] provides, in pertinent part, that

> [i]t shall be unlawful for any person ...
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[20]

Pursuant to that section the SEC promulgated Rule 10b-5[21] which provides, in pertinent part, that

> [i]t shall be unlawful for any person ...
> (a) to employ any device, scheme, or artifice to defraud,...
> (c) to engage in any act, practice or course of business which operates ... as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[22]

Although nowhere specifically prohibiting insider trading, these general antifraud provisions have been the primary bases for lawsuits against those who have bought or sold securities while in possession of material, nonpublic information about those securities.[23] Because Congress has declined to be specific about the prohibitions on insider trading, it has been left to the SEC and courts to determine what fraud means in this context.

The SEC determined in re Cady, Roberts & Co.[24] that the common law imposes on corporate officers, directors, other insiders, and "tippees" who are privy to the same information as insiders, a duty to disclose material, nonpublic information before trading in their company's securities.[25] The United States Supreme Court has also looked to the common law definition of fraud and has used it in interpreting Section 10(b) and Rule 10b-5.[26] In Chiarella v. United States[27] the Court held that one who trades in securities using material, nonpublic information is committing fraud, and violating Rule 10b-5, only if he or she has a duty to disclose the information and such a duty arises only from a relationship of trust and confidence.[28] Thus, traders have no obligation to reveal material facts to those with whom they are doing business if they are neither insiders nor fiduciaries.[29] According to the Court, silence cannot be fraudulent absent a duty to disclose and duties arise only from some special relationship.[30]

Chiarella, who was employed by a financial printer, was able to deduce from documents he handled at work, the names of companies that were the targets of corporate takeovers.[31] Without disclosing his knowledge, Chiarella bought the target firms' stock which he sold at a profit after the takeover bids were made public.[32] The Court reversed his conviction of violating Section 10(b) and Rule 10b-5 holding that Chiarella's use of the nonpublic information was not fraud because he did not have a duty to disclose it before trading.[33] The Court declined to rule on a theory, that had not been presented to the jury, that Chiarella violated the securities laws because he breached a duty that his employer had to the acquiring corporation.[34]

Chief Justice Burger, in dissent, asserted the theory that those, like Chiarella, who misappropriate material, nonpublic information have an affirmative duty to disclose the information before trading.[35] Such a theory, he opined, would not limit legitimate professional securities activities, but would prohibit the use of information inaccessible to others by legal means.[36] Justice Blackmun, in dissent, also asserted that "persons having access to confidential material information that is not legally available to others generally

are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities. To hold otherwise ... is to tolerate a wide range of manipulative and deceitful behavior."[37]

In Dirks v. SEC[38] the Supreme Court reiterated that "mere possession of nonpublic information does not give rise to a duty to disclose or abstain; only a specific relationship does that."[39] The Court also repeated its rejection of a parity of information rule which would require that traders refrain from trading if they are in possession of information unavailable to others.[40] The Court held that a tippee, one who receives information from an insider, has a duty to disclose or abstain from trading that derives from the duty of the insider.[41] Thus, a tippee's duty not to trade on material, nonpublic information arises from an insider's duty to shareholders and attaches only when the tippee knows or should know of the insider's breach of duty.[42]

What is clear from Chiarella and Dirks is that Rule 10b-5 liability requires the breach of a duty by one who trades on material, nonpublic information; mere possession of material, nonpublic information by one who trades on that information in the securities markets is not enough for liability. The misappropriation theory of liability outlined by former Chief Justice Burger adheres to this general formula but does not require that the breach be of a duty owed to buyers or sellers of securities.[43] The breach may be of a duty owed to an employer,[44] to a patient[45] or to a relative,[46] for example. Rule 10b-5 liability, according to this theory, attaches when people engage in securities transactions using material, nonpublic information they have misappropriated from any owner of that information in violation of a fiduciary duty or other relationship of trust and confidence. The misappropriation theory has been adopted by the Second, Third, Seventh and Ninth Circuits.[47] It has not been definitively approved by the United States Supreme Court.[48]

In 1991 the United States Court of Appeals for the Second Circuit, sitting in banc, decided United States v. Chestman,[49] a case that illustrates the difficulties courts have in making sense of insider trading law as it currently exists. The occurrences that gave rise to the lawsuit began in November, 1986 when Ira Waldbaum, the president and controlling shareholder of Waldbaum, Inc., a publicly traded company, negotiated the sale of the company to the Great Atlantic and Pacific Tea Company, Inc. (A&P).[50] Mr. Waldbaum told his sister, Shirley Waldbaum Witkin, that he would tender her shares of Waldbaum stock as part of the sale so that she could avoid the complications of tendering after the public announcement.[51] He warned her not to discuss the impending sale with anyone.[52] On November 24 Mrs. Witkin gave her stock certificates to her brother. Later that day, Mrs. Witkin told

her daughter, Susan Loeb, in response to questions about her whereabouts that morning, that she had gone out to turn over her Waldbaum stock to her brother. Mrs. Witkin also told her daughter that it was important that she not tell anyone except her husband because it could jeopardize the sale.[53] Mrs. Loeb told her husband, Keith, and warned him not to tell anyone.[54]

On November 26 Keith Loeb called Robert Chestman, a stockbroker and financial advisor for Gruntal & Co., a brokerage house.[55] Loeb had been doing business with Chestman since 1982 and Chestman knew that Loeb's wife was Ira Waldbaum's niece.[56] According to Loeb's testimony, some time between 9 and 10:30 in the morning he told Chestman that he "'had some definite, some accurate information' that Waldbaum was being sold at a 'substantially higher' price than the market value of the stock."[57] Between 9:49 a.m. and 12:35 p.m. that day Chestman purchased 11,000 shares of Waldbaum stock (including 3000 for himself, 1000 for Loeb, and 7000 for his other discretionary accounts) at prices ranging from $24.65 to $26.00 per share.[58] Chestman denied having spoken to Loeb that morning.[59] At the close of trading on November 26 the tender offer was announced and on November 27 the price of Waldbaum shares rose to $49.00.[60]

During an SEC investigation into the Waldbaum transactions, Loeb agreed to cooperate with the government, paid a fine, and disgorged the profits from his 1000 share purchase.[61] Chestman denied any wrongdoing, claiming his November 26th Waldbaum purchases were based on his research.[62] Chestman was tried and convicted of, inter alia, ten counts of fraudulent trading in connection with a tender offer in violation of Rule 14e-3 and ten counts of securities fraud in violation of Rule 10b-5.[63] He was barred from the securities industry and turned over to the government $235,125 in gains from the Waldbaum transactions.[64] He voluntarily began serving a two-year sentence in Allenwood Federal Prison Camp in June 1988 and was released in May 1989 after his conviction was reversed by a three-judge panel of the Second Circuit Court of Appeals.[65]

After the SEC and federal prosecutors complained that the Chestman decision would hamper their efforts to prosecute other insider trading cases, the Second Circuit agreed to the unusual measure of a full court review.[66] The court heard oral arguments in banc on November 9, 1990 and handed down its opinion on October 7, 1991.[67] The full court vacated the panel's decision on, inter alia, the Rule 14e-3 and Rule 10b-5 questions and then affirmed the convictions for fraudulent trading in connection with a tender offer, but reversed the Rule 10b-5 convictions.[68] Judge Meskill, writing for the court, was joined by four other judges and a fifth concurred.[69] Five judges concurred in the Rule 14e-3 convictions but dissented from the reversals of the Rule 10b-5 convictions.[70] One judge concurred with the Rule 10b-5

reversals but dissented from the Rule 14e-3 affirmances.[71]

Chestman's Rule 10b-5 convictions had been based on (1) his purchase of Waldbaum stock for Keith Loeb "aiding and abetting Loeb's misappropriation of nonpublic information in breach of a duty Loeb owed to the Waldbaum family and to his wife Susan;" and, (2) his purchase of Waldbaum stock for himself and other clients resulting from his being a tippee of the misappropriated information.[72] Based on the past Rule 10b-5 jurisprudence of Chiarella, Dirks and the misappropriation theory, the full court concluded that Chestman could not be convicted of violating the Rule unless Keith Loeb had breached a duty owed to his wife and/or her family because of a fiduciary-like relationship of trust and confidence, and Chestman knew of Loeb's breach.[73] The court then concluded that kinship alone does not create the required relationship and that there was no evidence offered that Loeb had a fiduciary-like relationship with his wife or her family nor that he had expressly agreed to keep confidential the information about the impending sale of the family business.[74] Without Loeb's having breached a duty by disclosing the information about Waldbaum's to Chestman, Chestman could not be liable for violating Rule 10b-5.[75]

Nevertheless, the Second Circuit affirmed Chestman's convictions for violating Rule 14e-3.[76] The court was able to so affirm while reversing the Rule 10b-5 convictions because of the different language of the two Rules and their authorizing statutes, as supported by other evidence of Congressional intent.

IV. Rule 14e-3

Section 14(e) of the Securities Exchange Act of 1934[77], which was enacted as part of the Williams Act in 1968[78] and amended to its current version in 1970,[79] provides that

> [i]t shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.[80]

Section 10(b) and Section 14(e) are similar. The former prohibits the use of manipulation or deception in connection with the purchase or sale of securities.[81] The latter prohibits manipulation or deception or fraud in connection with a tender offer.[82] Both sections specifically authorize the SEC to promulgate rules designed to prevent the prohibited activities.[83]

Faced with the difficulty of prosecuting insider trading cases after the Chiarella decision because of the duty requirement, the SEC promptly promulgated Rule 14e-3 pursuant to Section 14(e) in October 1980.[84] Many of the highly publicized insider trading cases involved buying shares of publicly traded companies just before tender offers for those shares were made public and then selling the shares at a substantial profit after the offer was announced.[85] If Section 10(b) required the SEC to prove that such traders were breaching a duty in using the nonpublic information for personal gain or that they obtained their information from others who were breaching a duty for personal advantage, then the SEC would use Section 14(e) instead to prosecute such insider trading cases. Contrary to the requirements the Supreme Court established in Chiarella for a Section 10(b), Rule 10b-5 prosecution, Rule 14e-3 says that in a situation involving a tender offer, trading by persons in possession of material, nonpublic information which they know or should know was acquired from insiders constitutes prohibited conduct.[86] There is no specification that such trading is prohibited only if the insider is breaching a duty created by some relationship of trust and confidence and the trader knows of the breach.

In Chestman, the Second Circuit addressed the validity of Rule 14e-3.[87] The court emphasized the deference given to an administrative agency's regulation promulgated under an express Congressional delegation unless the regulation is "'arbitrary, capricious, or manifestly contrary to the statute.'"[88] The court then considered whether Congress authorized the SEC to enact Rule 14e-3.[89] After analyzing the plain meaning of the words of Section 14(e), the legislative history of the Section and subsequent legislation, it concluded that Congress did so authorize.[90]

Section 14(e) directs the SEC to "define ... such acts and practices as are fraudulent, deceptive, or manipulative."[91] Congress' specific use of the term "define", rather than "explain" or "give examples of" or "enumerate" or "identify and regulate",[92] must mean that the SEC is being authorized to determine what acts and practices are fraudulent in the context of tender offer activity. In this connection, where the concern is maintaining securities markets that are fair, and appear to be fair, to the investing public, there is no purpose for requiring a breach of a fiduciary duty to any particular person or corporation as an element in a trading violation. The Congressional purpose in prohibiting insider

trading is to have the securities markets be fair so that the investing public will have confidence in their integrity and keep investing in them.[93] Thus, it is reasonable that Congress would have authorized the SEC to tinker with a definition of fraudulent acts and practices to make it suit the particular problem addressed by the Williams Act. The Second Circuit concluded that the words of the statute, particularly "define", are dispositive.[94] At the very least, that word makes it difficult to conclude that Rule 14e-3 is "arbitrary, capricious, or manifestly contrary to the statute."[95]

In addition, Judge Meskill, writing for the court, noted support for his interpretation of Section 14(e) in the legislative history of the 1970 amendment.[96] He also pointed to legislative activity since the promulgation of Rule 14e-3, specifically the Insider Trading and Sanctions Act of 1984 (ITSA)[97] and the Insider Trading and Securities Fraud Enforcement Act (ITSFEA),[98] as indicative of the Rule's validity.[99] The legislative histories of ITSA and ITSFEA specifically mention Rule 14e-3 with tacit approval.[100] In fact, the House Energy and Commerce Committee noted its intention that the SEC adopt a rule under ITSA similar to Rule 14e-3.[101] The whole tone of these legislative histories evidences Congress' primary interest in strengthening enforcement against inside traders by giving the SEC broad authority and flexible laws with which to work.[102]

Nevertheless, critics have argued that Section 14(e) cannot be significantly distinguished from Section 10(b) and, therefore, interpretations of the latter also set precedent for the former.[103] The argument asserts that when the United States Supreme Court in Chiarella ruled that there can be no Rule 10b-5 violation by trading on material, nonpublic information absent a duty to speak, the Court was creating law that also applies to Rule 14e-3.[104]

V. Reconciling Rule 10b-5 and Rule 14e-3

Because the language of Sections 10(b) and 14(e) are not the same, it is not a stretch to conclude, as the Second Circuit did, that Chiarella's interpretation of the former does not necessarily set precedent for the latter. Section 14(e) instructs the SEC to "define ... acts and practices as are fraudulent,"[105] a much more "compelling legislative delegation"[106] than exists in Section 10(b). This strong, clear language combined with Congress' subsequent extended considerations of insider trading law and passage of ITSA and ITSFEA make it hard to dispute Congress' intent to eliminate insider trading and to allow the SEC a great deal of flexibility in pursuing that objective.[107] That intent supports the validity of Rule 14e-3.

Unfortunately, acceptance of Rule 14e-3 as a valid

exercise of SEC authority, although making it easier for the SEC to prosecute insider trading cases, creates an incoherent body of insider trading law. If the Congressional purpose in enacting insider trading laws is to maintain the integrity of financial markets so that outsiders will keep investing, then there is no reason to have liability attach with greater requirements under Rule 10b-5 than under Rule 14e-3 merely because the latter regulates trades in the context of tender offers. Outside investors may perceive themselves to be at an unfair disadvantage, and decline to invest in the securities markets, whenever they believe the markets are controlled by others who have access to any material, nonpublic information, unless that access is achieved through particular diligence, intelligence or inexplicable fortuity. Holding investors liable for inside trading only when they have breached a duty or have used information obtained from someone else who breached a duty will permit many trades which threaten the integrity of the markets. For example, if the information Chestman received from Loeb was about a revolutionary new product or marketing concept Waldbaum's was about to reveal, instead of about a pending tender offer, Rule 14e-3 would not have been applicable and Rule 10b-5 would not have been violated under the Second Circuit's analysis of Loeb's absence of a duty. Nevertheless, outside investors would have been similarly disadvantaged because of their lack of access to information Chestman obtained through his special relationship with Keith Loeb. The inconsistencies in the interpretations of the two rules resulted in the Second Circuit's peculiar decision in Chestman: (1) Chestman was guilty of being an inside trader because he traded on material, nonpublic information concerning a pending tender offer that he knew or should have known came from an insider and that is a violation of Rule 14e-3; but, (2) Chestman was not guilty of fraud in connection with the purchase and sale of his Waldbaum stock because Keith Loeb, from whom Chestman obtained the material, nonpublic information on which he traded, did not breach a fiduciary-type duty to his wife in disclosing the information; therefore, there was no Rule 10b-5 violation.[108]

It is reasonable for both Rule 10b-5 and Rule 14e-3, in view of the Congressional purpose of achieving fairness and the perception of fairness in the securities markets, to create liability for trading on material, nonpublic information whenever it has been acquired in a way that is not legally available to the general investing public. The idea of unfair informational advantage serving as the basis for insider trading violations has been circulating for more than a decade.[109] This theory responds to the basic Congressional purpose and to the psychology of investors. It obviates the need for creating artificial theories of liability,[110] that do not reflect the aim of protecting investors, in order to catch inside traders who seem to elude standard interpretations of fraud.

The practical problem is, however, that a significant body of law, relying on common law definitions of fraud, already exists for Rule 10b-5.[111] The Second Circuit's solution in Chestman was to interpret Rules 10b-5 and 14e-3 differently relying on the differences in language in their authorizing statutes, but eschewing a discussion of policy reasons for the varying interpretations.

VI. Conclusion

It is time for Congress to define fraud, or to expressly empower the SEC to do so, in the context of all insider trading securities transactions. There is no policy reason for Sections 10(b) and 14(e) and the rules promulgated under them to be interpreted differently. There is no policy reason for the rules of common law fraud to govern securities law liability. There is no policy reason for insider trading to be illegal only when a duty is breached. The actual threat to public participation in security markets is the perception that insiders and their friends have access to information that puts all others at a disadvantage when transacting purchases or sales in the securities markets.

