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A LONG SHOT FINALLY HITS THE TARGET: AN ILLINOIS COURT ACCEPTS THE POTENTIAL APPLICATION OF A PUBLIC NUISANCE CLAIM AGAINST GUN MANUFACTURERS

by

Dennis D. DiMarzio*

I. Introduction

Young v. Bryco Arms.[1] is a pending lawsuit filed in Cook County, Illinois in which a state trial court repeatedly denied gun manufacturers' motions to dismiss a public nuisance action filed by families of people killed by gun violence in Chicago. In fact, the First District Appellate Court of Illinois in an interlocutory appellate decision unanimously affirmed the trial court's refusal to dismiss the public nuisance claim.[2] Most significantly, however, "... of the more than 30 such suits filed around the country, this was the first case to win a favorable appellate decision."[3] Prior to this potentially successful claim, gun violence victims have filed countless unsuccessful claims based on various other theories against those in the gun industry. It was against this backdrop of litigation history that the title to this paper was born – "A Long Shot Finally Hits the Target: An Illinois Court Accepts the Potential Application of a Public Nuisance Claim Against Gun Manufacturers."

The purpose of this paper is to examine the plight of gun violence victims and their families in America in light of rampant gun violence and the current state of the law. First, a historical view of gun violence litigation will be presented. Next, a comprehensive analysis of the *Young v. Bryco Arms*[4] case will be presented. Then, the projected ultimate decision of the *Young* case will be evaluated, including a discussion of the clear implications of that decision. Finally, the paper will offer a conclusion in which the author suggests his view of how American justice should respond to the gun violence problem.

II. Historical View of Gun Violence Litigation in America

Gun violence has long been a problem in America. Recent statistics indicate how serious the gun violence problem continues to be today. "...Approximately 35,000 Americans die from gunfire each year."[5] In 1998, a typical recent year, "... more than 170,000 people were robbed at gunpoint, and approximately 104,000 people were shot but survived."[6]

To date, gun violence victims, their families, and more recently local governments

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have filed a steady stream of largely unsuccessful lawsuits against those in the gun industry. A legal commentator[7] has aptly identified five doctrinal approaches used in claiming gun manufacturer liability for crime-related injuries. Those five approaches are as follows: "(1) strict liability for abnormally dangerous activities, (2) product liability for design defect, (3) negligent marketing, (4) public nuisance, and (5) deceptive trade practices."[8] The remainder of this section of the paper will isolate and briefly discuss each of these five approaches and the typical judicial response it has engendered.

A. Strict Liability for Abnormally Dangerous Activities

The Second Restatement of Torts States: "One who carries on an abnormally dangerous activity is subject to liability for harm to the person, land or chattels of another resulting from the activity, although he has exercised the utmost care to prevent the harm."[9] The ultra hazardous activity issue is considered to be a question of law and the court considers six factors in answering the question. The six factors include: "a) existence of a high degree of risk of some harm to the person, land or chattels of others; b) likelihood that the harm that results from it will be great; c) inability to eliminate the risk by the exercise of reasonable care; d) extent to which the activity is not a matter of common usage; e) inappropriateness of the activity to the place where it is carried on; and f) extent to which its value to the community is outweighed by its dangerous attributes."[10]

Plaintiffs have generally asserted that the manufacture, marketing, and sale of handguns is an abnormally dangerous activity.[11] Courts have generally responded that there is no abnormal risk inherent in the manufacture, marketing, or sale of guns. The large number of new guns manufactured and sold each year makes these activities very common and ordinary events.[12] Furthermore, "... the risks of harm from handguns do not come from their sale and distribution as such."[13] One commentator has aptly described the situation as follows: "... the emphasis of the doctrine is on the use of a product in an ultra hazardous manner, not on the manufacturing of an ultra hazardous product."[14] The pro-gun industry's explanation that guns do not kill people, but rather that people kill people truly represents the final nail in this theory's coffin.

B. Strict Products Liability

Strict products liability claims are generally brought for manufacturing or design defects.[15] Potentially, all parties in the chain of distribution can be held liable for a defective product. Generally, any user injured by the defective product can recover.

One commentator has succinctly described the problem with this theory as follows: "In the context of a well-made gun, a strict products liability theory is virtually insupportable. The very purpose of a handgun is to cause injury – to kill and to wound. Thus, the injury caused by a gun results from the intended use of that gun, not a defect in design or manufacturing."[16]

With one exception,[17] the case law has overwhelmingly held for the gun industry in strict products liability litigation. In *Kelley V.R.G. Industries,*[18] the Supreme Court of

Maryland held that manufacturers and sellers of Saturday Night Specials should be "strictly liable to innocent persons who suffer gunshot injuries from the criminal misuse of their products."[19] The Court described "Saturday Night Specials" as being "particularly attractive for criminal use and virtually useless for ... legitimate purposes...."[20] The Court further found that manufacturers of these guns know or should know that the principal use of their products is for criminal activity.[21] Shortly after this decision, the Maryland legislature passed a gun control act "... creating a board of experts to identify and restrict the sale of handguns with a high risk of criminal misuse and overturning the doctrine of strict liability for the manufacture and sale of Saturday Night Specials.[22] Furthermore, the *Kelley* exception has been rejected by other courts.[23]

C. Negligence

Most of the lawsuits against the gun industry have focused on negligence in marketing and or distribution of guns.[24] The elements of a common law negligence claim have long required the plaintiff to establish the following: 1) that the defendant owed the plaintiff a duty of care, 2) that the defendant breached that duty in some specific way, and 3) that the defendant's breach of duty proximately caused damage to the plaintiff.[25]

Clearly, the greatest roadblock to recovery in a negligence claim is establishing proximate cause. Simply put, Courts have refused to impose a duty on a gun manufacturer for the criminal acts of a third party.[26]

The most common argument that plaintiffs have made is that "... a gun manufacturer owes a duty to the public to take precautions against the ... criminal misuse of their products where their own promotion and distribution of weapons contribute to the risk of such misuse."[27] Then the plaintiffs seek to show a breach of the duty by tracing defendants' guns to criminals who in fact use them in the commission of crimes. Finally, the victims of third party criminal attacks seek to hold the gun manufacturers liable for their injuries.