Therefore, liability under Rules 10b-5 and 14e-3 should attach when the method of acquisition of the information is wrongful. Achieving an informational advantage should be wrongful when it is the result of some special relationship and, therefore, is not lawfully available to the investing public. An informational advantage achieved through mere good fortune[112] or extra diligence or superior intelligence could be traded on lawfully without prior disclosure. Congress' clear statement to this effect would help to achieve the goal of fair securities markets and would clarify for investors when disclosure before trading is required.

1. See, e.g., Review and Outlook: SEC Bounty Hunters?, Wall St. J., May 9, 1991, at A14.

2. See, e.g., Connie Bruck, The World of Business: No One Like Me, The New Yorker, Mar. 11, 1991, at 40.

3. See, e.g., Wade Lambert, Ann Hagedorn & Kevin Salwen, Amid Court Reversals, Securities Law Cops Grow More Cautious, Wall St. J., July 25, 1991, at A1; Kevin Salwen & Laurie P. Cohen, Getting Tough: SEC under Breeden Takes a Harder Line on Securities Crime, Wall St. J., June 10, 1990, at A1.

4. Supra note 3 & infra note 5.

5. See, e.g., Ellen Joan Pollock & Wade Lambert, SEC Accuses Former Arbitragers of Insider Trading, Wall St. J., Mar. 11, 1991, at B8; Laurie P. Cohen & James P. Miller, SEC Accuses New York Lawyer, Henry Singer, of Insider Trading, Wall St. J., June 29, 1990, at B6; Wade Lambert & Edward Felsenthal, Insider-Trading Rule Extends to Therapy, Wall St. J., May 17, 1990, at B10; SEC Files Charges against B. F. Saul III, Former Roommate, Wall St. J., May 10, 1990, at A14.

6. H.R. Rep. No. 910, 100th Cong., 2d Sess. 7, reprinted in 1988 U.S. Code Cong. & Ad. News 6043, 6044 [hereinafter H.R. Rep. No. 910]; H.R. Rep. No. 355, 98th Cong., 2d Sess. 3, reprinted in 1984 U.S. Code Cong. & Ad. News 2274, 2275-79 [hereinafter H.R. Rep. No. 355].

7. H.R. Rep. No. 910, supra note 6, at 6044.

8. H.R. Rep. No. 910, supra note 6, at 6048.

9. H.R. Rep. No. 355, supra note 6, at 2279.
Although the term "insider" used to refer to officers, directors and beneficial owners of a corporation, it now clearly includes outsiders who use confidential information to generate security trading profits. Regan, Pension Fund Perspective - Outsider Trading, Fin. Analysts J., Sept.-Oct. 1990, at 12.

10. Supra note 6.

11. Insider Trading and Securities Fraud Enforcement Act, Pub. L. No. 100-704, 102 Stat. 4677 (1988); Insider Trading Sanctions Act, Pub. L. No. 98-376, 98 Stat. 1264 (1984).

12. H.R. Rep. No. 355, supra note 6, at 2286.

13. H.R. Rep. No. 355, supra note 6, at 2275.

14. H.R. Rep. No. 910, supra note 6, at 6048.

15. H.R. Rep. No. 355, supra note 6, at 2276-86.

16. Id. 2286 n. 20 (specifically noting Rule 14e-3, United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983)(relying on misappropriation theory), and SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983)(relying on temporary insider theory)).

17. United States v. Chestman, 947 F.2d 551 (1991).

18. Infra notes 27-34, 38-42 and accompanying text.

19. 15 U.S.C. § 78j(b) (1982).

20. Id.

21. 17 C.F.R. § 240.10b-5 (1988).

22. Id.

23. See, e.g., United States v. Carpenter, 484 U.S. 19 (1987); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971); In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

24. 40 S.E.C. 907 (1961).

25. Id. at 911-12.

26. Chiarella v. United States, 445 U.S. 222, 227-28 (1980).

27. 445 U.S. 222 (1980).

28. Id. at 227-28.

29. Id. at 229-30.

30. Id. at 232.

31. Id. at 224.

32. Id.

33. Id. at 231.

34. Id. at 236.

35. Id. at 240.

36. Id. at 240-43.

37. Id. at 251.

38. 463 U.S. 646 (1983).

39. Id. at 656 n. 15.

40. Id. at 657.

41. Id. at 659.

42. Id. at 660.
In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the United States Supreme Court analyzed the language and legislative history of Section 10(b) and concluded that Rule 10b-5, which is authorized by Section 10(b), cannot prohibit merely negligent conduct, that proof of scienter is required. Id. at 212-14.

43. United States v. Newman, 664 F.2d 12, 17 (1981).

44. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd, 484 U.S. 19 (1987) (financial columnist breached duty to employer newspaper); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (copyholder breached duty to employer printing company); United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (securities trader breached duty to employer brokerage firm).

45. United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990) (psychiatrist breached duty to patient, trading on information obtained from patient in analysis sessions).

46. United States v. Redd, 601 F. Supp. 685 (S.D.N.Y.), rev'd on other grounds, 773 F.2d 477 (2d Cir. 1985) (son breached duty to father who was corporate director).

47. See, e.g., SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985), rev'd on other grounds after remand, 808 F.2d 252 (1986), cert. denied, 481 U.S. 1017 (1987); United States v. Newman, 664 F.2d 12, aff'd after remand, 722 F.2d 729 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983).

48. It was an evenly divided Court which affirmed the securities fraud convictions based on the misappropriation theory in United States v. Carpenter. 484 U.S. 19, 24 (1987).

49. 947 F.2d 551 (2d Cir. 1991).

50. United States v. Chestman, 903 F.2d 75, 77 (2d Cir. 1990), vacated, 947 F.2d 551 (2d Cir. 1991) (in banc).

51. Id.

52. Id.

53. Id.

54. Id.

55. Id.

56. Id.

57. Id.

58. Id.

59. Id. at 77-78.

60. Id. at 78.

61. Id.

62. Id.

63. Id.

64. Regan, Pension Fund Perspective - Outsider Trading, Fin. Analysts J., Sept.-Oct. 1990 at 12; Amy Dockser Marcus & Wade Lambert, Chestman's SEC Settlement, Wall St. J., Mar. 6, 1991, at B4.

65. Wade Lambert, Court Puts Brake on Insider-Trading Cases, Wall St. J., May 3, 1989, at B7.

66. Wall St. J., Nov. 12, 1990, at B5. The Second Circuit had only one other rehearing in banc argued in 1990, United States v. MacDonald, 916 F.2d 766 (2d Cir. 1990), cert. denied, 111 U.S. 1071 (1991).

67. United States v. Chestman, 947 F.2d 551 (2d Cir. 1991).

68. Id. at 571.

69. Id. at 554, 582.

70. Id. at 571.

71. Id. at 583.

72. Id. at 564.

73. Id.

74. Id. at 567-70.

75. Id. at 571.

76. Id.

77. 15 U.S.C. § 78n(e) (1976)(as amended by the Williams Act, Pub. L. No. 90-439, 90th Cong., 2d Sess., 82 Stat. 454 (1968), which regulates tender offers).

78. Pub. L. No. 90-439, 82 Stat. 454 (1968).

79. Pub. L. No. 91-567, 84 Stat. 1497 (1970).

80. Id.

81. Supra notes 19-20 and accompanying text.

82. Supra notes 77 & 80 and accompanying text.

83. Supra notes 19, 20, 77, 80 and accompanying text.

84. Adoption of Rule 14e-3, 45 Fed. Reg. 60410 (1980). Rule 14e-3, 17 C.F.R. § 240.14e-3 (1988), provides in pertinent part:

Transactions in securities on the basis of material, nonpublic information in the context of tender offers.

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) the issuer of the securities sought or to be sought by such tender offer, or (3) any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise. . . .

(d)(1) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section except that this paragraph shall not apply to a communication made in good faith.

(i) To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer;

(ii) To the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or

(iii) To any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

(d)(2) The persons referred to in paragraph (d)(1) of this section are:

(i) The offering person or its officers, directors, partners, employees or advisors;

(ii) The issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or advisors;

(iii) Anyone acting on behalf of the persons in paragraph (d)(2)(ii); and

(iv) Any person in possession of material information relating to a tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from any of the above.

See also 569 Sec. Reg. & L. Rep. (BNA) A-2 (1980).

85. See, e.g., United States v. Carpenter, 484 U.S. 19 (1987); Chiarella v. United States, 445 U.S. 222 (1979).

86. Supra note 84.

87. Chestman, 947 F.2d at 556.

88. Id. at 557 (quoting Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843-44 (1984)).

89. Id. at 558.

90. Id. at 557-60.

91. 15 U.S.C. § 78n(e) (1981).

92. The dissent in Chestman claims the only power given to the SEC is to "identify and regulate" the "acts and practices" that are "fraudulent, deceptive, or manipulative." 947 F.2d at 584.

93. See 134 Cong. Rec. S17219-20 (daily ed. Oct. 21, 1988) (statement of Sen. D'Amato) (supporting Insider Trading and Securities Fraud Enforcement Act of 1988 because insider trading undermines investor confidence in integrity of securities markets and fairness is essential foundation of markets); 134 Cong. Rec. E3078-79 (daily ed. Sept. 23, 1988) (speech of Rep. Markey) (supporting Insider Trading and Securities Fraud Enforcement Act of 1988 because insider trading undermined public trust in fundamental fairness and integrity of securities markets and it is most important to assure average investor of fairness); 113 Cong. Rec. 24,664 (1967) (statement of Sen. Williams) (supporting amendment to Securities Exchange Act of 1934 adding inter alia subsection (e) to Section 14 and noting that securities markets thrive when they enjoy confidence of investing public); Richard M. Phillips & Robert J.Zutz, The Insider Trading Doctrine: A Need for Legislative Repair, 13 Hofstra L. Rev. 65, 65 (1984) (stating that insider trading doctrine interpreting federal securities laws presupposes investor expectations of fairness in securities markets) [hereinafter Phillips & Zutz]; Spencer Derek Klein, Note, Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence, 16 Hofstra L. Rev. 665, 666-68 & n.8 (1988) (noting importance of investor confidence in securities markets and central role of insider trading abuses therein) [hereinafter Note - Hofstra].

94. Chestman, 947 F.2d at 558.

95. Id. at 557 (quoting Chevron, U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837, 843-44 (1984)).

96. Id. at 559 (noting remarks of Senator Williams and Chairman of SEC).

97. Insider Trading Sanctions Act, Pub. L. No. 98-376, 98 Stat. 1264 (1984).

98. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).

99. Chestman, 947 F.2d at 560.

100. H.R. Rep. No. 910, 100th Cong., 2d Sess. 7, reprinted in 1988 U.S. Code Cong. & Ad. News 6043, 6051 [hereinafter H.R. Rep. No. 910]; H.R. Rep. No. 355, 98th Cong., 2d Sess. 3, reprinted in 1984 U.S. Code Cong. & Ad. News 2274, 2284 [hereinafter H.R. Rep. No. 355].

101. H.R. Rep. No. 355, supra note 100, at 2284.

102. H.R. Rep. No. 910, supra note 100; H.R. Rep. No. 355, supra note 100. But see Brent G. Stahl, Note, Rule 14e-3: Invalid in the Criminal Context, 16 Am. J. Crim. L. 367, 376-77 (asserting that legislative histories of ITSA and ITSFEA do not support validity of 14e-3). The Note's reliance on the small quantity of references in the histories to the Rule to prove that they do not indicate Congress' intent with reference to the Rule is misplaced. Those references must be interpreted in light of the general tenor of the histories and the resulting legislation. Viewed from that perspective, Congress' outrage at highly publicized inside traders, their intent to proceed vigorously against all inside traders, and their reliance on the SEC to use broad authority in so doing is patent.

103. See, e.g., Chestman, 947 F.2d at 586 (Mahoney, J., dissenting).

104. Id.

105. 15 U.S.C. § 78n(e) (emphasis added).

106. Chestman, 947 F.2d at 558 (2d Cir. 1991).

107. Supra notes 97-102 and accompanying text.

108. Chestman, 947 F.2d at 571.

109. The definitive work is Victor Brudney, Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws, 93 Harv. L. Rev. 322 (1979). See also Chiarella, 445 U.S. at 251 (Blackmun, J., dissenting).

110. For example, the misappropriation theory was advanced by Chief Justice Berger in his dissent in Chiarella. 445 U.S. at 240. Under that theory, one is liable for trading on material, nonpublic

information obtained illegally or obtained legally and then illegally misappropriated for personal use. Phillips & Zutz, supra note 93, at 86-93; Barbara Bader Aldave, Misappropriation: A General Theory of Liability for Trading on Nonpublic Information, 13 Hofstra L. Rev. 101, 122 (1984).

Under a constructive insider theory one "who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading." Dirks, 463 U.S. at 656. See Phillips & Zutz, supra note 93, at 93-95.

The breach of duty under each of these theories, however, is not to the investing public and, therefore, each is a rather roundabout way of protecting the public. Under the misappropriation theory the wrong is to the rightful possessor of the information. Under the constructive insider theory the wrong is to the corporate shareholders.

111. See, e.g., United States v. Carpenter, 484 U.S. 19 (1987); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Industries v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); SEC v. Texas Gulf Sulphur C., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

112. An example of "mere good fortune" is inadvertently, while waiting on line at the movies, overhearing a conversation about a particular corporation's business, and then, in reliance on the overheard information, buying shares of the corporation's stock. The corporate information on which Chiarella traded, on the other hand, was not obtained because of Chiarella's "mere good fortune." It was available to him because of his special relationship as an employee of the corporation's printing contractor.

CAN DEMAND NOTES REALLY BE DEMANDED?

by

Peter M. Edelstein*

Introduction

Facts: ABC Bank lends $100,000 to B. Benny. B. Benny executes and delivers to the bank a negotiable promissory note payable "on demand". ABC later demands payment. B. Benny refuses. ABC sues B. Benny for $100,000. B. Benny defends on the grounds that reasonable notice was required and not given.

Issue: Whether a holder of a demand note can demand payment at any time?

Decision: Maybe.

A "demand note" is an instrument payable on demand and includes those payable at sight or on presentation and those in which no time for payment is stated.[1] By its nature, and as reflected in long accepted case law and in the U.C.C., a demand note entitles the holder to freely determine the time for payment. In fact, such a note is actually due on the date it is made, and it has been suggested that its name is misleading in that no actual prior demand is necessary to enforce payment.[2]

Questions concerning a holder's ability to require payment of a demand note at any time arise because of two apparently inconsistent rules of law and because the intent of the parties is not always clear. A two step analysis is called for: (1) what is the effect of the applicable provisions of the Code? and, (2) what is the intent of the parties?

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The Problem

U.C.C. Section 1 - 203, embodies a principle long a part of the common law of contracts,[3] by imposing an obligation of good faith with respect to all transactions covered by the Code: "Every contract or duty within this Act imposes an obligation of good faith in its performance and enforcement." Good faith is defined as "honesty in fact in the conduct or transaction concerned".[4] Since negotiable notes are covered in Article 3 (Commercial Paper) and security agreements in Article 9 (Secured Transactions), one could fairly assume that demand notes are subject to the requirement of good faith.

The Official Comment to Section 1-208, however, proves this assumption to be incorrect. Section 1-208, entitled "Option to Accelerate at Will", imposes the requirement of good faith on a party, who among other things, desires to accelerate payment or performance "at will" or "when he deems himself insecure." The Official Comment states: "Obviously, this section has no application to demand instruments <u>whose very nature permit call at any time with or without reason</u>".[5] (emphasis added).

While the authors of the Code could have been more precise by setting forth the two rules in the body of Article 2, the Official Comment is not unclear. The obligation of good faith simply does not apply to demand instruments. Determining whether a demand instrument exists, based on the intent of the parties may not be so clear.

A "pure" demand note is simple and classic and by its terms is due "on demand". In the absence of any inconsistent language, either within or without the instrument, it may be called at any time with or without reason. By contrast, there is the note which was born as a demand note, but may have been bastardized into something else.

Consider a demand note which contains a provision that it is due on demand, but if no demand is made, the note is payable "at a certain date"; or a demand note which contains a default interest rate which is "due and payable at maturity, on demand or otherwise"; or a demand note given in conjunction with the execution and delivery of a loan agreement which contains covenants, ratios, and other requirements, the default of which constitutes an "event of default".

Since a court will look to the documents as a whole to determine the intent of the parties, it might conclude when reviewing the foregoing examples that the parties did not, in fact, intend the instrument to be payable on demand. The court might wonder why the parties agreed to such additional and unnecessary language if the note was really due on demand? These "demandable" types of notes have been labelled "impure"[6] demand notes and can become a lender's worst nightmare.

<u>Shaughnessy v. Mark Twain State Bank</u>, addressed this issue and concluded that the so-called "demand note" in question was not entitled to be treated as one:

> "First, the words "[o]n demand, and if no demand is made, then on the" are printed on the form, but according to the note's language the date February 16, 1980 is typewritten in. Second, the interest rate is prime plus two but after the note becomes "due and payable (whether at maturity, on demand or otherwise)" the interest rises to prime plus three. In addition, paragraph 16 of the deed of trust lists eight events which constitute default. The deed itself recites 26 paragraphs of covenant by Shaughnessy. The deed then states that defaults or failure to perform the covenants shall cause the obligation to become due and payable regardless of maturity. Again, we apply the court's analysis [in an earlier case] to underscore the point that a demand note is, on issue, due. Further, Shaughnessy, in the security ... agreement, agreed that failure to pay at maturity constituted default. Therefore, had the note been a demand note it would be mature and Shaughnessy would have been immediately in default. Likewise, with the deed of trust language, if this were a demand note, the note would not need default for it to be due and payable at the option of the bank. It would already have been due."[7]

Once the conclusion is reached that the instrument alleged by the lender to be a demand instrument is not entitled to be treated as such, the U.C.C. requirements of good faith apply by virtue of U.C.C. Section 1-203. In the context of commercial instruments this means that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract".[8] This obligation to protect the legal expectations of a party translates, in the case of demand notes,into an obligation to give fair notice to the borrower before requiring payment.

<u>K.M.C. Co., v. Irving Trust Company</u>,[9] did not directly deal with the right of the lender to demand its note, but did require "the exercise of reasonableness" and "valid business judgment"[10] in electing to terminate a line of credit under an agreement by which the loan was payable on demand.

K.M.C., a wholesale grocer, entered into a financing agreement with Irving Trust Company ("Irving") whereby Irving agreed to provide a line of credit, in its discretion, up to $3.5 million. The loan was due on demand and was secured by all of K.M.C.'s accounts receivables and inventory. The

proceeds of all of K.M.C.'s receivables were required to be deposited into a "blocked account" to which only Irving had access.

K.M.C. requested an advance of $800,000, which was available under its line. Irving, which was fully collateralized, refused and eventually K.M.C. was forced to liquidate its business.

K.M.C., in its lawsuit against Irving alleged, among other things, that Irving breached its implied duty of good faith and fair dealing by terminating the line without notice. Irving defended by arguing that since the line was due on demand and that because advances were discretionary, it could terminate the line at any time.

The court found for K.M.C. The jury awarded K.M.C. $7.5 million in damages on the theory that Irving breached its implied duty of good faith and fair dealing by not giving K.M.C. notice of its intention to terminate the line.

The court noted that even though the obligation of K.M.C. was evidenced by a demand note (to which the obligation of good faith under the U.C.C. did not apply), provisions in the loan agreements indicated that the parties did not actually intend the instrument to be due on demand. The existence of financial covenants and events of default required that Irving exercise discretion, in good faith.

The court held:

> "The record clearly established that a medium-sized company ... such as K.M.C. could not operate without outside financing. Thus, the literal interpretation of the financing agreement ... as supplemented by the "blocked account" mechanism, would leave K.M.C.'s continued existence entirely at the whim or mercy of Irving, absent an obligation of good faith performance ... Logically, at such time as Irving might wish to curtail financing K.M.C., as was its right under the agreement, this obligation to act in good faith would require a period of notice to K.M.C. to allow it a reasonable opportunity to seek alternative financing ..."[11]

Avoiding the Problem

The problem, once recognized, is subject to avoidance by early and thorough attention to drafting. If a pure demand note is intended, care should be taken not to include any language inconsistent with the right to demand at any time, for any reason, or for no reason.

If the transaction requires a demand instrument together

with other loan documents, use a pure demand instrument together with clear and specific "saving" language in another document stating that the note is due on demand, in all events, and that any other language is to be construed cumulatively for the lender's benefit and not in derogation of its right to demand without notice. Any apparently inconsistent language may be justified as serving to assure the continued credit-worthiness of the borrower or to provide the borrower with notice of circumstances when the note is likely to be called.

The issue will never arise if you use a time instrument together with such due dates, events of default, default interest rates and covenants, and like provisions, as you wish.

Related Problems

"Discretionary advances" language is subject to an analysis similar to demand notes. Even where the language of the loan documents makes advances discretionary, the lender may be required, by the rules of good faith and commercial reasonableness (as in K.M.C.), to give the borrower fair notice that future advances will not be made.

If other terms in the loan documents require commitment fees or periodic payments, for example, a court might find these provisions inconsistent with the right to make discretionary advances, and infer an obligation on the part of the lender to make the advances.

To avoid this issue, consider using language in the loan documents which commit the lender to make the advances, instead of making them discretionary, but make the agreement subject, in each instance, to the borrower's satisfaction of a list of conditions (ratios, performance standards, affirmative and/or negative covenants, absence of default, etc.) which will give the lender sufficient comfort.

The right to accelerate the entire indebtedness in the event of default usually causes no problems. The risk lies with the use of language permitting acceleration "at will" or when "insecure". The U.C.C., in Section 1-208, states that the lender may accelerate at will or when it deems itself insecure <u>only if it believes in good faith that the prospect of payment or performance is impaired</u> (emphasis added).

If the lender accelerates pursuant to an "acceleration at will" clause the file should support the belief, in good faith, that the loan is in jeopardy. As noted above, this U.C.C. section does not apply to demand instruments, therefore, to avoid the issue consider, when appropriate, casting the instrument as "demand' and avoiding the use of the "at will" language, or alternatively, using a time instrument

with well-defined events of default tied to performance standards.

Like the "acceleration at will" language, an "insecurity" clause is subject to the provisions of U.C.C. Section 1-208, requiring the lender to believe in good faith that the prospect of repayment or performance is impaired. To cover this situation, include in the loan documents a definition of "insecure" or set forth those acts or events which would render the lender insecure; for example, state that a breach of a covenant requiring certain financial ratios to be maintained renders the lender insecure. Your client's file should then contain information evidencing the breach and supporting the determination of insecurity before the loan is called. Better yet, do not use or rely upon the"insecurity" clause. Whatever would make the lender feel insecure should be included as an event of default, in the case of a time instrument; or use a pure demand instrument to which the U.C.C. section does not apply.

Conclusion

The K.M.C. decision and subsequent cases[12] constitute notice to the bar that the courts will not consider the title of the instrument to be determinative of the intent of the parties. If the instrument is a pure demand instrument and there exists no documentary evidence indicating otherwise (ratios, covenants, events of default, etc.), the courts will not impose an obligation of good faith. Where, however, notwithstanding the title of the instrument, the intent of the parties is clear from other related agreements, the instrument may be held not to be a demand instrument, but a "demandable" instrument, and subject to the obligations of good faith.

At least one author has stated that "... it is rarely, if ever appropriate to document a commercial loan transaction with a demand note ...".[13] This suggestion surely deserves more than casual consideration. It is a common feeling by lenders that a demand note gives them more control over their money and its repayment. They feel that by being able to demand repayment at any time they can constantly monitor the credit-worthiness of their borrowers. Well, while this may seem to make sense, consider the following:

1. Case law (K.M.C.) tells us that the demandable instrument may not be subject to demand without reasonable notice.

2. The same control and monitoring can be obtained by the use of time instruments with performance standards (tied to events of default) covenants, and ratios.

3. Most importantly, as a matter of fairness and equity, what business person, dealing at arms length would

ever voluntarily execute and deliver a demand note which could have the effect, if demanded without notice, of causing it substantial economic difficulties?

ENDNOTES

1. U.C.C. §3-108.

2. Halt & Willier, "Commercial Paper" in 2 Bender's U.C.C. Serv. §5.02[2] (1988).

3. Restatement (Second) of Contracts, §205. See also: Palisades Properties, Inc. v. Brunetti, 44 NJ 117, 207 A2d 522, 531 (1965).

4. U.C.C. Section 1-201(19).

5. See: Centerre Bank of Kansas City, NA v. Distributors, Inc., 705 SW2d 42 (Mo. Ct. App. 1985).

6. "The Law of Lender Liability", Helen Davis Chaitman, published by Warren, Gorham & Lamont, 1990, §2.01[4][a][ii].

7. Shaughnessy v. Mark Twain State Bank, 715 SW2d 944, 951 (Mo. Ct. App. 1986).

8. Palisades Properties, Inc. v. Brunetti, 44 NJ 117, 207 AD2d 522, 531 (1965).

9. K.M.C. Co., Inc. v. Irving Trust Company, 757 F2d 752 (6th Cir. 1985).

10. Id at 761. See: Centerre Bank of Kansas City, NA v. Distributors, Inc., 705 SW2d 42 (Mo. Ct. App. 1985).

11. Id, at 759 - 760.

12. See: Reid v. Key Bank of Southern Maine, Inc., 821 F2d 9 (1st Cir. 1987); MSV, Inc. v. Bank of Boston, 87 BR 752 (Bankr. D. Mass. 1988); Spencer Cos v. Chase Manhattan Bank, N.A., 81 BR 194 (D. Mass 1987).

13. "The Law of Lender Liability", Helen Davis Chaitman, published by Warren, Gorham & Lamont, 1990, §2.01[4][a].

A SUGGESTED APPROACH TO HANDLING ESCROW ACCOUNTS FOR LAWYERS

by

Winston Spencer Waters and Frederick D. Heiman*

This article reviews the controlling law as it pertains to the new rules for establishing and maintaining escrow accounts in New York State. This article illustrates the accounting system which should be employed by presenting a suggested approach for the practicing attorney in any judicial department. For purposes of discussion, emphasis is placed on the rules of the Appellate Division, Second Judicial Department because it has the most stringent requisites in the State. Consequently, the rules of the Appellate Division, Second Judicial Department are explored in greater depth, particularly with respect to the illustration outlined herein. These requirements are summarized herein, followed by a hypothetical set of facts used to illustrate the methodology suggested by the authors. The suggested record keeping should satisfy any disciplinary committee conducting an investigation into an attorney's financial records relating to his practice.

In November, 1988, the Appellate Division of the Supreme Court, Second Judicial Department, enacted the new rules governing the Conduct of Attorneys with respect to financial recording.[1] These rules were originally published in the New York Law Journal.[2]

Throughout New York State, all judicial departments require that attorneys maintain in a bank or trust company in New York State a special account separate and apart from any business or personal accounts.[3] The formal name for such accounts in New York State is "IOLA" (Interest on Lawyer Account).[4] The IOLA is an outgrowth of the State Agency which uses accrued interest on lawyers escrow accounts to fund non-profit agencies which provide civil legal services for the poor and programs that serve to enhance the judicial system.[5] This account is required in every judicial department.[6] This account is used primarily for short-term money being held in escrow.[7] If the lawyer is a fiduciary in another capacity, e.g., conservator, receiver, etc., the funds should be invested in an interest bearing account as opposed to IOLA.[8]

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The escrow account is required to be opened in the attorney or firm name.[9] The rule requires that such escrow account be separate from any account which such attorney or firm maintains in a fiduciary capacity such as an executor, guardian, trustee or receiver, or in any other such fiduciary capacity.[10] The rule further requires that the deposit slips be maintained for each in a separate and distinguishable manner.[11]

All records of deposits and withdrawals must be maintained for seven years.[12] Records must include the date, source and description of each item deposited as well as the date, payee and purpose of each withdrawal or disbursement.[13]

The manager of such records should keep a record of all funds deposited, the names of all persons for who the funds were held, the amount of such funds, the description and amounts, and the names of all persons to whom such funds were disbursed in a separate ledger.[14]

Sanctions will be imposed for the failure to maintain escrow account records.[15] Failure to maintain a ledger book or similar records for an escrow account are grounds for discipline.[16] Failure to preserve books and records evidencing the identity of funds of clients previously held in escrow are grounds for discipline.[17] Moreover, failure to account for funds would likewise be grounds for discipline.[18]

In the Second Judicial Department, if an attorney places money to be held in escrow in a personal or business account with the intent to leave money designated and approved by the client for disbursements; withdrawing the amount claimed attributable to the client and placing it in another personal account; then finally placing it in an escrow account is grounds for discipline[19] In Matter of Rolnick, on October 23, 1985, the attorney received $15,000 which was to be used for reimbursement of legal fees paid by his clients, members of a tenant association. The attorney claimed that $5,000 was owed to him to cover his disbursements. On November 2, 1985, the attorney deposited $10,000 of the $15,000 in a savings account at Crossland Savings Bank, and $5,000 of the $15,000 in a separate savings account at the same bank. Both accounts were entitled "Sy L. Rolnick." Thereafter, the attorney withdrew the $10,000 plus interest and deposited that sum into a certificate of deposit at the American Savings Bank. He later closed out the certificate of deposit and placed the

$10,000 plus interest in an escrow account at Manufacturers Hanover Trust Company on December 12, 1986. As of January 2, 1987, he was obligated as escrow agent to be holding that $10,000 in escrow. However, on that day the funds on deposit totaled only $5,945.52.

The disciplinary committee charged the attorney with not only failing to maintain the $10,000 balance in the escrow account but charged him with breaching his fiduciary duty in failing to deposit his client's funds in a special account separate from his personal account.[20] The sanction was disbarment.[21]

Likewise, the First Department has held that failure to properly maintain trust accounts coupled with conversion of client funds warrants disbarment.[22] The First Department held that in the absence of extremely unusual mitigating circumstances, failure to maintain escrow records, i.e., depositing escrow funds into a separate account and the intentional conversion of funds belonging to a client or a third party is so egregious in nature as to warrant disbarment.[23] Lack of income due to surgery in a solo practice is not a sufficient mitigating circumstance.[24] The unrealized expectation of receipt of funds to cover a defalcation coupled with a failure to preserve the identity of funds will not excuse such a serious breach of trust.[25] Interestingly, the First Department has held that failure to adequately supervise an associate with respect to deposit and handling of funds received on behalf of an estate coupled with failing to preserved the identity of an estate's funds, and failing to have an estate's funds deposited into an escrow account or estate account only warrants censure.[26] Moreover, this department has been so inconsistent that censure has been held to be sufficient where the attorney committs escrow account violations, coupled with misleading clients as to the status of their cases, as well as other professional misconduct.[27]

Interestingly, not all departments are in agreement that disbarment should result from either the failure to (1) maintain an escrow account; (2) maintain accurate records, or (3) maintain an accurate escrow account balance. In Matter of Purser, the Third Department merely suspended an attorney for failure to maintain records of deposits and withdrawals from his escrow account as well as his failure to maintain a balance of $44,000 in his escrow account.[28] This was not an isolated incident, the same department again merely suspended an attorney from the practice of law even though he was suppose to be holding $50,000 on deposit and at

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one time had a negative balance.[29] Additionally, there were other occasions where the Third Department displayed leniency when an attorney failed to maintain an escrow account and ledger books with supporting records.[30] Yet, in other instances, the Third Department has held that conversion of client funds, commingling, failure to maintain adequate records, deceiving other attorneys, failing to cooperate with and misleading the disciplinary committee would warrant disbarment.[31]

The Fourth Department has held that failing to maintain true and correct records of a client's fiduciary account coupled with the balance of an escrow account falling below the amount belonging to his client and on at least two occasions, the account having been overdrawn warrants suspension.[32] This same department held that an attorney withdrawing $50,000 for a client's trust account and depositing it into the firms general operating account would support a finding of impermissible commingling, but not conversion, for purposes of disciplinary proceeding, although the amount due the firm for its fee had already been withdrawn from its trust account, only warrants censure.[33] There are many other instances of lenient treatment of trust account violations in this department.[34]

Finally, maintaining escrow funds in a safety deposit box is insufficient to avoid discipline[35] Failure to maintain an escrow account may result in disbarment.[36] Failure to deposit assets which should be placed into an escrow account is grounds for disbarment coupled with other violations of the Code of Professional Responsibility.[37] In other factual situations failure to deposit escrow funds only warrants suspension.[38]

In cases where an attorney maintains two offices for the practice of law in two different states, there is a duty to deposit escrow funds in an account in the State of representation.[39] Mismanagement of an escrow account will not preclude the sanction of disbarment.[40]

Lastly, a lawyer cannot retain interest on an escrow account. It is further required by the rules that an attorney maintain a separate business account for office and miscellaneous expenses. In

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maintaining records in the law office, an attorney should have the journals noted herein available and in use on a daily basis in the law office.

II. Illustration

The following is a hypothetical set of facts used to illustrate the methodology suggested by the authors which is applicable based on the rules of the Second Judicial Department and should satisfy the rules for attorneys in the other three departments.

Fred Nash has a neighborhood law office in Nassau County, New York. Fred is engaged in the private practice of law as a sole practitioner. He handles criminal and civil matters. His civil matters include personal injury cases, contract cases and litigation. He serves as an attorney for a receiver. He also represents clients of several real estate brokers in the area. The following is a diary of money received and disbursed by him during the period: July, 1991 through January, 1992.

July 16, 1991 — He received a retainer in the amount of $2,000.00 from W. Wainwright in defense of of breach of contract action.

July 17, 1991: He draws a draft from his escrow account in the amount of $900 for services rendered in Coe v. Wainwright.