With one noteworthy exception,[28] the plaintiffs' negligent marketing and distribution claims have been defeated at or before the trial stage of the case. The vast majority of those claims have been defeated by courts granting defendants' motions for summary judgment.[29] In the case of *Hamilton v. Accu-Tek*,[30] relatives of six people killed by handguns, as well as one injured survivor and his mother sued twenty-five handgun manufacturers based on negligent marketing practices. They argued that common industry practices such as marketing guns through gun shows raised the risk that the guns would be resold to criminals.[31] The plaintiffs also presented social science data and expert testimony to support the link between the gun industry marketing practices and crime.[32] The jury ultimately found that fifteen defendants had marketed or distributed handguns negligently and that three plaintiffs should be awarded provable damages under a market share theory of liability, which was warranted for their claims.[33] Only three defendant manufacturers were assessed damages.

The plaintiffs' jury trial victory was short-lived. In *Hamilton v. Beretta U.S.A. Corp.*,[34] the Federal Appellate Court, after directing the New York Court of Appeals, New York's highest State Court, to answer two certified questions of state law, and reviewing those State Court answers, vacated the federal district court's judgment order.

The two certified questions considered by New York State's Highest Court were as follows: "1) Whether the defendants owed plaintiffs a duty to exercise reasonable care in the marketing and distribution of the handguns they manufacture? 2) Whether liability may be apportioned on a market share basis; and if so, how?"[35] The New York High Court, determining the evidence submitted to be insufficient, answered the first certified question in the negative. The Court found the defendants' relationships with their dealers and distributors did not "place the defendants in the best position to protect against the risk of harm," in light of the "very large" pool of potential plaintiffs and the "remote" connection between defendants, the criminal wrongdoers, and plaintiffs.[36] The Court determined that there was a lack of evidence of "any statistically significant relationship between particular classes of dealers and crime guns ..."[37] While the Court acknowledged that a duty of care might arise in certain cases, there was simply a lack of evidence in this case that defendants knew or had "reason to know their distributors were engaging in substantial sales of guns into the gun-trafficking market on a consistent basis."[38]

In light of its negative answer to the negligence duty question, the Court acknowledged that "it arguably need not reach the market share issue."[39] However, the Court chose to answer the market share issue. Ultimately the Court again answered the question in the negative, concluding that "plaintiffs have not shown a set of compelling circumstances ... justifying a departure from traditional common law principles of causation."[40]

The Federal Appellate Court was duty bound to vacate the trial court's judgment for the plaintiffs after receiving the New York High Court's negative answers to the aforementioned certified questions of law. The rule is clear that a federal court in a case of this nature must accept the fact that "the highest court of a state has the final word on the meaning of state law."[41]

The outcome in the *Hamilton* case does not entirely preclude the future possibility of a successful negligence in marketing claim against gun manufacturers. However, the statistical and connective evidence between classes of dealers and crime guns would have to be significant, and the charged gun manufacturers would have to have knowledge of these significant connections prior to the initial sale of their guns. At best, the *Hamilton* case is an open blue print of how much further plaintiffs must go to establish a valid negligence in marketing claim against gun manufacturers.

D. Public Nuisance

The historical view of the public nuisance claim will be pointed and brief. A more substantial discussion of public nuisance will be presented later in this paper in connection with analyzing the *Young* case, a case where the central claim is public nuisance. Two primary parties stand out as potential plaintiffs in public nuisance claims against the gun industry. First, state or local governments might claim public nuisance by the gun industry in that it interferes with or provides dangers to "health, safety, convenience and public peace" rights common to the public.[42] The Governments could bring criminal or civil claims. Secondly, private plaintiffs who have suffered a distinct injury could bring a tort claim for public nuisance. The remedies could include damages, an injunction, or abatement. The public nuisance civil tort claims, like the previous types of tort claims, are most vulnerable to a causation attack. These cases will rise and fall based on their specific facts, and this paper will focus on the *Young* facts in a more substantial later discussion.

E. Deceptive Trade Practices

Several cities have filed suit against the gun industry, claiming deceptive trade practices. "The plaintiffs in these suits allege that manufacturers' advertising claims that gun ownership in the home increases safety contradict public health studies, and that these claims constitute intentional misrepresentation in violation of state laws governing deceptive trade practices."[43] These suits rely heavily on controversial social science studies, and there is major disagreement among social scientists and their research.[44] Under current circumstances, proving the manufacturers' intent to deceive the public looks like an overwhelming task.

III. Young v. Bryco Arms

Initially, the *Young* case involved a claim filed by Anthony Ceriale on behalf of his son, Michael Ceriale, who was killed in the course of his duties as a Chicago police officer by a juvenile gang member using a .357 Magnum revolver manufactured by defendant Smith & Wesson Corporation. Two additional complaints were consolidated with the Ceriale complaint for the purpose of an interlocutory appeal from the trial court's refusal to dismiss these public nuisance claims. Stephen Young filed a complaint on behalf of his son Andrew Young, who was killed on the streets of Chicago by a juvenile street gang member using a gun manufactured by defendant Bryco Arms. Obrellia Smith filed a complaint on behalf of her daughter, Salada Smith who was killed in the course of a drive-by shooting by a juvenile gang member using a gun manufactured by defendant Navegar, Inc. Plaintiffs, representing the surviving relatives of two other Chicago shooting victims, whose murder weapons were never recovered, had their claims dismissed for failure to establish standing.