August 1, 1992: He draws a draft from his escrow account in the amount of $300.00 for services rendered in the matter of Coe v. Wainwright.

August 15, 1992: He draws a draft from his escrow account in the amount of $300.00 for services rendered in Coe v. Wainwright.

September 7, 1991: He settled a civil fraud case in the amount of $12,000.00 in the matter of Bent v. Witter. His fee is one third less expenses in the amount of $1,000.00. He draws a draft for the balance payable to Ms. Bent.

October 5, 1991: He settled a civil personal injury case in the amount of $17,500.00. His fee is one third less expenses in the amount of $1,168.00. He draws a draft for the balance payable to Mr. Moyer.

October 16, 1991: He settled a civil personal injury case in the amount of $8,500.00. His fee is one third less expense in the amount of $450.00. He draws a draft for the balance payable to Mrs. Deleaver.

December 21, 1991: He received $10,000.00 as a fee from a receivership on invoices dated, November 2, 1991 and November 27, 1991.

December 27, 1991: He settles a breach of contract case for ABC Co. in the amount of $5,000.00. His fee is one third less expenses in the amount of $500.00.

January 15, 1992: He draws a draft from his escrow account in the amount of $300.00 for services rendered in the matter of Coe v. Wainwright.

January 28, 1992: He settled a personal injury case in the matter of Bullock v. Carrao in the amount of $10.000.00. His fee is one third less expenses in the amount of $350.00.

On the same day, he settled a personal injury action in the matter of Bullock v. Winston in the amount of $5,000.00. His fee is one third.

The minimum records needed by Fred Nash are:

A. Fred Nash Escrow Bank Account (EBA) and

Fred Nash General Bank Account (GBA)

B. An Escrow Account:

- Checkbook (ECB) out of which all checks drawn on the escrow bank account will be written.
- Cash receipts journal (ERJ).
- Cash payments journal (EPJ).
- Client Ledger Card (CLC) for each client for whom escrow money is received.

C. A General Account:

- checkbook (GCB) out of which all checks drawn on the General bank account will be written.

- cash receipts journal (GRJ) and cash payments journal (GPJ).

- general ledger.

The following is a suggested approach to comply with the Appellate Division Rules for handling escrow accounts and general accounts relative to the November, 1991 through January, 1992 transactions. In the interest of brevity, these abbreviations will be used:

EBA - Escrow Bank Account	GBA - General Bank Account
ECB - Escrow Checkbook	GCB - General; Checkbook
ERJ - Escrow Cash Receipts Journal	GRJ - General; Cash Receipts Journal
EPJ - Escrow Cash Payments Journal	GPJ - General Cash Payments Journal
CLC - Client's Ledger Card	"- " Name of Column in Journal

Date	Escrow Account Records	General Account Records
1991		
7/16	$2,000 deposited in EBA $2,000 add in ECB $2,000 enter in ERJ $2,000 credit on Wainwright CLC	
7/17	$900 check to GBA $900 deduct in ECB $900 record in EPJ $900 debit on Wainwright CLC	deposit in GBA add in GCB enter in GRJ "cash" and "fees earned"
8/1	$300 check to GBA $300 deduct in ECB $300 record in EPJ $300 debit on Wainwright CLC	deposit in GBA add in GCB enter in GRJ "cash" and "fees earned"
8/15	$300 Check to GBA $300 deduct in ECB $300 recorded in EPJ $300 debit on Wainwright CLC	deposit in GBA add in GCB enter in GRJ "cash" "fees earned"

Date	Escrow Account Records	General Account Records
9/7	$12,000 deposit in EBA $12,000 add in ECB $12,000 enter in ERJ $12,000 credit on Bent CLC $7,333.33 check to Bent $4,666.67 check to GBA record both checks in EPJ debit each amount in Bent CLC	deposit in GBA add in GCB enter $4,666.67 in GRJ "cash" & "fees earned"
10/5	$17,500 deposit in EBA $17,500 add in ECB $17,500 enter in ERJ $17,500 credit on Moyer CLC $10,888 check to Moyer $ 6,612 check to GBA record both checks in EPJ debit both amounts on Moyer CLC	deposit in GBA add in GCB enter $6,612 in GRJ "cash" and "fees earned"
10/16	$8,500 deposit in EBA $8,500 add in ECB $8,500 record in ERJ $8,500 credit on Deleaver CLC $5,3666.67 check to Deleaver $3,133.33 check to GBA record both checks in EPJ debit each amount on Deleaver CLC	deposit in GBA add in GCB enter $3,133.33 in GRJ "cash" & "fees earned"
12/21		$10,000 deposit in GBA $10,000 add in GCB $10,000 enter in GRJ "cash" & "fees earned"
12/27	$5,000 deposit in EBA $5,000 add in ECB $5,000 record in ERJ $5,000 credit ABC Co. CLC $3,000 check to ABC. Co $2,000 check to GBA record both checks in EPJ debit each amount on ABC Co. CLC	deposit in GBA add in GCB enter $2,000 in GRJ "cash" & "fees earned"

Date	Escrow Account Records	General Account Records
1/15	$300 check to GBA $300 deduct in ECB $300 record in EPJ $300 debit on Wainwright CLC	deposit in GBA add in GCB enter in GRJ "cash" & "fees earned"
1/28	$10,000 deposit in EBA $10,000 add in ECB $10,000 record in ERJ $10,000 credit Bullock CLC $ 6,433.33 check to Bullock $ 3,566.67 check to GBA record both checks in EPJ debit each amount on Bullock CLC	deposit in GBA add in GCB enter $3,566.67 in GRJ "cash" and "fees earned"
1/28	$5,000 deposit in EBA $5,000 add in ECB $5,000 record in ERJ $5,000 credit Bullock CLC $3,333.33 check to Bullock $1,666.67 check to GBA record both checks in EPJ debit each amount on Bullock CLC	deposit in GBA add in GCB enter $1,666.67 in GRJ "cash" & "fees earned"

After the transactions are recorded, Fred Nash's Journals and client ledger cards would look as follows:

Escrow Cash Receipts Journal

Date	Client	Posted Credit to Client Ledger Card	Cash Received
1991			
7/16	Wainwright	X	2000.00
9/7	Bent	X	12000.00
10/5	Moyer	X	17500.00
10/16	Deleaver	X	8500.00
12/27	ABC, Co.	X	5000.00

Escrow Cash Receipts Journal

Date	Client	Posted Credit to Client Ledger Card	Cash Received
1992			
1/28	Bullock	X	10000.00
1/28	Bullock	X	5000.00

Escrow Cash Payments Journal

Date	Payee	Cash Paid	Client	Posted Debit Client Ledger Card
1991				
7/17	Fred Nash	900.00	Wainwright	X
8/1	Fred Nash	300.00	Wainwright	X
8/15	Fred Nash	300.00	Wainwright	X
9/7	Bent	7333.33	Bent	X
9/7	Fred Nash General A/C	4666.67	Bent	X
10/5	Moyer	10888.00	Moyer	X
10/5	Fred Nash General A/C	6612.00	Moyer	X
10.16	Deleaver	5366.67	Deleaver	X
10/16	Fred Nash General A/C	3133.33	Deleaver	X
12/17	ABC Co.	3000.00	ABC Co.	X
12/17	Fred Nash General A/C	2000.00	ABC Co.	X

Escrow Cash Payments Journal

Date	Payee	Cash Paid	Client	Card (con
1992				
1/15	Fred Nash General A/C	300.00	Wainwright	X
1/28	Bullock	6433.33	Bullock	X
1/28	Fred Nash General A/C	3566.67	Bullock	X
1/28	Fred Nash General A/C	3333.33	Bullock	X
1/28	Fred Nash General A/C	1666.67	Bullock	X

Wainwright Ledger Card

Date	Comments	Ref.	Debit	Credit	Balance
7/16/91				2,000.00	2,000.00
7/17/91			900.00		1,000.00
8/1/91			300.00		800.00
8/15/91			300.00		500.00
1/15/92			300.00		200.00

Bent Ledger Card

Date	Comments	Ref.	Debit	Credit	Balance
9/7/91				12000.00	12000.00
9/7/91			7333.33		4666.67
9/7/91			4666.67		-0-

Mover Ledger Card

Date	Comments	Ref.	Debit	Credit	Balance
10/5/91				17500.00	17500.00
10/5/91			10888.00		6612.00
10/5/91			6612.00		-0-

Deleaver Ledger Card

Date	Comments	Ref.	Debit	Credit	Balance
10/16/91				8500.00	8500.00
10/16/91			5366.67		3133.33
10/16/91			3133.33		-0-

ABC CO. Ledger Card

Date	Comments	Ref.	Debit	Credit	Balance
12/27/91				5000.00	5000.00
12/27/91			3000.00		2000.00
12/27/91			2000.00		-0-

Bullock Ledger Card

Date	Comments	Ref.	Debit	Credit	Balance
1/28/91				1000.00	1000.00
1/28/91				5000.00	15000.00
1/28/91			6433.33		8566.00
1/28/91			3566.67		5000.00
1/28/91			3333.33		1666.67
1/28/91			1666.67		-0-

General Cash Receipts Journal

Date	Account	Cash	Other	Folio	Fees Earned	Other	Folio
7/17/91		900.00			900.00		
8/1/91		300.00			300.00		
8/15/91		300.00			300.00		
9/7/91		4666.67			4666.67		
10/5/91		6612.00			6612.67		
10/16/91		3133.33			3133.33		
12/21/91		10000.00			10000.00		
12/27/91		2000.00			2000.00		
1991 Totals		27912.00*			27912.00		
1/15/92		300.00			300.00		
1/28/92		3566.67			3566.67		
1/28/92		1666.67			1666.67		
January, 1992 Total		5533.34*			5533.34*		

*Totals posted to the general ledger.

General Cash Payments Journal

Date	Account	Debits	Folio	Cash	Other	Folio

None of the illustrative transactions involve general a/c payments.

In conclusion, the attorney practicing in any Judicial Department in the State of New York must become proficient with basic accounting principles. Such fundamental accounting principles will enable the practitioner to maintain trust records in accordance with Court rules and will enable the attorney to simplify and sustain an audit by any Appellate Division.

Footnotes

1 See generally, 22 N.Y.C.R.R. 600 et seq.
2 See, New York Law Journal, December 15, 1988.

The Appellate Division of the Supreme Court, Second Judicial Department, pursuant to the authority vested in it DOES HEREBY, effective Nov. 30, 1988, with respect to its Rules governing the Conduct of Attorneys amend section 691.12 of Part 691 of Title 22 of the Official Compilation of Codes, Rules and Regulations of the State of New York by rescinding section 691.12 and by substituting therefor the following section 691.12.

Sec. 691.12 Fiduciary Responsibility; Maintenance of Bank Accounts; Record Keeping; Examination of Records.

(a) Prohibition Against Commingling

An attorney in possession of any funds or other property belonging to another person, where such possession is incident to his or her practice of law, is a fiduciary, and must not commingle such property with his or her own.

(d) Authorized Signatories

All special account withdrawals shall be made only by authorized intrastate or interstate bank transfer or by check payable to a named payee and not to cash. Only an attorney admitted to practice law in New York State shall be an authorized signatory of a special account.

(e) Availability of Bookkeeping Records; Random Review and Audit.

The financial records required by this section shall be located at the principal New York State office of the attorneys subject hereto. Such records shall be available, at that location, for inspection, copying and determination of compliance with this section, to a duly authorized representative of the court pursuant to the issuance, on a randomly selected basis, of a notice or subpoena by this Court or a Grievance Committee for the Second Judicial Department.

(f) Confidentiality

All matters, records and proceedings relating to compliance with this section, including the selection of an attorney for review hereunder, shall be kept confidential in accordance with applicable law, as and to the extent required of matters relating to professional discipline.

(g) Regulations and Procedures for Random Review and Audit

Prior to the issuance of any notice or subpoena in connection with the random review and audit program established by this section, the Grievance Committee shall propose regulations and procedures for the proper administration of the program. The Court shall approve such of the regulations and procedures of the Department Disciplinary Committee as it may deem appropriate, and only such regulations and procedures as have been approved by the Court shall become effective.

(h) Missing Clients

Whenever any sum of money is payable to a client and the attorney is unable to locate the client, the attorney shall apply to the Court in which the action was brought, or, if no action was commenced, to the Supreme Court in the county in which the attorney has his or her fee and disbursements and to the clerk of the court of balance due to the client.

(i) Dissolution of a Firm

Upon the dissolution of any firm of attorneys, the former partners or members shall make appropriate arrangements for the maintenance by one of them or by a successor firm of the records specified in subdivision (c) of this section.

(j) Records Subject to Production in Disciplinary Investigations and Proceedings

Notwithstanding any other provisions of this section, records required to be kept by this section shall be produced in response to a notice or subpoena duces tecum issued in connection with a complaint before or any investigation by a Grievance Committee, or shall be produced at the direction of this Court before any person designated by it for review or audit in connection with any plan of review or audit other than that provided by subdivision (e). All books and records produced pursuant to this subdivision shall be kept confidential, except for the purpose of the particular proceeding and their contents shall not be disclosed by anyone in violation of the attorney-client privilege.

(k) Disciplinary Action

Any attorney who does not maintain and keep the accounts and records as specified and required by this section, or who does not produce any such records pursuant to this Part, shall be deemed in violation of these rules and shall be subject to disciplinary proceedings.

(l) Annual Certification of Compliance

During the month of January but not later than Jan. 31 of each year, any attorney subject to this Court's jurisdiction shall file an affidavit with the Clerk of the Court certifying for the prior year, that the attorney is in compliance with this section.

The certification shall be in the following form and shall be available at all times to the Grievance Committee:

County of

State of New York

(type name) being duly sworn, deposes and says:

I am familiar with DR 9-102 of the Lawyer's Code of Professional Responsibility, as adopted by the New York State Bar Association, effective Jan 1, 1970 as amended, and with section 691.12 of the Court's Rules Governing the Conduct of Attorneys, which requires an attorney to preserve the identity of funds and property entrusted to him or her and to maintain certain records relating thereto.

I certify to this court that I am in compliance with the above provisions of the Lawyer's Code of Professional Responsibility and this Court's rules.

Signature of Attorney
Firm Name
Office & P.O. Address
Office telephone number
Home address
Home telephone number

Attorney

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3 N.Y.C.R.R. §691.12(b)

Separate Accounts.

Every attorney subject to this Court's rules, who is in possession of funds belonging to another person incident to the attorney's practice of law, shall maintain in a bank or trust company within the State of New York in the attorney's own name, or in the name of a firm of attorneys of which he or she is a member, or in the name of attorney or firm of attorneys by whom he or she is employed, a special account or accounts, separate from any business or personal accounts of the attorney or attorneys firm, and separate from any accounts which the attorney may maintain as executor, guardian, trustee or receiver, or in any such fiduciary capacity, in which a special account or accounts all funds held in escrow or otherwise entrusted to the attorney or firm shall be deposited.

Other than accounts maintained by an attorney as executor, guardian, trustee or receiver, or in any other such fiduciary capacity all special accounts as well as all deposit slips relating to and checks drawn upon such special accounts, shall be designated in a manner sufficient to distinguish them from all other bank accounts maintained by the attorney or attorneys firm.

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4 State Finance Law §97-v, N.Y. Jud. Law §497 (McKinney 1992).
5 See N.Y.S.B.A. Comm. on Prof. Ethics, Ops. 554 (1983), 575 (1986).
6 Id.
7 Id.
8 Id.
9 See note 3, supra.
10 Id.
11 Id.
12 N.Y.C.R.R.§691.12(c) Required Bookkeeping Records

All attorneys subject to this section shall maintain for seven years after the events which they record:

(1) the records of all deposits in and withdrawals from the accounts specified in subdivision (b) of this section and of any other bank account which concerns or affects their practice of law. These records shall specifically identify the date, source and description of each item deposited, as well as the date, payee and purpose of each withdrawal or disbursement;

(2) a record for special accounts, showing the source of all funds deposited in such accounts , the names of all persons for whom the funds are or were held, the amount of such funds, the description and amounts, and the names of all persons to whom such funds were disbursed;

(3) copies of all retainer and compensation agreements with clients;

(4) copies of all statements to clients or other persons showing the disbursement of funds, to them or on their behalf;

(5) copies of all bills rendered to clients;

(6) copies of all records showing payments to attorneys, investigators or other persons not in their regular employ, for services rendered or performed.

(7) copies of all retainer and closing statements filed with the Office of Court Administration; and

(8) all checkbooks and check stubs, bank statements, pre-numbered canceled checks and duplicate deposit slips.

All such attorneys shall make accurate entries of all financial transactions in their records of receipts and disbursements, in their special accounts, in their ledger books or similar records, and in any other books of account kept by them in the regular course of their practice, which entries shall be made at or near the time of the act, condition or event recorded.