More exactly, the remaining plaintiffs' complaints allege a public nuisance claim against eighteen firearm manufacturers, four wholesale distributors, and two suburban retail gun dealers who were individually responsible for making handguns widely available to juveniles in the City of Chicago.

> The complaints assert that the plaintiffs and others possess a public right to use the streets and other public areas without fear, apprehension and undue risk of injury to themselves or to their families. Plaintiffs allege that defendants'

> marketing and distribution practices have unreasonably interfered with this public right by virtue of the wide availability of handguns that are accessible to juveniles in Chicago. Specifically, plaintiffs allege that defendants produce and sell handguns designed to appeal to criminally oriented juvenile street gangs and other criminals... Finally, Plaintiffs allege that defendants: (1) distributed firearms through a market structure intentionally created by defendants by relying on low-end retailers who encourage purchasers to illegally transport weapons to Chicago; (2) failed to regulate or discipline known irresponsible dealers; (3) flooded the market in areas surrounding Chicago, knowing and foreseeing the excess firearm supply would be taken to Chicago and possessed and used illegally; and (4) created and maintained an underground market for handguns 'knowing and intending this result.'[45]

The question certified for interlocutory appeal asked whether the plaintiffs' complaints "state a viable public nuisance cause of action under Illinois law against the defendants."[46] It was an issue of first impression before an Illinois State Appellate Court. In unanimously affirming that the plaintiffs' complaints did state a viable public nuisance cause of action against the defendants, the Appellate court made several key statements regarding Illinois public nuisance law. A public nuisance is "an unreasonable interference with a right common to the general public."[47] Furthermore, "a private individual may bring a public nuisance claim if he suffers damages distinct from those suffered by the public at large."[48] The Court rejected the argument that a public nuisance claim must necessarily fail if there is criminal misuse of defendants' product. In fact, the Court stated, "... a reasonable trier of fact could find that the criminal misuse of guns killing persons were occurrences that defendants knew would result or were substantially certain to result from the defendants' alleged conduct in the instant case."[49] Finally, the Court stated that "... a plaintiff may seek monetary damages as well as injunctive relief in a public nuisance action."[50] The Court disagreed that the plaintiffs were really bringing wrongful death claims. The defendants were allegedly interfering with plaintiff's public right to use the "public spaces of the City of Chicago without undue risk of injury to themselves and to their families."[51]

One reason why the *Young* case might succeed whereas other prior public nuisance claims have failed is because of the unique circumstances connected with the Chicago claims. First of all, the City of Chicago and Cook County Illinois strongly regulate and limit the sale of handguns within their boundaries. Secondly, Chicago Law Enforcement people have done an extraordinary job in tracing the flow of firearms used in crimes in Chicago through various irresponsible gun dealers operating in Chicago and the surrounding suburban areas. Furthermore, the City has put gun manufacturers on notice about the various irresponsible gun dealers. Finally and most importantly, the plaintiffs in the *Young* case were able to do an outstanding job in establishing the exact chain of distribution connecting the guns used to kill plaintiffs' family members through certain irresponsible gun dealers, of whom the defendant gun manufacturers had been given advance notice. The weapons were traced to the criminal killers, and finally into the hands of law enforcement where they could be used as valuable evidence at trial. A closer examination of the key plaintiffs' complaints illustrates the masterful job of tracing the chain of distribution of the murder weapons. First, the *Young* Complaint alleges that Andrew Young was shot and killed on June 10, 1996, at the corner of Clark and Howard Streets in Chicago. The Complaint asserts that Mario Ramos, who was associated with the Latin Kings, shot Young. The firearm used by Ramos was a Bryco 59 manufactured by defendant Bryco Arms; "It was shipped to defendant distributor Jennings Firearms, Inc. on July 23, 1993. On July 28, 1993, Jennings shipped the weapon to defendant distributor Riley's Inc. On August 6, 1993, Riley's shipped the gun to defendant retail seller Breit & Johnson Sporting Goods, Inc. located in Oak Park, Illinois."[52] It is alleged that Bryco was on notice that both Jennings and Riley's were among a core group of 10 irresponsible distributors who acted as distributors for nearly half of the firearms traced to crimes in Chicago. Breit & Johnson was also identified as part of a core group of irresponsible gun dealers. On September 7, 1993, the gun was sold to Marianno DiVittorio under circumstances, which should have alerted Breit & Johnson that this was a "straw purchase" – a purchase not for DiVittorio himself, but for the benefit of Daniel Escobedo, a notorious convicted felon with ties to the Latin Kings street gang.[53] Escabedo then directly or indirectly caused the gun to be transferred to the Latin Kings, making it available to Mario Ramos, who used it to kill Andrew Young.[54]

Second, the Smith Complaint includes a critical tracing of the chain of distribution of the murder weapon. Salada Smith was murdered on June 22, 1997 and Darnell Foxx was one of three juveniles arrested and charged with her death. The TEC-DC9 used to kill Smith was manufactured by defendant Navegar. "On February 3, 1992, Navegar shipped the gun to a distributor called RSR Wholesale Guns. On February 17, 1992, RSR shipped the gun to retailer Perry's Trading Post in Greenwood, Mississippi."[55] About two and a half weeks before RSR shipped the weapon, the partners who owned Perry's were indicted by the federal government for illegal gun sales. It is alleged that RSR and defendant Navegar knew or reasonably should have known that the principals of Perry's Trading Post were engaged in illegal gun sales when the weapon was shipped to Perry's. Perry's sold the gun to an unknown purchaser on March 28, 1992. Following that sale, the weapon flowed into an underground market and was ultimately owned by the Vice Lords street gang in Chicago. Finally, on June 22, 1997, Darnell Foxx used the weapon to kill Salada Smith and her unborn child.[56]