13 Id.

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14 Id.
15 See DR 9-102(D).
16 22 N.Y.C.R.R. §691.12.
17 Matter of Taub, 171 A.D.2d 349, 576 N.Y.S.2d 523 (2d Dep't 1991).
18 Id.
19 Matter of Rolnick, 171 A.D.2d 29, 574 N.Y.S.2d 369 (2d Dep't 1991).
20 Id.
21 Id.
22 Matter of Grubart, 164 A.D.2d 144, 561 N.Y.S.2d 169 (1st Dep't 1990).
23 Matter of Baltimore, 132 A.D.2d 424 (1st Dep't 1990); Matter of Solomon, 12 A.D.2d 36, 511 N.Y.S.2d 239 (1st Dep't 1987); Matter of Wright, 110 A.D.2d 274 (1st Dep't 1985).
24 Matter of Sylvan, 166 A.D.2d 20, 568 N.Y.S.2d 934 (1st Dep't 1991); Matter of McLaughlin, 158 A.D.2d 12, 556 N.Y.S.2d 609 (1st Dep't 1990); Matter of Schmidt, 145 A.D.2d 103, 536 N.Y.S.2d 1010 (1st Dep't 1989).
25 Matter of Sylvan, 166 A.D.2d 20, 568 N.Y.S.2d 934 (1st Dep't 1991); Matter of McLaughlin, 158 A.D.2d 12, 556 N.Y.S.2d 609 (1st Dep't 1990).
26 Matter of Pollack, 142 A.D.2d 386, 536 N.Y.S.2d 437 (1st Dep't 1989).
27 Matter of Frankel, 123 A.D.2d 468, 506 N.Y.S.2d 477 (1st Dep't 1986).
28 161 A.D.2d 826, 556 N.Y.S.2d 405 (3d Dep't 1990).
29 Matter of Harp, 173 A.D.2d 957, 569 N.Y.S.2d 822 (3d Dep't 1991).
30 Matter of Resseguie, 138 A.D.2d 887, 526 N.Y.S.863 (3d Dep't 1988); Matter of Gallow, 110 A.D.2d 920, 487 N.Y.S.2d 168 (3d Dep't 1985).
31 Matter of Lewis, 159 A.D.2d 854, 553 N.Y.S.,2d 861 (3d Dep't 1990). See also Matter of McLaughlin, 158 A.D.2d 12, 556 N.Y.S.2d 609 (1st Dep't 1990).
32 Matter of Rudin, 153 A.D.2d 338, 551 N.Y.S.2d 152 (4th Dep't 1990).
33 Matter of Aquilio, 162 A.D.2d 58, 560 N.Y.S.2d 583 (4th Dep't 1990).
34 Matter of Marriot, 83 A.D.2d 288, 444 N.Y.S.2d 39 (4th Dep't 1981).
35 Matter of Kaplan, 137 A.D.2d 328, 529 N.Y.S.2d474 (1st Dep't 1988).

36 Matter of Eisenberg, 134 A.D.2d 91, 523 N.Y.S.2d 109 (1st Dep't 1988).
37 Matter of Sylvan, 166 A.D.2d 20, 568 N.Y.S.2d 934 (1st Dep't 1991).
38 Matter of Weisberg, 149 A.D.2d 58, 544 N.Y.S.2d 145 (1st Dep't 1989).
39 Matter of Weisman, 139 A.D.2d 249, 531 N.Y.S.2d 255 (1st Dep't 1988).
40 Matter of Eisenberg, 134 A.D.2d 91, 523 N.Y.S.2d 109 (1st Dep't 1988).

INCENTIVE PROGRAMS BY MERCHANT-SELLERS IN WHICH CASH AND PRIZES ARE PAID TO BUYERS' AGENTS: TO WHAT EXTENT SHOULD THEY BE PERMITTED UNDER SECTION 2(c) OF THE ROBINSON-PATMAN ACT?

by

William E. Greenspan*

Imagine a situation whereby American Appliance Company is a large retail dealer selling most major brands of appliances, including washers, dryers, ranges, microwaves, dishwashers, refrigerators and freezers. National Corporation, an appliance manufacturer, sells appliances to American. On one occasion National offers an "incentive" program to American's salespeople. Under the terms of the program, an American salesperson will receive twenty dollars for each National appliance the salesperson sells during the month of January. Payments are mailed by National to the salespersons at their home address. Naturally, any customer entering American's spectacular showroom during January, looking for an appliance, will be greeted by an American salesperson who eagerly points out the advantages of National appliances over other major brands. Some of these customers, relying on the salesperson's recommendation, will buy a National appliance never knowing the salesperson was partially motivated by the incentive plan.

Many neutral observers, looking at this incentive plan, may think it is unethical, while others may approve of it as a widely acceptable way of doing business. Some may think such incentive plans should be illegal. This paper examines to what extent it is wise and feasible to regulate such incentive plans under section 2(c) of the Robinson-Patman Act: Payment or acceptance of commission, brokerage or other compensation.[1]

More specifically this paper will discuss (1) a Robinson-Patman Act overview,[2] (2) F.T.C. v. Henry Broch & Company,[3] the only United States Supreme Court case reviewing section 2(c), (3) recent lower court interpretations of section 2(c), (4) Metrix v. Daimler-Benz Aktiengesellschaft,[4] a " case in point" on incentive programs similar to the American Appliance example stated above, and (5) conclusions and recommendations.

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A ROBINSON-PATMAN ACT OVERVIEW

In 1936 Congress amended section 2 of the Clayton Act and enacted the Robinson-Patman Act[5] which deals with illegal price discrimination. Sections 2(a) and 2(b) are the heart of the Act, addressing the primary purpose for which it was passed:

> The legislative history of the Robinson-Patman Act makes it abundantly clear that Congress considered it to be an evil that a large buyer could secure a competitive advantage over a small buyer solely because of the large buyer's quantity purchasing ability. The Robinson-Patman Act was passed to deprive a large buyer of such advantages except to the extent that a lower price could be justified by reason of a seller's diminished costs due to quantity manufacture, delivery or sale, or by reason of the seller's good faith effort to meet a competitor's equally low price.[6]

Section 2(a) prohibits a discrimination in price between competing purchasers of commodities of like grade and quality, where the effect of such discrimination may be substantially to lessen competition. However a seller may grant a price differential which reflects reduced costs due to quantity manufacture, delivery or sale.[7]

Section 2(b) provides another defense to section 2(a), the "meeting not beating" defense. In order to prevail on a section 2(b) "meeting not beating" defense, an accused seller must show that he lowered his price in good faith to meet, but not beat, that of a competitor of the seller.[8]

Sections 2(d) and 2(e) are companion sections. A seller is prohibited from making cash payments [2(d)] to a customer for promoting the seller's product, or furnishing services or facilities [2(e)] (advertising, catalogs, demonstrators, display materials, special packaging) to a customer for promoting the seller's product, unless such payments, services or facilities are made available to all competing customers on proportionally equal terms.[9]

> The difference between the two subsections is that in subsection (d) the customer supplies the services or facilities and his vendor pays the bill, and in subsection (e) the wholesale vendor himself supplies the services and facilities for the use of his customer in facilitating resales.[10]

Section 2(f) is the "flip side" of section 2(a). It prohibits a buyer from knowingly inducing or receiving a discrimination in price prohibited by section 2(a).[11] Even though the purpose of the Robinson-Patman Act was to prevent large buyers from using their economic advantage to secure a discrimination in price, section 2(a) makes no mention of any restraint on buyers. Instead it only prevents sellers

from engaging in price discrimination. Therefore, although a buyer could not be held liable under section 2(a) for price discrimination, such buyer could be held liable for violating section 2(f) for having knowingly induced a violation of section 2(a).[12]

Section 2(c), with which this paper is concerned, prohibits a party from paying or receiving a commission, brokerage, or discount in lieu thereof, except for services rendered, to or from the other party or his agent.[13] Stated otherwise, section 2(c) prohibits a seller from paying a commission to a buyer or his agent in connection with the sale of goods, unless actual services are performed in connection with the sale. Likewise a buyer or his agent is prohibited from receiving a commission from the seller in connection with the sale of goods, unless actual services are performed in connection with the sale. Section 2(c) is a "per se" violation. None of the enumerated defenses in sections 2(a) and 2(b) (no lessening of competition, cost justification, "meeting not beating") are available when one is charged with a violation of section 2(c). The only possible defense, the "for services rendered" proviso, has been narrowly interpreted and rarely allowed as a defense. Early interpretations of the "for services rendered" defense indicate that it was only included to make sure that a "bona-fide independent" broker would not be denied compensation:

> The agent cannot serve two masters, simultaneously rendering services in an arm's length transaction to both. While the phrase, "for services rendered," does not prohibit payment by the seller to his broker for bona fide brokerage services, it requires that such service be rendered by the broker to the person who has engaged him. In short, a buying and selling function cannot be combined in one person.[14]

In 1960 the United States Supreme Court reviewed the legislative history of section 2(c) in F.T.C. v. Henry Broch & Company,[15] and gave examples of the type of conduct section 2(c) was intended to prohibit. This was the first and only section 2(c) case to reach the Court.

F.T.C. v. HENRY BROCH & COMPANY

Broch was a broker or sales representative for approximately 25 sellers of food products, including Canada Foods, a processor of apple concentrate and other products. Canada Foods set its price for apple concentrate at $1.30 per gallon in 50-gallon steel drums, including a five per cent commission for Broch. J.M. Smucker Co., a large buyer of apple concentrate for use in its manufacture of apple butter and preserves, offered to purchase 500 steel drums of apple concentrate at $1.25 per gallon. After some negotiations, a sale was arranged at $1.25, with the

condition that Broch reduce its commission from five per cent to three per cent to absorb half of the price reduction. The reduced price of $1.25 was granted to Smucker on subsequent sales, while sales to all other customers continued to be $1.30 with Broch earning his usual five per cent commission.[16]

The Federal Trade Commission found the price reduction granted to Smucker was a discount in lieu of of brokerage in violation of section 2(c).[17] The Seventh Circuit reversed, holding that "[n]either the language of § 2(c) nor its legislative history indicates that a seller's broker is covered by § 2(c)."[18]

The United States Supreme Court granted certiorari to decide whether section 2(c) is applicable to this conduct.[19] Reviewing the legislative history of the Robinson-Patman Act, the Court stated:

> The Robinson-Patman Act was enacted in 1936 to curb and prohibit all devices by which large buyers gained discriminatory preferences over smaller ones by virtue of their greater purchasing power . . . . Congress in its wisdom phrased § 2(c) broadly, not only to cover the other methods then in existence but all other means by which brokerage could be used to effect price discrimination.[20]

The Court further noted which parties may be included as "any person" in section 2(c):

> The particular evil at which § 2(c) is aimed can be as easily perpetrated by a seller's broker as by the seller himself . . . . The seller's broker is clearly "any person" as the words are used in § 2(c) - as clearly such as a buyer's broker.[21]

Thus the Court supported the position of the Federal Trade Commission:

> We conclude that the statute clearly applies to payments or allowances by a seller's broker to the buyer, whether made directly to the buyer, or indirectly, through the seller. The allowances proscribed by § 2(c) are those made by "any person" which, as we have said, clearly encompasses a seller's broker.[22]

Although there are numerous ways one may abuse the brokerage function to effect a price discrimination in violation of section 2(c), one instructive aspect of Broch is that it identifies three situations which are clearly violations of section 2(c). The first situation describes setting up "dummy" brokers:

> One of the favorite means of obtaining an indirect price concession was by setting up "dummy" brokers who were employed by the buyer and who, in many cases,

rendered no services. The large buyers demanded that the seller pay "brokerage" to these fictitious brokers who then turned it over to their employer. This practice was one of the chief targets of § 2(c) of the Act.[23]

In a second situation, a large buyer seeks to evade section 2(c) by accepting price reductions equivalent to the seller's normal brokerage payments. The buyer negotiates directly with the seller, instead of through the seller's broker. The buyer insists on and receives a price reduction from the seller equal to the amount of the brokerage or commission the seller would have normally paid to the broker. This is "an allowance in lieu of brokerage under § 2(c) and [is] prohibited even though, in fact, the seller had 'saved' his brokerage expense by dealing directly with the selected buyer."[24]

The third situation is Broch. A large buyer (Smucker) asks for a price reduction from the seller (Canada Foods). The seller normally sells through a broker (Broch). The seller telephones the broker and advises the broker that the seller will make the sale at the reduced price if the broker agrees to yield part of his brokerage fee for sales with that buyer only. The broker agrees, and the sale takes place. This violates section 2(c).

> Congress enacted the Robinson-Patman Act to prevent sellers and sellers' brokers from yielding to the economic pressures of a large buying organization by granting unfair preferences in connection with the sale of the goods. The form in which the buyer pressure is exerted is immaterial . . . . There is no difference in economic effect between the seller's broker splitting his brokerage commission with the buyer and his yielding part of the brokerage to the seller to be passed on to the buyer in the form of a lower price.[25]

In summary, the Court made it clear that section 2(c) is a "per se" statute, absolute in its terms. None of the defenses in section 2(a) (no lessening of competition, cost justification, "meeting not beating") are available when one is charged with a section 2(c) violation. In addition the "services rendered" exception appeared to be limited to situations involving payments by a seller or buyer to his own broker, and that neither party to a transaction nor his broker could perform legitimate services for the other party.

However, in dictum, the Court made one troubling statement:

> There is no evidence [in this case] that [Smucker] rendered any services to [Canada Foods] nor that anything in [Smucker's] method of dealing justified its getting a discriminatory price by means of a reduced brokerage charge. We would have quite a different case if there were such evidence . . . .[26]

Does this mean there might be some situation whereby the "services rendered" exception would be used to allow a limited cost justification defense when the seller shows a savings in distribution costs because of a particular buyer's method of dealing? Would it make any difference if allowances in brokerage were made on a nondiscriminatory basis? Broch left these questions unanswered, risking inconsistent applications of Broch in future court decisions.

RECENT LOWER COURT INTERPRETATIONS OF SECTION 2(c) ISSUES

Predictably, recent court opinions dealing with section 2(c) have discussed whether Broch dictum "opened the door" for limited defenses when one is charged with a section 2(c) violation. The results have been inconsistent.

In Federal Paper Bd. Co., Inc. v. Amata,[27] Federal sold wood and paper products, including recycled paperboard and paperboard cartons made from wastepaper. Federal routinely bought wastepaper from several wastepaper suppliers. Amata, who worked for Federal, was responsible for purchasing wastepaper from these competing suppliers at the most advantageous price and delivery terms. Amata demanded and accepted bribes and kickbacks from these suppliers with the result that the majority of Federal's wastepaper came from suppliers making payments to Amata. The cost of the bribes was passed on to Federal in the sales price. When Federal discovered Amata's conduct, Federal fired Amata. Federal was then able to purchase wastepaper from several suppliers at lower prices.[28]

Federal sued Amata and the bribe-paying suppliers claiming, among other things, a violation of section 2(c) of the Robinson-Patman Act. Federal alleged "that the payments received by Amata were not for bona fide services rendered, but were commercial bribes."[29] In defense, the defendants claimed Federal failed to allege anticompetitive injury, which is a prerequisite for a section 2(c) violation.[30]

The court held that the facts of this case were covered by section 2(c), and that anticompetitive injury is not a prerequisite for a section 2(c) violation.

> Payments were made to Amata, an agent of the buyer Federal, that were not for services rendered. To require Federal to make additional allegations of anticompetitive effect in order to establish a prima facie violation of section 2(c) would be to impose a common law limitation on the broad language enacted by Congress. At least a few courts appear to have held that in order for payments to constitute a violation of

section 2(c) the payments must have an anticompetitive effect . . . . This court finds, however, that long-standing Second Circuit precedent and Supreme Court dicta refute any claim that anticompetitive injury is an element of a violation of section 2(c) of the Robinson-Patman Act.[31]

In Seaboard Supply Co. v. Congoleum,[32] Congoleum Corporation, a felt manufacturer, sold products to Seaboard and others who engaged in the wholesale distribution of roofing felt. Jack Berk, a sales manager for Congoleum, recommended to Congoleum that Manufacturers Reps Company (MRC) become a commissioned sales agent for Congoleum. Congoleum agreed. Unknown to Congoleum, Berk and MRC had a secret arrangement whereby MRC paid bribes (consulting services) to Berk. Since Berk had the ability to cause orders to be cancelled or delayed and could steer customers to another distributor or agent, Seaboard lost several customers who transferred their business to MRC. When Congoleum's management found out about Berk's conduct, it discharged Berk. Meanwhile, Seaboard sued Congoleum, Berk and MRC alleging, among other things, a violation of section 2(c) of the Robinson-Patman Act.[33]

The district court recognized that section 2(c) "prohibits unearned payments to the other party to a transaction or to an agent who is subject to the control of a person other than the one making the payment." Considering the statute, case precedents and legislative history, the district court concluded that section 2(c) "applies only to unlawful payments which pass between sellers and purchasers." In this case MRC was not a purchaser from Congoleum; instead MRC was an agent of Congoleum. Therefore the payments made from MRC to Berk did not violate section 2(c).[34]

The court of appeals agreed with the district court, noting concern "whether Congress intended to sweep commercial bribery within the ambit of section 2(c)."[35] While the court recognized that at least three circuits (6th Cir., 7th Cir., 9th Cir.) held commercial bribery came within the terms of section 2(c), and that these decisions have been generally accepted and supported by the statutory language, the court was not convinced the scope of 2(c) covers the conduct here.