Third, the Ceriale Complaint alleges a critical tracing of the chain of distribution of the murder weapon. Police officer Michael Ceriale was shot while he was conducting a narcotics surveillance on a vacant lot in Chicago. Officer Ceriale died on August 21, 1998 and Jonathan Tolliver, who was then a member of the Gangster Deciples street gang, was convicted of the murder. The Defendant Smith & Wesson marketed the .357 Magnum revolver used by Tolliver and sold it to distributor Camfour, Incorporated on April 4, 1995. "On April 10, 1995, Camfour shipped the revolver to a gun dealer listed in an invoice as Strictly Shooting, located in Merrionette Park, Illinois."[57] It is alleged that Smith & Wesson was on notice that Camfour was among a core group of 55 irresponsible distributors who acted as initial distributors for "nearly 80% of the firearms traced to crimes in Chicago." The Complaint also alleged that Camfour was also on notice that Strictly Shooting was one of a group of irresponsible gun dealers located in close proximity to Chicago.

Strictly Shooting sold the revolver some time later to an unknown purchaser. Laura Crowell, a Chicago resident took possession of the gun and she sold it in September 1997 to a retail store in Cook County called Chuck's Gun Shop. It is alleged that on December 28, 1997, Chuck's sold the revolver to Erza Evans in circumstances that should have alerted Chuck's that this was a straw purchase made for the benefit of the Gangster Deciples street gang. On August 15, 1999, Tolliver then used the revolver to shoot Ceriale.[58]

All of the aforementioned circumstances would suggest, as the Illinois Interlocutory Appellate Court decision ruled, that a public nuisance theory in the Chicago cases represents a viable theory of recovery.

IV. The Ultimate Young Decision and the Implications of That Decision

The *Young* case is still at its infancy stage, with a trial and potentially a long appeal to follow. The gun industry has a strong will, deep pockets, and passionate supporters who historically have an extraordinary record of success in the courts. However, the fact patterns in the Chicago claims were very unique. The City strictly regulates gun sales, accurately and routinely traces guns from manufacturers through irresponsible gun dealers to Chicago crimes, and notifies gun manufacturers in advance about certain irresponsible gun dealers and the high and significant percentage of their sold guns being used in Chicago crimes. Even if the case were ultimately to succeed and be upheld on appeal, it would only have immediate legal implications as a precedent for Illinois courts. An Earlier public nuisance claim filed by the City of Chicago against gun manufacturers was summarily dismissed, and that suit would likely be refiled by the City and would likely prove to be a winner. Public nuisance claims in other states with less than perfect facts would continue to fail.

It has long been suggested that the only hope to significantly hold the gun industry accountable for gun violence is through legislation. However, the strong lobbying influence of the gun industry and active groups like the National Rifle Association dictates that the legislative route to accountability might well represent a greater long shot than piece-meal litigation efforts.

The aforementioned City of Chicago lawsuit[59] sought 433 million dollars in its complaint against gun manufacturers. Numerous other cities across the country have filed similar claims against the gun industry. Shortly after the first municipal suits were filed, the gun industry and its supporter's lobbied state legislatures to pass legislation prohibiting cities from bringing tort claims against gun manufacturers. Thirteen states, including Texas, Georgia, and Louisiana have passed such legislation.[60]

However, a group of gun manufacturers have entered into settlement negotiations with a number of municipal plaintiffs. Smith & Wesson has shocked the gun industry with its settlement proposal to several cities. By the terms of the settlement it would "(1) use a hidden second serial number to assist in tracing; (2) install trigger locks on all guns;

(3) develop "smart gun" technology; (4) employ larger handle grips to deter use by children; (5) change its distribution practices and refuse to sell to dealers involved in straw sales and those whose guns are disproportionately traced to crime; and (6) change its advertising practices to eliminate emphasis on home safety uses of guns."[61]

Even with gun industry representatives and American cities talking settlement, it appears to be a slow process and in the absence of a continuing onslaught of decisions like that handed down in the *Young* case, gun violence victims and their families will largely go uncompensated.

V. Conclusion

There appear to be no immediate legislative or judicial solutions to the gun violence problem in America. Successfully pursuing, prosecuting, and suing the criminals who ultimately perpetrate the gun violence in America is a right and just beginning. Gun violence victims, their families, and local governments, should continue to pursue their legitimate rights through litigation and fair gun regulation through legislation. Perhaps, the greatest hope for American Justice is for those in the gun industry to follow the lead of its own Smith & Wesson Corporation and its colleagues in the tobacco industry by volunteering to enter into reasonable settlement agreements in response to reasonable claims by the various victims of gun violence in America. Accepting accountability in appropriate cases like the pending *Young* case is a step in the right direction. There are those who would hope that the *Young* case, decided in the plaintiffs favor, would instigate a large and dramatic wave of change in the balance of power between gun manufacturers and gun violence victims and their families. They are hoping that this case might involve "a shot heard around the world" which would allow other gun violence victims across the country to successfully sue gun manufacturers for conduct that amounts to a public nuisance. The reality of the matter, however, is probably more analogous to a group of hunters (the Chicago plaintiffs) using a sophisticated trap (the unique Chicago facts, including accurate and routine gun tracking and gun manufacturer notifications) who managed only "to catch a tiger (gun manufacturers) by the tail." The Chicago plaintiffs might potentially recover a measure of damages, but the tiger (the gun industry) will be angrier than ever and forever more diligent to avoid similar public nuisance traps (claims) that might be attempted in other regions of the country.