> In the appellate decisions which have found commercial bribery within the ambit of section 2(c) the common thread has been the passing of illegal payments from seller to buyer or vice versa. Adherence to the requirement that payments cross this seller-buyer line is consistent with the interpretation of 2(c) in nonbribery cases . . . . Here, that line has not been crossed. MRC, a sales agent of the seller Congoleum, bribed Berk, the seller's employee. MRC was not a purchaser, and consequently, the statutory requisites have not been met.[36]

In Gregoris Motors v. Nissan Motor Corp. in USA[37] Gregoris is a Datsun dealership, while Nissan is the American branch of the Japanese manufacturer of Datsun vehicles. Richard Hungerford is Nissan's Regional Sales Manager. Gregoris alleges, among other things, a violation of section 2(c) when Hungerford sought and received bribes from Datsun dealers competing with Gregoris. Any dealer paying bribes would receive a favorable allocation of cars, including receiving early delivery and desirable models. Since Gregoris did not give bribes, its allocations of new cars was substantially reduced to the point of threatening to destroy its business.[38]

One of the defenses raised by Hungerford and the bribe-paying dealers was that there can be no violation of section 2(c) without anticompetitive injury. The district court held:

> While several courts have required anticompetitive injury for a section 2(c) claim . . . this Court is persuaded that anticompetitive injury is not necessary for maintaining a claim under § 2(c) . . . . Such a requirement is unduly restrictive and is not part of the plain language of the statute.[39]

Another defense was that the "plaintiff must have suffered the injury of price discrimination as a result of bribery." The district court rejected this defense.

> Although the Robinson-Patman Act is directed mainly at price discrimination, § 2(c) does not specifically mention price discrimination as the forbidden goal of the bribery. Increasingly the case law supports the conclusion that a violation of § 2(c) can be based on indirect price discrimination. In fact, business practices other than price discrimination can give rise to a § 2(c) violation.[40]

It is interesting to note that although the court in Seaboard expressed doubts whether Congress intended to sweep commercial bribery within the ambit of section 2(c), Gregoris expressly declared that section 2(c) "forbids commercial bribery in connection with the sale or purchase of goods or services."[41]

In Stephen Jay Photography, Ltd. v. Olan Mills, Inc.,[42] Stephen Jay and Olan Mills are competing commercial photographers in the Norfolk, Virginia, area. Through competitive negotiation Olan Mills and one other commercial photographer contracted with all 22 high schools in the Norfolk area whereby Olan would be the official photographer for high school yearbook pictures. It was also agreed that Olan would pay the schools a percentage of the profits

earned from sales of optional portrait photographs of students. Letters to the students disclosed that Olan was the official photographer and that part of the optional portrait photograph price would be given to the school to support various school activities. Although students were not obligated to use the official photographer, this marketing plan of coordinating the yearbook pictures and portraits, coupled with the endorsement of the school, gave Olan a competitive advantage over competing photographers, such as Stephen Jay, in selling portraits. Stephen Jay sued Olan claiming, among other things, that Olan engaged in commercial bribery in violation of section 2(c) of the Robinson-Patman Act.[43]

One of the defenses raised by Olan was that commercial bribery does not constitute a violation of section 2(c). The court indicated that this circuit (4th Cir.) had not yet addressed the issue. Nevertheless four circuits (3d, 6th, 7th, 9th) have applied a commercial bribery analysis in section 2(c) cases.[44] Also the legislative history of section 2(c), as stated in Broch, supports the proposition that Congress intended to bring commercial bribery within the ambit of section 2(c).[45] Therefore the court assumed, without deciding, that section 2(c) proscribes commercial bribery.

Another defense raised by Olan was that the schools were not "agents . . . acting in fact for . . . any party to such transaction." The court recognized that commercial bribery cases must involve the corruption of an agency relationship. Any alleged bribes must cross the seller-buyer line. In this case, according to the court, there was no agency relationship between the schools and the students because "the schools did not have authority to bind the students to purchase portraits. Instead the students were free to purchase portraits from [Olan] or from a photographer of their choice, or to purchase no portraits from anyone."

> Therefore, even assuming section 2(c) proscribes commercial bribery, we conclude that no violation occurred here. Unquestionably, the schools and the students enjoy a special relationship of trust. And it is true that the schools arranged to have yearbook photographs taken by [Olan] and encouraged students to purchase portraits from them. However, letters encouraging the students to purchase these photographs . . . indicated that their decision to purchase portraits was optional. From this correspondence it is abundantly clear that the schools did not assume a position resembling that of a portrait purchasing agent for the students.[46]

Another recent case questioning whether an agency relationship existed is Harris v. Duty Free Shoppers Ltd. Partnership.[47] Harris and Duty Free Shoppers operate competing duty free stores in downtown San Francisco, catering especially to Japanese tourists. Duty Free paid lump sum amounts and commissions to tour companies and to tour guides to promote Duty Free's downtown shop by scheduling stops of tour buses at the store. The tourists are not required to buy from Duty Free. They can and do purchase goods from other stores . The tourists do not know that Duty Free is making these payments. Apparently, hotels, airlines, and other businesses make similar payments to travel companies. Harris, who does not make payments, sued Duty Free claiming, among other things, a violation of section 2(c) of the Robinson-Patman Act. More specifically Harris claimed that the tour guides owe a fiduciary duty to the tourists, and that duty was breached by accepting payments from Duty Free.[48]

The court held that the "tour guides and tour operators are not in an agency or fiduciary relationship with their passengers, nor do they serve as intermediaries 'subject to the direct or indirect control' of those passengers, with regard to the transactions in question - the purchase of Duty Free's retail goods." The reasons given by the court were that there was no employment relationship between the tour guides and the tourists, the tour guides were not "experts" on whose advice the tourists relied, the tour guides were not "at all times subject to the control" of the tourists, and the tourists were free to purchase their souvenirs anywhere, or, in fact, not at all. Therefore there was no violation of section 2(c).[49]

The court underscored the issue by stating it made no difference "whether the tour guides' services were available to competitors of Duty Free on like terms or conditions, . . . whether the value of the tour guides services correspond to the payments, and whether the payments were secret." The crucial issue here was "whether the tour guides are agents of the tourists such that they owe a fiduciary duty."[50] Since there was no fiduciary duty between the tour guides and the tourists, there could be no violation of section 2(c).

Although these recent lower court interpretations of section 2(c) are sometimes inconsistent with each other, the following principles can be gleaned:

(1) Section 2(c) is a "per se" violation.

(2) The "for services rendered" defense in section 2(c) is very narrowly applied. It has only been included to make sure a "bona fide" independent broker will not be denied compensation for rendering services to his own principal.

(3) Although some courts question whether anticompetitive injury is a necessary element for a section 2(c) violation, there is strong support in section 2(c), its legislative history, Broch, and court opinions, that anticompetitive injury is not a prerequisite for a section 2(c) violation.

(4) Section 2(c) applies only to unlawful payments (or other discriminatory business practices) that pass between sellers and purchasers. There must be corruption of an agency relationship.

(5) Several federal court decisions indicate that Congress intended to sweep commercial bribery cases within the ambit of section 2(c).

(6) Section 2(c) can be based on indirect price discrimination. Business practices other than price discrimination can give rise to a section 2(c) violation.

(7) It is irrelevant in defense of a section 2(c) charge whether alleged illegal payments are equally available to all purchasers, whether payments correspond to the value of services rendered, or whether payments were secret.

Having reviewed the provisions of the Robinson-Patman Act, especially section 2(c); the Broch decision, including its discussion of the legislative history of section 2(c); and recent lower court opinions interpreting section 2(c); the question still remains to what extent incentive programs by merchant-sellers, in which cash and prizes are paid to buyers' agents, should be permitted under section 2(c) of the Robinson-Patman Act. A "case in point" (similar to the American Appliance example introducing this paper) is Metrix v. Daimler-Benz Aktiengesellschaft.[51]

METRIX v. DAIMLER-BENZ AKTIENGESELLSCHAFT

Metrix Warehouse, Inc. (Metrix) and Mercedes-Benz of North America (MBNA) are competitors in the sale of automobile parts to approximately 400 Mercedes-Benz dealers in the United States. Metrix has an incentive program whereby it makes payments to parts managers of Mercedes-Benz dealerships based on the number of Metrix products purchased by the parts managers' employers.

More specifically the incentive program involves the awarding of points redeemable for either cash or merchandise or the payment of cash directly to the parts managers of the Mercedes-Benz dealers. These payments are based on a percentage of total parts purchased from Metrix. As consideration for the payments, the parts managers perform

no services other than placing their employers purchase orders with Metrix.

During a six-year period, Metrix paid at least $119,980 in cash and $394,551 in cash and/or merchandise to parts managers of Mercedes-Benz dealers for the placement of approximately $13,000,000 in spare parts orders with Metrix. Payments are mailed monthly by Metrix to the parts managers at their home address. The value of the points is approximately 3½ percent of the purchase price.[52]

When Metrix was charged with a violation of section 2(c), Metrix argued there could be no violation since the incentive program increased, rather than decreased, competition. Therefore there was no adverse effect on competition. The district court agreed with Metrix finding "that questions of fact remain whether the incentive program decreases competition." Stated otherwise, the district court agreed with Metrix that a finding of an adverse effect on competition is necessary for there to be a violation of section 2(c).[53]

The court of appeals reversed, holding that section 2(c) is a "per se" violation, and that Metrix violated section 2(c).

> Nothing in the language of section 2(c) . . . requires proof of an adverse effect on competition before a violation may be found where there is an admitted payment of a commission or other compensation to an agent of the purchaser . . . . Any change in the law to address the competitive effect of such compensation must be made by Congress . . . .[54]

Using the language of section 2(c), Metrix is "any person" who "pay(s) . . . anything of value as . . . compensation" to "an agent" (parts managers) of the "other party" (Mercedes-Benz dealers), where such agent (parts managers) is "subject to the direct control" of any party (Mercedes-Benz dealers) "other than the person (Metrix) by whom such compensation is paid."[55]

Comparing Metrix to the American Appliance example introducing this paper, there appears to be no difference between the two. Both are "per se" violations of section 2(c). National is "any person" who "pay(s) . . . anything of value as . . . compensation" to "an agent" (American's salespeople) of the "other party" (American), where such agent (American's salespeople) is "subject to the direct control" of any party (American) "other than the person (National) by whom such compensation is paid."

To what extent it wise and feasible to regulate such incentive plans under section 2(c)?

CONCLUSIONS AND RECOMMENDATIONS

Incentive programs by merchant-sellers in which cash and prizes are paid to buyers' agents should be strictly prohibited under section 2(c). It is well settled that section 2(c) is a "per se" violation. The weight of authority is that anticompetitive injury is not a prerequisite for a section 2(c) violation. It is irrelevant whether payments correspond to the value of services rendered or whether the payments were secret. Section 2(c) covers commercial bribery. As long as there is corruption of an agency relationship (i.e. the payments pass between sellers and buyers) the conduct should be subject to scrutiny under section 2(c).

The purpose of section 2(c) is to cover <u>all</u> means by which brokerage could be used to effect price discrimination. Since there is always the problem of antitrust standing when an individual alleges a section 2(c) violation,[56] the Federal Trade Commission should take responsibility for vigorous enforcement of section 2(c). Any dissatisfaction with the anticompetitive effects of 2(c) should be addressed by Congress and not by the courts.

Footnotes

1 15 U.S.C. § 13(c) (1988).
2 15 U.S.C. § 13(a)-(f) (1988).
3 363 U.S. 166 (1960).
4 716 F.2d 245 (4th Cir. 1983), <u>appeal after remand,</u> 828 F.2d 1033 (4th Cir. 1987), <u>cert. denied,</u> 486 U.S. 1017 (1988).
5 15 U.S.C. § 13(a)-(f) (1988).
6 Federal Trade Commission v. Morton Salt Co., 334 U.S. 37, 43 (1948).
7 Section 2(a) provides:
It shall be unlawful for any person engaged in commerce, in the course of such commerce . . . to discriminate in price between purchasers of commodities of like grade and quality, where such commodities are sold for use, consumption, or resale . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly . . . Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered . . . And provided further, That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade: And provided further, That nothing herein contained shall prevent price changes from time to time where in response to

changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned. 15 U.S.C. § 13(a) (1988). <u>See, e.g.,</u> Texaco Inc. v. Ricky Hasbrouck, 110 S.Ct. 2535 (1990); Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967); F.T.C. v. Borden Company, 383 U.S. 637 (1966); Hanson v. Pittsburgh Plate Glass Industries, Inc., 482 F.2d 220 (5th Cir. 1973).
8 Section 2(b) provides:
Upon proof being made, at any hearing on a complaint under this section, that there has been discrimination in price or services or facilities furnished, the burden of rebutting the prima-facie case thus made by showing justification shall be upon the person charged with a violation of this section, and unless justification shall be affirmatively shown, the [Federal Trade] Commission is authorized to issue an order terminating the discrimination: Provided, however, That nothing herein contained shall prevent a seller rebutting the prima-facie case thus made by showing that his lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor. 15 U.S.C. § 13(b) (1988). <u>See, e.g.,</u> Falls City Industries, Inc. v. Vanco Beverage, Inc., 460 U.S. 428 (1983); F.T.C. v. Sun Oil Company, 371 U.S. 505 (1963); Standard Oil Company v. F.T.C., 342 U.S. 231 (1951).
9 Section 2(d) provides:
It shall be unlawful for any person engaged in commerce to pay or contract for the payment of anything of value to or for the benefit of a customer of such person in the course of such commerce as compensation or in consideration for any services or facilities furnished by or through such customer in connection with the the processing, handling, sale, or offering for sale, of any products or commodities manufactured, sold, or offered for sale by such person, unless such payment or consideration is available on proportionately equal terms to all other customers competing in the distribution of such products or commodities. 15 U.S.C. § 13(d) (1988).
Section 2(e) provides:
It shall be unlawful for any person to discriminate in favor of one purchaser against another purchaser or purchasers of a commodity bought for resale, with or without processing, by contracting to furnish or furnishing, or by contributing to the furnishing of, any services or facilities connected with the processing, handling, sale, or offering for sale of such commodity so purchased upon terms not accorded to all purchasers on proportionally equal terms. 15 U.S.C. § 13(e) (1988).
10 Exquisite Form Brassiere, Inc. v. FTC,

301 F.2d 499, 500 (D.C. Cir. 1961). See also, F.T.C. v. Fred Meyer, Inc., 390 U.S. 341 (1968); Federal Trade Com. v. Simplicity Pattern Co., Inc., 360 U.S. 55 (1959); L & L Oil Co., Inc. v. Murphy Oil Corp., 674 F.2d 1113 (5th Cir. 1982); R. H. Macy & Co. v. FTC, 326 F.2d 445 (2d Cir. 1964).

11 Section 2(f) provides:

It shall be unlawful for any person engaged in commerce, in the course of such commerce, knowingly to induce or receive a discrimination in price which is prohibited by this section. 15 U.S.C. § 13(f) (1988).

12 See, Great Atlantic & Pacific Tea Co., Inc. v. F.T.C. 440 U.S. 69 (1979); Automatic Canteen Co. v. Federal Trade Commission, 346 U.S. 61 (1953).

13 Section 2(c) provides:

It shall be unlawful for any person engaged in commerce, in the course of such commerce, to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control of any party to such transaction other than the person by whom such compensation is so granted or paid. 15 U.S.C. § 13(c) (1988).

14 Great Atl. & Pac. Tea Co. v. FTC, 106 F.2d 667, 674-75 (3d Cir. 1939), cert. denied, 308 U.S. 625 (1940). See also, Southgate Brokerage Co. v. FTC, 150 F.2d 607 (4th Cir.), cert. denied, 326 U.S. 774 (1945); Quality Bakers of America v. FTC, 114 F.2d 393 (1st Cir. 1940); Webb-Crawford Co. v. FTC, 109 F.2d 268 (5th Cir.), cert. denied, 310 U.S. 638 (1940); Oliver Bros., Inc. v. FTC, 102 F.2d 763 (4th Cir. 1939); Biddle Purchasing Co. v. FTC, 96 F.2d 687 (2d Cir.), cert. denied, 305 U.S. 634 (1938).

15 363 U.S. 166 (1960).

16 Id. at 167-68.

17 54 F.T.C. 673 (1957).

18 261 F.2d 725, 728 (7th Cir. 1958).

19 360 U.S. 908 (1959).

20 363 U.S. at 168-69.