ENDNOTES

[1] *Young v. Bryco Arms,* 765 N.E. 2d 1 (Ill. App. 1 Dist. 2001).

[2] Id.

[3] Robert Becker and Christi Parsons, *Anti-gun Suit Gets a Major Victory,* Chi. Trib. January 1, 2002, at 1.

[4] *Young v. Bryco Arms,* 765 N.E. 2d 1 (Ill. App.1 Dist. 2001).

[5] Frank J. Vandall, *O.K. Coral II: Policy Issues in Municipal Suits Against Gun Manufacturers*, 44 Vill. L. Rev. 547, 548 (1999).

[6] Carl T. Bogus, *Gun Litigation and Societal Values*, 32 Conn. L. Rev. 1353, 1364 (2000).

[7] Timothy D. Lytton, *Tort Claims Against Gun Manufacturers for Crime-Related Injuries: Defining a Suitable Role for the Tort System in Regulating the Firearms Industry*, 65 Mo. L. Rev. 1 Winter (2000).

[8] Id at 1.

[9] Restatement (Second) of Torts § 519 (1977).

[10] Id.

[11] *Richman v. Charter Arms Corp.* 571 F. Supp. 192 (E.D. La. 1983); *Delahanty v. Hinkley*, 564 A. 2d 758 (D.C. 1989); *Martin v. Harrington & Richardson, Inc.*, 743 F. 2d 1200 (7th Cir. 1984).

[12] Id.

[13] *Perkins v. F.I.E. Corp.*, 762 F. 2d 1250, 1265 n. 43 (5th Cir. 1985).

[14] Michael Wallenstein, *Comment: Gun Manufacturers and Unfair Business Practices*, 30 Sw. U.L. Rev. 435, 440 (2001).

[15] Id. at 441.

[16] Id. at 442.

[17] *Kelley v. R.G. Indus. Inc.*, 497 A. 2d 1143 (Md. 1985).

[18] Id.

[19] Id. at 1159.

[20] Id. at 1154.

[21] Id. at 1159.

[22] Lytton, supra note 7 at 4.

[23] Wallenstein, supra note 14 at 443.

[24] Id. at 440, 441.

[25] Id.

[26] Id.

[27] Id.

[28] *Hamilton v. Accu-Tek,* 62 F. supp. 2d 802 (E.D.N.Y. 1999).

[29]Wallenstein, supra note 14 at 443.

[30] *Hamilton v. Accu-Tek,* 62 F. Supp. 2d 802, 809 (E.D.N.Y. 1999).

[31] Id. at 824-27.

[32] Id. at 829-32.

[33] Id. at 811.

[34] *Hamilton v. Beretta U.S.A. Corp.*, 264 F. 3d. 21 (2nd Cir. 2001).

[35] Id. at 27.

[36] *Hamilton v. Beretta U.S.A. Corp.* 750 N.E. 2d 1055, 1061 (2001).

[37] Id. at 1063.

[38] Id.

[39] Id. At 1066.

[40] Id.

[41] *Hamilton v. Beretta U.S.A. Corp.*, 264 F. 3d 21, 29 (2nd Cir. 2001).

[42] Lytton, supra note 7 at 24.

[43] Id.

[44] Id.

[45] *Young v. Bryco Arms,* 765 N.E. 3d. 1, 5-6 (Ill. App. 1 Dist. 2001).

[46] Id. at 9.

[47] Id.

[48] Id. at 9 and 10.

[49] Id. at 18 and 19.

[50] Id. at 17.

[51] Id. at 18.

[52] Id. at 6.

[53] Id.

[54] Id.

[55] Id.

[56] Id. at 7.

[57] Id.

[58] Id.

[59] Robert Becker and Christi Parsons, *Anti-gun suit Gets a Major Victory,* Chi. Trib. January 1, 2002 at 2.

[60] Vandall, supra note 5 at 570.

[61] Lytton, supra note 7 at 28.

WHAT ARE THE HISTORY AND ISSUES, OF MANDATORY RETIREMENT, AGE AND GENDER EMPLOYMENT DISCRIMINATION IN COLLEGES AND UNIVERSITIES

by

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Age has been a late comer to the ranks of the invidious"-isms", as ageism has only recently joined racism and sexism as the object of public condemnation. Many who denounce ageism describe it as "just another form of discrimination" and, to be sure, discrimination on the basis of age does bear a certain resemblance to discrimination on other bases which have been declared to be contrary to public policy and illegal.

Ageism in general, and mandatory retirement in particular, involves the use of stereotypes. It imposes a blanket presumption of incapacity without any opportunity for rebuttal on the basis of individual performance. It involves a status into which affected persons are locked by the accident of their birth. It imposes a stigma on members of a class, rendering them "second class citizens." Yet, notwithstanding these apparent similarities with discrimination on other impermissible bases, both Congress and the courts have treated age differently.

HISTORY

At the time the 95th Congress began consideration of age discrimination legislation in the late spring and early summer of 1977, the federal courts had been almost uniform in denying relief to litigants who sought to challenge policies of forced retirement on constitutional grounds. Although private employers were by and large not subject to constitutional requirements, numerous cases had arisen in which state and local government retirement policies had been challenged under the due process and equal protection clauses of the Fourteenth Amendment (and, likewise, federal policies under the due process clause of the Fifth Amendment). In 1976 the issue reached the U.S. Supreme Court squarely for the first time in the case of Massachusetts Board of Retirement v. Murgia,[1] (a police officer) and the court as expected refused to declare a public employer's policy of mandatory retirement unconstitutional.

Before the Supreme Court's decision in Murgia, there had been few modern constitutional challenges to mandatory retirement involving the teaching profession, and what cases there were had been unsuccessful. The principal case at an institution of higher education ---------------------------

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was Weiss v. Walsh,[2] where a philosophy professor at Catholic University alleged that Fordham University, having offered him a prestigious humanities chair, withdrew its offer when it learned that he had passed his sixty-fifth birthday. The professor brought suit in federal district court alleging violation of his rights under the First and Fourteenth Amendments as well as under other state and federal laws.

The case was a clear-cut one in two respects. First, there was no question that the plaintiff's physical and mental health were excellent and that he had the requisite stamina and acuity to fulfill the job's responsibilities. (The National Retired Teachers Association, Inc. and the American Association of Retired Persons as amici curiae argued by reference to biographies of former giants in philosophy, showing that the prognosis for breadth and duration of productivity was excellent as well.) So clear were the plaintiff's qualifications for the position that the district court was compelled to observe. "In this litigation, however, the court is called upon to judge neither the brilliance nor worthiness of a man, but the merit of his legal claims."

Secondly, it was admitted that the sole reason for withdrawal of the alleged offer was the plaintiff's age (sixty-nine). Fordham University, which had selected the plaintiff and which was said to have been enthusiastic about the choice, was compelled to reconsider when the New York Board of Regents, which had statutory authority to set the terms and conditions of contracts with occupants of the state-supported chair, directed the University to reject the plaintiff because of his age.

The district court gave short shrift to the plaintiff's First Amendment claim, which bordered on being frivolous, and went on to reject his Fourteenth Amendment claim as well. Age, said the court, is a classification that cuts across racial, religious and economic lines and that generally bears some relation to mental and physical capacity; it therefore is unlikely to be an invidious distinction. The court concluded:

> Notwithstanding great advances in gerontology, the era when advanced age ceases to bear some reasonable statistical relationship to diminished capacity or longevity is still future. It cannot be said, therefore, that the age ceilings upon eligibility for employment are inherently suspect, although their application will inevitably fall injustly [sic] in the individual case. If the precision of the law is impugnable by the stricture of general applicability, vindication of the exceptional individual may have to attend the wise discretion of the administrator. On its face, therefore, the denial of a teaching position to a man approaching seventy years of age is not constitutionally infirm...[3]

This was upheld by the Second Circuit.[4] The Supreme Court denied certiorari.[5]

The only pre-Murgia case in which a constitutional challenge to a policy of mandatory retirement at an educational institution succeeded was Nelson v. Miwa,[6] a case of limited impact because of its unique factual setting. A tenured English professor at the University of Hawaii brought suit when he was compelled to retire at age sixty-five. The University's board had adopted a retirement policy which set sixty-five as the mandatory retirement age but which permitted renewals on a year-to-year bases until age seventy. Elaborate procedures were established for determining whether the incumbent passed that test (as Nelson had), however, the Chancellor was permitted to apply a second test, whether the incumbent's personal services were "essential" to the University. The court found no rational basis for the latter test with respect to persons who had passed the former test, and declared that the University's action violated the plaintiff's right to equal protection. The court was careful to distinguish the case on its facts from the many other cases upholding uniformly-applied policies of mandatory retirement.

Thus the law seemed rather settled when, in 1976, the Supreme Court found it necessary to take on the retirement issue due to a maverick decision in the First Circuit. One Robert Murgia had brought suit in federal district court challenging on equal protection grounds the constitutionality of a Massachusetts statute requiring state police officers to retire at age fifty. Murgia's case seemed a strong one, given the lowness of the retirement age at issue and given the fact that he had passed required annual physical examinations with flying colors. Nonetheless, the district judge refused to convene a three-judge panel and routinely dismissed Murgia's complaint for failure to raise a substantial federal question.

On appeal, however, the First Circuit set aside the district court's judgment and remanded the case with a direction for the convening of a three-judge panel. (The First Circuit's action was especially baffling in that its judgment was issued in an unreported memorandum of decision.) The panel that was convened rules in favor of Murgia and enjoined enforcement of the retirement law, on the grounds that there was no rational basis for the state's decision to compel state police officers to retire at age fifty.[7] The Supreme Court accept the Massachusetts Retirement Board's direct appeal,[8] the statutory procedure in such cases, and reversed the panel's judgment.

The Supreme Court's anonymous majority opinion[9] was brief and dealt squarely with the equal protection issue. The Court applied its usual "two-tiered" analysis developed in a long line[10] of Fourteenth Amendment cases: where a legislative classification impermissibly interferes with the exercise of a "fundamental right" or operates to the peculiar disadvantage of a "suspect class,: it will be upheld only when there is a "compelling state interest" to be served and where there is no less restrictive alternative available (the so-called "strict scrutiny" test); in all other cases, a legislative classification will be upheld merely upon a showing that the classification is rationally related to a legitimate state purpose (the so-called "rational basis" test).

It should be noted that these phrases have been carefully honed by the Court, and have very specific meanings. "Suspect classes," for example, include classes based upon ancestry,[11] race,[12] and alienage,[13] but not sex.[14] And, as Justice Marshall pointed out in his bitter dissent in Murgia, legislative classifications subjected to the "rational basis" test almost always pass muster. Thus the key to winning an equal protection case is convincing the court that the statute or policy in question either invades a "fundamental right" or discriminates against a "suspect class."