21 Id. at 170.

22 Id. at 175.

23 Id. at 169.

24 Id. at 172. See, Great Atlantic & Pacific Tea Co. v. FTC, 106 F.2d 667 (3d Cir. 1939), cert. denied, 308 U.S. 625 (1940).

25 Broch, 363 U.S. at 174-75.

26 Id. at 173.

27 693 F.Supp. 1376 (D. Conn. 1988).

28 Id. at 1379-80.

29 Id. at 1380.

30 Id. at 1385.

31 Id. at 1385-86. Although there was antitrust injury, the court held there was no antitrust standing for treble damages and attorney fees by reason of § 4 of the Clayton Act: "[A]ny person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor . . . and shall recover threefold the damages by him sustained, and the cost of the suit, including a reasonable attorney's fee. . . ." 15 U.S.C. § 15(a). See also, Brunswick v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477 (1977). (To recover treble damages . . . a plaintiff must make some showing of actual injury attributable to something the antitrust laws were designed to prevent. 429 U.S. at 486.) Nevertheless, In Federal, the court implied that Federal would have a claim in a civil action for damages for a commercial tort. 639 F.Supp. at 1389. Also this conduct would be subject to scrutiny by the Federal Trade Commission, the federal administrative agency responsible for enforcing the antitrust laws. 15 U.S.C. § 45(a) (1988).

32 770 F.2d 367 (3d Cir. 1985).

33 Id. at 368-69.

34 Id. at 370-71.

35 Id. at 372.

36 Id. The court noted that "although the activity was reprehensible and probably violated state civil [tort law - tortious interference with contractual relationships and prospective economic advantage] and criminal law [embezzlement and theft by deception], we agree that the scheme did not come within the scope of the antitrust laws [which has the attraction of treble damages and attorney fees, rather than the simple compensatory damages available under state law]. 770 F.2d at 368-72.

37 630 F.Supp. 902 (E.D.N.Y. 1986).

38 Id. at 905-906.

39 Id. at 910.

40 Id.

41 Id. at 909.

42 903 F.2d 988 (4th Cir. 1990)

43 Id. at 990.

44 Id. at 992, n. 6.

45 Id. at 992-93.

46 Id. at 993.

47 940 F.2d 1272 (9th Cir. 1991)

48 Id. at 1274.

49 Id. at 1275.

50 Id. at 1276.

51 716 F.2d 245 (4th Cir. 1983), appeal after remand, 828 F.2d 1033 (4th Cir. 1987), cert. denied, 486 U.S. 1017 (1988).

52 716 F.2d at 246-47.

53 Id. at 247.

54 Id.

55 Upon review, the federal court of appeals reversed in part its previous decision. Although affirming that

Metrix committed a violation of § 2(c), the court found that MBNA had not proven by a preponderance of the evidence that it had standing to sue, i.e., that Metrix's incentive program caused MBNA to suffer actual injury of a type that § 2(c) was designed to prevent. 828 F.2d at 1046. *See, Brunswick, supra*, note 31.

56 Section 4 of the Clayton Act provides:"[A]ny person who shall be injured in his business or property *by reason of* anything forbidden in the antitrust laws may sue therefor . . . and shall recover threefold the damages by him sustained. . . ." 15 U.S.C. § 15(a). Even if a defendant has committed a violation of the antitrust laws (i.e. antitrust *injury*,), it does not necessarily follow that a plaintiff has antitrust *standing*. To recover treble damages . . . a plaintiff must make some showing of actual injury attributable to something the antitrust laws were designed to prevent. Brunswick v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477 (1977). The United States Supreme Court has enumerated several factors it will consider on a case-by-case basis to determine whether a plaintiff has antitrust standing: the nature of the plaintiff's alleged injury [i.e. does it fall squarely within the area of congressional concern], the relationship between the alleged antitrust violation and the plaintiff's alleged injury [i.e. is it tenuous and speculative?], the directness or indirectness of the alleged injury, the potential for duplicative recovery or complex apportionment of damages, and the existence of more direct victims. Assoc. Gen. Contractors of Cal. v. Cal. St. Council, 459 U.S. 519 (1983). *See also*, Sharp v. United Airlines, Inc., 967 F.2d 404 (10th Cir. 1992). (Employees of Frontier Airlines lacked standing to sue United Airlines, even if United engaged in violations of the antitrust laws causing Frontier to fail.)

BARGAINING WITH STAKEHOLDERS: CORPORATE CODES OF CONDUCT AND SHAREHOLDER WEALTH

by

Julianne Nelson*

Corporate codes of conduct or ethics have become increasingly popular in recent years. Of the 264 companies responding to a recent Conference Board survey, more than 75% had some form of ethics code; almost half of the firms with codes in place had adopted them since 1987.[1] Nor is the adoption of codes merely a recent phenomenon: a 1980 study by White and Montgomery found that almost 100% of the largest US corporations had codes in place.[2]

When, if ever, would a self-interested shareholder support a corporate code of conduct? Do such codes ever increase shareholder wealth? If one relies on instincts honed by the study of competitive markets, one is likely to assume that benefits for customers, suppliers, employees and the local community necessarily come at the expense of corporate shareholders. The very structure of the much-publicized Johnson and Johnson (J&J) Credo (reprinted in the Appendix) appears to support this hypothesis. When detailing corporate responsibilities, the Credo mentions the interests of corporate shareholders *last*, only after it enumerates the duties owed to a variety of other stakeholders. In effect, the J&J Credo seems to implement a plural purpose view of the firm that asks managers to serve a number of constituencies. It remains to be seen whether or not this approach could also benefit a strictly self-interested shareholder.

Recent results from applied bargaining theory suggest that the J&J Credo may actually increase shareholder wealth in some circumstances. Institutional theorists have recently turned to "cooperative" solution concepts to determine the efficiency implications of different corporate ownership structures. In general, research in this area starts from the assumption that

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the output of a particular firm is the result of *joint* effort and that at least some individual contributions to this output cannot be observed or measured accurately. Since "complete contracting" on the basis of individual effort is impossible in this context, it becomes necessary to specify an alternative rule for allocating corporate profits among the relevant claimants.

In general, the rules proposed depend on both the surplus generated by the group as a whole and the alternatives available to subgroups (or "coalitions") should they choose to opt out of the bargain. The available alternatives (or default options) are in turn defined by the property rights of the coalition members. For example, Hart and Moore (1990) use the surplus sharing rule proposed by Lloyd Shapley (1953) to study the impact of decentralized asset ownership on the investment efforts of corporate claimants. In a related work, Holmstrom and Tirole (1991) use the Nash bargaining solution to characterize the impact of allowing subsidiaries to "defect" by refusing to trade with their parent company.

In this paper, I adapt the model developed by Hart and Moore (1990) to illustrate the incentive effects of the ownership structure implied by the J&J Credo. I assume the social value of a firm's activities depends on the effort (or investment) undertaken by *both* shareholders *and* (non-equity-owning) stakeholders.[3] In other words, I assume that both shareholders and stakeholders may take costly (and non-contractible) actions to increase the value of output produced by the firm. The benefits and the costs of this non-contractible effort depend on the share of corporate assets initially allocated to each player.[4]

This scenario arises whenever the firm's cost of manufacturing depends on employee care, on employees' firm-specific expertise or on the range of amenities provided by the local community. It also arises when company profits depend on the firm's reputation or on the care and precautions taken by consumers. Each of these examples can be characterized as a duopoly in which each player's investment incentive depends both on his or her anticipated share of the firm's surplus and on the action taken by the other player.

Read literally, the J&J Credo strengthens the bargaining position of corporate stakeholders by enhancing their default options. If treated as a contract, the Credo would essentially give workers, suppliers, customers, the local community, etc. grounds for suit if J&J fails to treat these stakeholders fairly. To formalize this commitment by J&J, I characterize the Credo as a transfer of some corporate assets from shareholders to stakeholders.

For the purposes of exposition, I limit discussion to workers as representative (non-equity owning) stakeholders, and assume

that the asset to be allocated between shareholders and workers is worker health. For example, J&J shareholders would have - in the absence of the Credo - an ownership claim of sorts to both the tangible assets of the firm and the health of its employees.[5] Without the Credo, J&J would be limited only by imperfect OSHA supervision and workers' compensation premia if it chose to overlook workplace hazards. Since the Credo promises workers better on-the-job conditions, it reduces the precautions that workers must take on their own to protect their physical (and emotional) health.

In this paper, I show that such an asset transfer may increase *both* the total surplus generated by the firm *and* the wealth of shareholders. As the asset transfer strengthens the bargaining position of workers vis à vis shareholders, it strengthens the incentive (and lowers the cost) for employees to exert themselves on behalf of the firm. Shareholders have the incentive to transfer assets if the gains from increased worker effort more than offset the cost of the enhanced worker bargaining position combined with the cost of the transfer itself.

1. Notation

The first task is to define the surplus generated by the different player combinations for a given allocation of corporate assets. I assume that there are two "players"; I label the representative shareholder/manager (the "owner") as player 1 and the representative worker/stakeholder as player 2. I assume that production requires a combination of existing assets (a_1, a_2) and player effort (x_1, x_2). For consistency of notation, let x_1 represent the level of managerial effort chosen by player 1 and let x_2 represent the level of worker effort chosen by player 2.

The existing assets to be allocated are the firm's physical plant and worker health. I assume throughout that while shareholders own all of the firm's physical plant, workers may only own a fraction of their health. More formally, let a_1 represent the existing physical plant and let a_2 represent worker health. I assume that player 1 owns all of asset a_1, while player 2 owns only a fraction α, $0 \leq \alpha \leq 1$, of asset a_2. The remaining fraction $(1-\alpha)$ of asset a_2 is owned by player 1.[6]

To illustrate the structure of the bargaining problem that arises between owners and workers, I use the following general notation to indicate the value of output (or joint surplus) produced by different player coalitions:

Output of owner and worker together: $v(x_1,x_2|a_1,a_2)$

Output produced by owner alone: $v(x_1|a_1,(1-\alpha)a_2)$

Output produced by worker alone: $v(x_2|\alpha a_2)$

Output of the "empty" coalition: $v(0) = 0$

From this notation it follows that the value of output for a particular coalition depends on both the assets owned (a_i) by coalition members and the levels of effort (x_i) that members undertake.

I assume that the structure of asset ownership also affects the cost of effort for individual players. In particular,

Cost of owner effort: $c_1(x_1|a_1,(1-\alpha)a_2)$

Cost of worker effort: $c_2(x_2|\alpha a_2)$.

This notation indicates that an individual player's cost of effort depends on the assets he or she owns, but not on the level of effort undertaken by the other members of the coalition. These cost functions also reflect the assumption that the representative worker owns a share α of asset a_2 and has no ownership claim on asset a_1.[7]

2. The Bargaining Problem

Given the production and cost functions specified in Section 1, it remains to define and solve the bargaining problem that arises between owners and workers for a given allocation of existing assets. To divide up the results of joint production, I rely on the "cooperative" approach proposed in Shapley (1953). This solution concept gives to each player a share of output equal to the player's average incremental contribution to the coalitions of which it might be a member.

There are a variety of reasons to use a "Shapley value" mechanism to allocate the rewards of joint effort. It is well-known that such a mechanism implements the "Nash bargaining solution" for two-person games.[8] In other words, output allocated on the basis of Shapley values would maximize the product of gains realized by individual players relative to their respective default utilities. More formally, a Shapley value mechanism would solve the allocation problem

$$\max_{\delta} [\delta v(x_1,x_2) - v(x_1)][(1-\delta)v(x_1,x_2) - v(x_2)]$$

proposed by Nash (1950).[9]

Starting from a slightly different notion of justice, Young (1988, p. 271) demonstrates that the Shapley value is the only sharing rule that (1) fully distributes output; (2) treats identical players equally; and (3) determines individual shares strictly on the basis of individual contributions to output. Hart and Moore (1990, p. 1129) observe that the Shapley value mechanism gives each player his or her "*expected* contribution to a coalition, where the expectation is taken over all coalitions to which [the player] might belong."[10] Any of these cooperative bargaining approaches provide the basis for an argument that market participants would agree in advance to use a Shapley value mechanism as the means of allocating output in the future.[11,12]

To define the Shapley values for the bargaining game between a representative owner and a representative worker, I first observe that each of these two players is potentially a member of two coalitions: a coalition "of the whole" and a coalition consisting of the player alone. If each player bears his or her full cost of effort, then the net benefit to each player when output is allocated using Shapley's method is given by

$$W_1 = .5[v(x_1,x_2|a_1,a_2) - v(x_2|\alpha a_2)] + .5[v(x_1|a_1,(1-\alpha)a_2) - v(0)] - c_1(x_1|a_1,(1-\alpha)a_2) \quad (2.1)$$

$$W_2 = .5[v(x_1,x_2|a_1,a_2) - v(x_1|a_1,(1-\alpha)a_2)] + .5[v(x_2|\alpha a_2) - v(0)] - c_1(x_2|\alpha a_2) \quad (2.2)$$

The first bracketed term in each of these equations represents the contribution the player makes to the coalition of whole: the difference between the value of output with both players and the value of output with only one player indicates the "value added" by the second player. The second bracketed term in each of these equations represents the contribution of (or value added by) each player to the empty coalition, $v(0)$.

Using the payoffs specified in equations (2.1) and (2.2), we can now define the equilibrium for the bargaining problem at issue. Assume that both the representative owner and the representative worker choose their effort levels x_1 and x_2 to maximize their respective payoffs. If each player takes the choice made by the other as given, then the first order conditions

$$\partial W_1/\partial x_1 = .5v_1(x_1^*,x_2^*|a_1,a_2) + .5v_1(x_1^*|a_1,(1-\alpha)a_2) - c_1(x_1^*|a_1,(1-\alpha)a_2) = 0 \quad (2.3)$$

$$\partial W_2/\partial x_2 = .5v_2(x_1^*, x_2^* | a_1, a_2) + .5v_2(x_2^* | \alpha a_2) - c_2(x_2^* | \alpha a_2) = 0 \quad (2.4)$$

jointly determine the equilibrium effort choices, x_1^* and x_2^*.[13] Given these effort choices, the equilibrium payoffs (i.e., net benefits) for the representative owner and the representative worker are found by substituting x_1^* and x_2^* into the objective functions given in (2.1) and (2.2).

3. The Asset Allocation Problem

The previous section defined equilibrium for a given allocation of the assets a_1 and a_2. It now remains to see if the representative owner has the incentive to adopt a code of corporate conduct that would effectively transfer some (or all) of a_2 to the representative worker. (This transfer is formally characterized as an increase in the parameter α.)

To determine the effect of adopting a code, it is first necessary to indicate the specific impact of asset ownership on the productivity and cost of player effort. Increasing α (and thereby increasing a worker's ownership claim on his or her health) would potentially have several effects. It could strengthen the bargaining position of workers by increasing the default utility $v(x_2|\alpha a_2)$ for each level of effort x_2. The asset transfer could also lower worker effort costs by decreasing $c_2(x_2|\alpha x_2)$ and/or raise owner effort costs by increasing $c_1(x_1|a_2,(1-\alpha)a_2)$. In summary, I characterize a code of conduct as a commitment to an improvement in workplace conditions. This transfer of corporate assets from owners to workers gives workers a greater ownership claim on their own health. It potentially increases the productivity and lowers the cost of worker effort while it raises the cost of owner effort.

To evaluate the impact of such transfers on equilibrium effort choices and on the net benefits realized, I examine a specific production technology and set of cost functions. Let the value of output produced by the set of possible coalitions be given by

Owner and worker together:
$$v(x_1,x_2|a_1,a_2) = [(a_1x_1)^\rho + (a_2x_2)^\rho]^{1/\rho}$$

Owner alone:
$$v(x_1|a_1,(1-\alpha)a_2) = a_1x_1$$

Worker alone:
$$v(x_2|\alpha a_2) = \alpha a_2 x_2.$$

This specification reflects the assumptions that player 2 is *indispensable* to asset a_2: player 1's ownership share of asset a_2 has no impact on output unless player 2 is also a member of the coalition.[14] In other words, the owner's claim on worker health $[(1-\alpha)a_2]$ is meaningless unless the worker is involved in production. Restricting the parameter ρ so that $1 > \rho > 0$ ensures that (1) worker effort is an imperfect substitute for owner effort (and vice versa); and that (2) owners and workers produce more when working together than when working separately.[15]

Let the cost of effort for the representative owner and the representative worker be given by

$$c_1(x_1|a_1,(1-\alpha)a_2) = c_1x_1^2/(1+\delta a_1+\epsilon(1-\alpha)a_2)$$

and

$$c_2(x_2|\alpha a_2) = c_2x_2^2/(1+\lambda\alpha a_2)$$

respectively. This specification reflects the assumption that asset ownership may influence the cost of effort for either or both players. The extent of the effect depends on the parameters δ, ϵ, and λ: the larger any of these parameters, the larger the cost-reducing impact of asset ownership.