The Supreme Court was able to dispose of Robert Murgia's appeal with almost record brevity for a constitutional case: four paragraphs were devoted to affirming the district court's holding that the "strict scrutiny" test is not applicable to the case, and four paragraphs were devoted to reversing the district court's holding that the Massachusetts retirement law fails to pass the "rational basis" test.

In ruling out the need for "strict scrutiny," the Court held that neither a "fundamental right" nor a "suspect class" was involved. Although it had long been clear that there is no "fundamental right" to governmental employment and that the "strict scrutiny" test does not apply to legislation restricting the availability of employment opportunities,[15] the question of whether age is a "suspect classification" had not been directly addressed by the Supreme Court prior to Murgia.

In order to constitute a "suspect class," a class must be a "discrete and insular group" which has been saddled with such disabilities or subjected to such a history of purposeful unequal treatment, or relegated to such a position of political powerlessness as to command extraordinary protection from the majoritarian political process," The Court first observed that the affected class in this case (uniformed state police officers over age fifty) hardly meets those requirements. Then, in dictum, the Court went on to observe that not even "old age" would qualify as a "suspect classification": "...(old age) marks a stage that each of us will reach if we live out our normal span., Even if the statute could be said to impose a penalty upon a class defined as the aged, it would not impose a distinction sufficiently akin to those classifications that we have found suspect to call for strict judicial scrutiny."

The Court then turned to examining the Massachusetts classification under the "rational basis" standard, which it described as "a relatively relaxed standard reflecting the Court's awareness that the drawing of lines that create distinctions is peculiarly a legislative task and an unavoidable one."[16] Perfection was said to be neither possible nor necessary, and legislative action was said to enjoy a presumption of validity.

The Court had little difficulty finding the needed elements for a constitutionally valid classification. A legitimate state objective was found in protecting the public. And, since physical ability generally declines with age, the Court found that mandatory retirement at age fifty is rationally related to Massachusetts' stated purpose.[17] The latitude permitted States when the "rational basis" test is applied is clear in the Court's concluding remarks:

> That the State chooses not to determine fitness more precisely through individualized testing after age 50 is not to say that the objective of assuring physical fitness is not rationally furthered by a maximum age limitation. It is only to say that with regard to the interest of all concerned, the State perhaps has not chosen

> the best means to accomplish this purpose. But where rationality is the test, a State "does not violate the Equal Protection Clause merely because the classifications made by its laws are imperfect."
>
> We do not make light of the substantial economic and psychological effects premature and compulsory retirement can have on an individual; nor do we denigrate the ability of elderly citizens to continue to contribute to society. The problems of retirement have been well documented and are beyond serious dispute. But "(w)e do not decide today that the (Massachusetts statute) is wise, that it best fulfills the relevant social and economic objectives that (Massachusetts) might ideally espouse, or that a more just and humane system could not be devised,." We decide only that the system enacted by the Massachusetts Legislature does not deny appellee equal protection of the laws. (Citations omitted.)

Justice Marshall filed a lone dissenting opinion in which he assailed the majority's continued adherence in equal protection cases to the "rigid two-tier model" which, according to Marshall, effectively precludes any judicial protection for those who are not members of a "suspect class" but who are nonetheless "unfairly burdened by invidious discrimination unrelated to (their) individual worth."[18] And, in a concluding footnote to his dissent, he gave his view of the scope of the majority's opinion:

> The court's conclusion today does not imply that all mandatory retirement laws are constitutionally valid. Here the primary state interest is in maintaining a physically fit police force, not a mentally alert or manually dextrous work-force. That the Court concludes it is rational to legislate on the assumption that physical strength and well-being decrease significantly with age does not imply that it will reach the same conclusion with respect to legislation based on assumptions about mental or manual ability. Accordingly, a mandatory retirement law for all government employees would stand in a posture different from the law before us today.[19]

Within twelve months after the Supreme Court's decision in Murgia, a case arose in which the plaintiff sought to rely in part on the footnote in Marshall's dissent.[20] A New York public school kindergarten teacher brought suit in federal district court challenging her retirement at age seventy pursuant to a state education statute permitting, but not requiring, mandatory retirement at that age.

The district court first found that the discretionary aspect of the New York statute did not distinguish it from the mandatory retirement cases decided by the Supreme Court. And, as to Justice Marshall's interpretation of the scope of the Murgia holding, the court described Marshall's comment as "questionable in light of acceptance of mandatory retirement statutes for teachers . . .and for judges..." (citations omitted). In any event, the court noted that a kindergarten teacher's job requires as much physical fitness as mental alertness. The case was dismissed for want of a substantial federal question, and insult was added to injury by the district court's quoting the Supreme Court's standard for such dismissals: federal claims are insubstantial only if 'prior decision inescapably render the claims frivolous."[21]

Another post-Murgia decision involved an occupation with no physical demands. An attorney in the State Real Property Bureau brought suit in federal district court challenging New York's civil service statute permitting, but not requiring, mandatory retirement at age seventy; discretionary renewals were permitted until age seventy-eight. The district judge dismissed the complaint for lack of a substantial federal question, and an appeal was taken to the Second Circuit.[22]

On the equal protection issue, Chief Judge Kaufman, speaking for a three judge panel, found no need even to address the physical/mental distinction. Following the majority opinion in Murgia, the Court sought only an articulated "rational basis" for the statutory scheme. As usual, the test was easily met. The court stated:

> It would appear without question that (the New York statute) is reasonably related to legitimate state interests in efficiency and economy. A mandatory retirement policy allows department heads to plan the training and advancement of their employees, and motivates young workers to acquit themselves well and to progress through the ranks. And the statute before us, which permits some employees to continue in their jobs until the age of 78, serves these legitimate state purposes without needless prejudice to the greater number of qualified employees.[23]

The Second Circuit's use of the adjective "greater" here is noteworthy: even if, among employees between the ages of seventy and seventy-eight, a "greater number" are qualified than are unqualified, there is still a "rational basis" for the state's decision to maintain a policy permitting forced retirement at age seventy. As long as some unqualified persons are weeded out by the policy, the state's interest in efficiency and economy is being served.