4. The Owner's Incentives to Adopt a Code of Conduct

We can now determine when, if ever, a code of conduct can increase shareholder wealth. As mentioned above, I characterize the adoption of a code as an increase in α, i.e., a (partial or complete) transfer of asset a_2 from owners to workers. Given the technology specified in Section 3, the increase in α has three direct effects on effort choices: as it (1) increases the representative worker's marginal benefit of effort and (2) lowers the worker's marginal cost of effort, it also (3) raises the representative shareholder's marginal cost of effort. It follows that, for a wide range of parameter values, an increase in α implies more worker effort and less owner effort in equilibrium. The net impact of adopting a code of conduct therefore depends on the balance between these effort effects.

Figures 1 and 2 illustrate the equilibrium effort choices and net benefits for the following parameter values:[16]

$$v(x_1,x_2|a_1,a_2) = [(20x_1)^{4/5} + (20x_2)^{4/5}]^{5/4}$$

$$v(x_1|a_1,(1-\alpha)a_2) = 20x_1$$

$$v(x_2|\alpha a_2) = \alpha 20x_2$$

$$c_1(x_1|a_1,(1-\alpha)a_2) = 20x_1^2/(1+20+(1-\alpha)160)$$

$$c_2(x_2|\alpha a_2) = 20x_2^2/(1+\alpha 160).$$

For this specification of the bargaining problem, we see that the owner does have some incentive to adopt a code of conduct: the owner's net benefit is at a maximum when $\alpha=.86$. In other words, if owners had title to 100 percent of a_2, then they could raise the value of their stock (i.e., the market value of their claim on firm profits) by transferring 14 percent of a_2 to workers.

The bad news is that what is best for owners is not necessarily best for the more complete set of corporate stakeholders. From Figure 2, it follows that $\alpha=.36$ maximizes the sum of owner and worker net benefits. In other words, owners have some incentive to improve workplace conditions, but not to the extent that "total surplus" is at a maximum.

5. The Role of Economic Analysis

This stylized view of corporate codes of conduct provides an opportunity to review an on-going debate in the "law and economics" field: the relationship between the initial assignment of property rights and the efficiency of equilibrium. Figure 2 indicates that some ownership structures for the asset a_2 are more efficient (i.e. generate a higher surplus) than others. This observation leaves open the question of whether or not there is a need to mandate a particular ownership structure.

The "first theorem" of welfare economics tells us that Pareto efficiency is the result of voluntary exchange in a competitive market. Coase (1959, 1960, 1988) examines a particular instance of this result: the case in which there is a unique efficient allocation. In reviewing the importance of liability rules for competitive market outcomes, Coase concludes that "in a regime with zero transaction costs, the allocation of resources remains the same whatever the legal position regarding liability for harmful effects."[17] Under either formulation, the efficiency of equilibrium is invariant to the initial assignment of rights in the absence of transactions costs.

It is generally agreed that this invariance result breaks down if exchange is costly. Nevertheless, disputes abound when it comes to defining the appropriate policy responses to these transaction costs.[18] The formal structure of the model presented in this essay provides a framework that enables us to identify at least some of the reasons for these disputes.

First, it is clear that the model proposed in this essay satisfies a "necessary condition" for the presence of transaction costs: the initial assignment of rights *does* matter. Figure 2 illustrates how the initial allocation of the asset a_2 influences the equilibrium level of surplus in the economy.

The next step is to discover *why* the assignment of rights matters. Is the reason plausibly described as a "transaction cost"? It is clear that the allocation of rights in the model affects both effort costs and output shares for market participants. It therefore influences the equilibrium level of production. However, the source of the transaction costs is not immediately obvious since the code of conduct (i.e., the transfer of a_2) is assumed to be costlessly enforceable.

The transaction costs in the model can be traced to the assumption that *owner and worker effort levels are "non-contractible"*.[19] In other words, neither owners nor workers can write binding "forcing" contracts to ensure optimal levels of effort.[20] There are a variety of possible justifications for such an assumption: effort levels may not be directly observable or the courts may have found contracts contingent on effort to be "against public policy." In any event, the non-contractibility assumption forces market participants to resort to sharing rules such as the Shapley value mechanism.

Given the impossibility of achieving a first-best optimum[21] with forcing contracts, we must then ask whether or not voluntary exchange will at least support a second-best optimum.[22] In other words, will initial trade in the asset a_2 ensure that the surplus-maximizing level of α (.36 in Figure 2) prevails in equilibrium? Economists are conditioned to answer this question in the affirmative almost as an article of faith. In fact, the appropriateness of this response depends on the extent of transactions costs at the very earliest stage of the bargaining process.

In their description of a model that served as an inspiration for the one presented in this paper, Hart and Moore (1990, p. 1131) write

> We shall take the point of view that efficient trading at date 0 leads to a control structure α that maximizes $W(x^e(\alpha))$. That is, if the initial α does not maximize $W(x^e(\alpha))$, someone will propose a new α and a set of side payments such that everyone is better off...[23]

In the model I propose, the equilibrium level of total surplus depends on the scope for trade in a_2. Figure 2 and the analysis in Section 4 indicate that owners do have some incentive to make unilateral transfers to workers for a wide range of parameter values. However, the value of α that maximizes shareholder wealth (.86 in Figure 2) generally fails to maximize total surplus. It is therefore not likely that owners would in general adopt the "optimal" code of ethics unilaterally.

Would workers have the incentive to purchase a greater stake in a_2 and thereby make it possible for society as a whole to

realize a second best optimum? In other words, can we rely on workers (along with other stakeholder groups) to bargain for the optimal code of ethics? Such a transaction would resurrect a "Coase-like" invariance result at this earlier stage in the contracting process: if there were a competitive market in a_2, then there would be no efficiency justification for regulating the contracting process. There would be no reason to require minimum workplace health and safety standards, to adopt environmental protection laws, or to set minimum product safety standards.

Economic analysis cannot provide a definitive answer to these policy questions; it merely enables us to examine the consequences of difference sets of assumptions. All policy applications of economic models start with a strong set of assumptions. The "transferrable utility" model presented in this paper requires that rights (however assigned) be costlessly enforceable and that $1 be worth the same to workers as to managers.[24] If we further assume that there is a competitive market in assets like worker health and environmental quality, then equilibrium will be (second-best) efficient; the initial allocation of assets will simply determine the final distribution of wealth. If, on the other hand, we assume that there are unavoidable transaction costs at this earlier bargaining stage, then the initial allocation of assets affects both the level of total surplus and its distribution.

6. Concluding Observations

Do we wish to use this type of economic analysis as a guide to the initial allocation of rights?[25] Economic analysis itself cannot resolve this issue. We must ultimately return to extra-market notions of justice, fairness and probably just plain common sense.

The discussion in Section 5 provides an outline for this expanded view of policy analysis. The first task is to identify the transaction costs at each stage in the bargaining process. If there are no transaction costs, we are left to determine the fairness of the equilibrium distribution of wealth given the initial allocation of rights. If the transaction costs (like the non-contractibility of effort) render (competitive) bargaining impossible at some stage, we are faced with a more difficult task, that of choosing the appropriate trade-off between equity and efficiency.

Figure 1: The Impact of α2 on Owner and Worker Effort

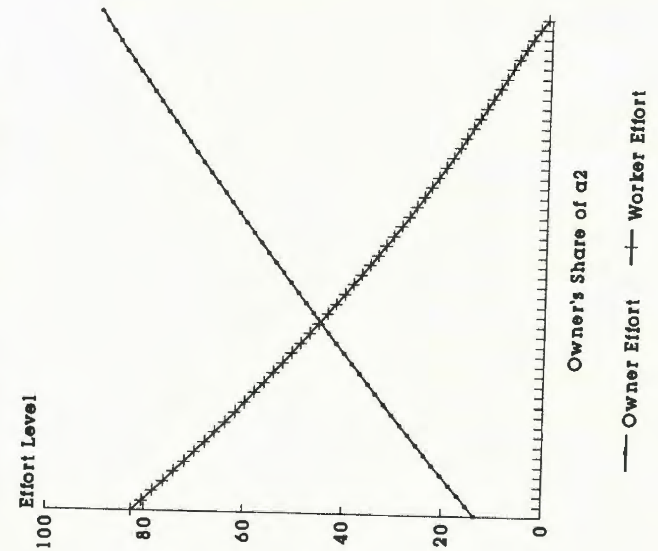
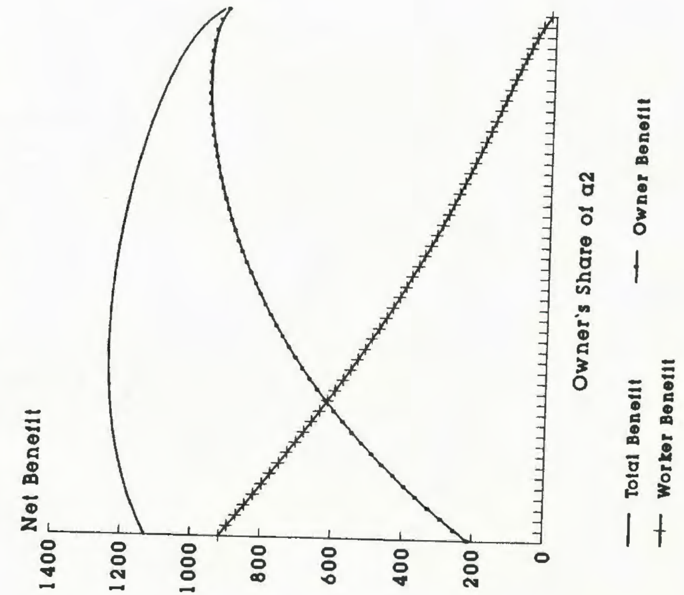


Figure 2: Owner's Incentive to Adopt a Code of Conduct



Appendix: The Johnson & Johnson Credo

We believe our first responsibility is
to the doctors, nurses and patients,
to mothers and all others who use our products and services.
In meeting their needs everything we do must be of high quality.
We must constantly strive to reduce our costs
in order to maintain reasonable prices.
Customers' orders must be serviced promptly and accurately.
Our suppliers and distributors must have an opportunity
to make a fair profit.

We are responsible to our employees,
the men and women who work with us throughout the world.
Everyone must be considered as an individual.
We must respect their dignity and recognize their merit.
They must have a sense of security in their jobs.
Compensation must be fair and adequate,
and working conditions clean, orderly and safe.
Employees must feel free to make suggestions and complaints.
There must be equal opportunity for employment, development
and advancement for those qualified.
We must provide competent management,
and their actions must be just and ethical.

We are responsible to the communities in which we live and work
and to the world community as well.
We must be good citizens - support good works and charities
and bear our fair share of taxes.
We must encourage civic improvements
and better health and education.
We must maintain in good order
the property we are privileged to use,
protecting the environment and natural resources.

Our final responsibility is to our stockholders.
Business must make a sound profit.
We must experiment with new ideas.
Research must be carried on, innovative programs developed
and mistakes paid for.
New equipment must be purchased, new facilities provided
and new products launched.
Reserves must be created to provide for adverse times.
When we operate according to these principles,
the stockholders should realize a fair return.

Endnotes:

1. Conference Board (1992, p. 11).

2. White and Montgomery (1980, pp. 81-83.) See Pitt and Groskaufmanis (1990, p. 1602) for a discussion of this and other survey results.

3. DeGeorge (1990, p. 163) defines stakeholders to be *all* constituencies to which the firm "has any moral obligations". Freeman's (1984, p. 46) definition includes "any group or individual who can affect or is affected by the achievement of the organization's objectives." For convenience of exposition I adopt a somewhat narrower definition. In this paper, I use the term "stakeholder" to indicate the set of all (potential) corporate claimants *except* equity owners. This group typically includes employees, suppliers, customers, clients, and the surrounding community.

4. This treatment of effort costs and asset ownership differs from that found in Hart and Moore (1990). I allow for "partial" asset ownership rather than assuming that assets are indivisible lumps that must be allocated in full to a single player. I also allow asset ownership to influence the marginal cost of effort as well as its marginal product.

5. By "ownership" here I mean the right to use an asset without having to purchase it; the right to obtain full compensation if the asset is damaged; and the right to withhold access to the asset.

6. This assumption reflects a more general definition of ownership than the one found in Hart and Moore (1990). Allowing fractional values for α enables me to treat worker health as a diverse asset. "Fractional ownership" makes it possible to consider a variety of compensation levels for worker illness or injury.

7. Note that since the functions

$$v(x_1|\cdot,\cdot) - c_1(x_1|\cdot,\cdot) \text{ and}$$

$$v(x_2|\cdot) - c_2(x_2|\cdot)$$

indicate the opportunities available to individual players when acting alone, these functions define the "default" or "reservation" utilities at given levels of effort for owners and workers respectively.

8. See Shapley (1988 reprint of 1969 article, p. 316).

9. This is a game with "transferrable" utility: monetary transfers have the same value to both players. The parameter δ serves to allocate joint output between the two players. The first bracketed term represents the difference between the output share received by player 1 and that player's default utility. The second bracketed term represents the corresponding difference for player 2.

10. Rothblum (1988) provides three specifications of the Shapley mechanism in which "a player gets 'the average relative payoff to coalitions that contain him'."

11. For transferrable utility games with two players, the Shapley value allocation also coincides with the cooperative bargaining solution proposed by David Gauthier. See Gauthier (1986) and (1985) for a discussion of the ethical underpinnings of his approach to individual rights in social contracts. The Shapley value mechanism can also be generalized to allow for differences in bargaining ability and/or broader definitions of egalitarian allocations. See Kalai and Samet (1985, 1988).

12. Recent authors have also argued argue that the Shapley value mechanism can be interpreted in a more "strategic" context as a *noncooperative* bargaining solution. Hart and Moore (1990, pp. 1129-30, footnote 11) observe that the Shapley value can be interpreted as the subgame perfect equilibrium for a multistage game involving a sequence of take-it-or-leave-it contracts. Gul (1989) provides an alternative interpretation for the Shapley value as a subgame perfect equilibrium.

13. More formally, these first order conditions are necessary and sufficient for an equilibrium if both objective functions (W_1 and W_2) are differentiable and strictly concave (i.e., have a maximum). Sufficient for concavity is that additional effort increases output at a decreasing rate and increases cost at an increasing rate: $v_1(x_1,x_2)>0$, $v_{11}(x_1,x_2)<0$, $v_2(x_1,x_2)>0$, $v_{22}(x_1,x_2)<0$, $v_1(x_1)>0$, $v_{11}(x_1)<0$, $v_2(x_2)>0$, $v_{22}(x_2)<0$, $c_1'(x_1)>0$, $c_1''(x_1)>0$, $c_2'(x_2)>0$, and $c_2''(x_2)>0$. The equilibrium defined by (2.3) and (2.4) is stable if $v_{12}(x_1,x_2)$ is sufficiently small. This last condition ensures that a change in effort choice by a given player has a greater impact on its own objective function than on the objective function of the other participants in the game.

14. This terminology is due to Hart and Moore (1988).

15. To see the benefit of joint effort with this specification, let $a_1=a_2=1$; $\alpha=1$ and $\rho=.5$. It follows that $v(x_1,x_2) = x_1 + x_2 + 2(x_1x_2)^{.5} > v(x_1) + v(x_2) = x_1 + x_2$. In other words, the value of output from the coalition consisting of one worker and one owner exceeds the sum of what the worker and the owner can each produce separately.

16. In particular, $\rho=4/5$, $a_1=a_2=c_1=c_2=20$, $\delta=1$ and $\epsilon=\lambda=8$.

17. Coase (1988), p. 170. For an earlier version of the Coase theorem, see Coase (1959), p. 27: "The delimitation of rights is an essential prelude to market transactions...the ultimate result (which maximizes the value of production) is

independent of the legal decision."

18. Newberry (1989, pp. 215-16) provides an overview of the policy debate over pollution externalities that has involved Pigou, Coase, Baumol, Oates and others since the 1930s.

19. Since it is impossible to write and enforce this type of contract, the cost of the "transaction" is effectively infinite.

20. A forcing contract promises payment if and only if effort (or in some cases output) reaches a pre-specified level. See Miller (1992, Chapter 5) for a discussion of the uses and limitations of this device as a method of eliminating free riders.

21. A "first best" optimum is an equilibrium that is fully Pareto efficient: all gains from trade have been realized.

22. A "second-best" optimum is the best feasible equilibrium given the constraints imposed by technology and various transaction costs.

23. In the notation found in Hart and Moore (1990) is similar to that used in this paper: α indicates the allocation of assets that exist when bargaining begins, while $W(x^e(\alpha))$ represents the *sum* of net benefits realized by market participants.

24. This latter assumption ensures that there are no "wealth effects" that distort owner and/or worker willingness-to-pay.

25. Coase has long recommended this approach. See Coase (1988) for his response to a number of his critics. Posner (1979, 1983) labels this approach "wealth maximization" and recommends it as a guide for judicial decision-making. Coleman (1984) provides a review of the criticisms of Posner's argument.

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