This leads in to the plaintiff's due process argument. Due process arguments are closely related to those grounded in equal protection, and, as we have seen, have been overshadowed in retirement cases. The plaintiff's substantive due process argument to the Second Circuit was that the New York retirement law creates an impermissible "irrebuttable presumption" of incapacity based upon age (in this case there was no question of plaintiff's continuing ability to perform as a real estate attorney). The court disposed of that argument by pointing out that a state's use of an irrebuttable presumption violates the due process clause only in cases involving "suspect classifications."[24] Again, failure to be denominated as a member of a "suspect class" effectively precluded the availability of judicial relief under the

Fourteenth Amendment.

The refusal of the federal courts to entertain challenges to the constitutionality of public employers' policies of mandatory retirement was very much a factor in fueling the political movement for legislative action in the 95th Congress. (In addition, outlawing of policies of mandatory retirement within the private sector could be achieved only through legislation.) Describing the likelihood of success in the courts as "bleak," the House Select Committee on Aging concluded:

> From the evidence presented, the committee concludes that "age" should be as protected a classification as race and sex. The argument that everyone ages and no particular group is singled out for discrimination ignores the fact that discrimination solely on the basis of age is wrong. If mandatory retirement because of age the final step in the practice of age discrimination - is not to be declared unconstitutional by the Courts, then Congress should act to make such a practice illegal.
>
> The major argument raised by the Colleges and Universities when the statutory enactment was being considered in Congress was that there will be very little faculty turnover without mandatory retirement. This means that younger members of the faculty, who are already having difficulties in becoming tenured because of the declining population, will have another obstacle placed in their path. Those who have worked hard to prepare themselves for a career in education are going to find particular difficulties.

CURRENT LEGAL SETTING

Section 296 of the New York Executive Law (Human Rights Law) defines and prohibits unlawful discriminatory practices, including discrimination based on age, by private and public employers. Subsection (1)(a) of Section 296 makes it an unlawful discriminatory practice for an employer to refuse to hire, to discharge, or to discriminate in compensation or in terms, conditions or privileges of employment because of the, *inter alia*, age of any individual. It provides, in pertinent part:

> 1. It shall be an unlawful discriminatory practice:
>
> (a) For an employer or licensing agency, because of the age, race, creed, color, national origin, sex, disability, genetic predisposition or carrier status, or marital status of any individual, to refuse to hire or employ or to bar or to discharge from employment such individual or to discriminate against

> such individual in compensation or in terms, conditions or privileges of employment....[25]

The statute is liberally construed.[26]

The federal Age Discrimination in Employment Act ("ADEA") is codified at 29 U.S.C. Sec. 623. It provides, in pertinent part:

> It shall be unlawful for an employer -- to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, condition, or privileges of employment, because of such individual's age....[27]

The federal Equal Pay Act is codified at 29 U.S.C. Sec. 206(d)(1). Its New York State counterpart can be found at Labor Law Sec. 194.

The elements of a successful employment discrimination claim are virtually identical under state and federal law.[28] Therefore, in interpreting the state statute, courts have relied on federal case law.[29] Although age discrimination cases are generally litigated in federal court, state courts have concurrent jurisdiction to hear such claims.

The primary focus of an employment discrimination claim is whether the employer has treated the employee less favorably than others for an impermissible reason.[30] Disparate treatment claims are based on less favorable treatment due to plaintiff's membership in a protected group. There are three (3) primary methods for establishing unlawful disparate treatment: direct evidence, circumstantial evidence, and evidence of mixed motives.[31]

Where the plaintiff has direct evidence of a discriminatory policy or discriminatory treatment, the burden shifts to the employer to justify its practice or policy by proving it is a bona fide occupational qualification (BFOQ).[32] The BFOQ defense is a narrow exception to the statutory prohibition against employment discrimination and requires that the employer demonstrate that the qualification is necessary to the business and that there are no reasonable non-discriminatory alternatives.

The more typical cases are those that are premised on circumstantial evidence. In these cases, there is a three stage formula for allocating the burdens of proof is based on the U.S. Supreme Court's decision in The McDonnell Douglas case.[33] In the first stage, plaintiff makes out a prima facie case by proving four elements: 1) that plaintiff is a member of a protected age group; 2) that plaintiff applied for or was qualified for a position for which the employer was seeking applicants; 3) that, despite plaintiff's qualifications, plaintiff was rejected or discharged; and 4) that the rejection or discharge occurred under circumstances giving rise to an inference of discrimination, i.e., after the rejection or discharge the position remained open and the employer continued to seek applicants from persons of plaintiff's qualifications.[34]

In order to satisfy the first element, the plaintiff must establish membership in the protected age category, which differs under state and federal law. New York law protects persons 18 years or older.[35] Under federal law, the protected age group is 40 years of age and older.[36] Although both state and federal law prohibit involuntary mandatory retirement, there are some limited exceptions which may be relevant. Prior to July 18, 1990, the New York Human Rights Law did not prevent the compulsory retirement of an employee 70 years of age or older who was serving under a contract for unlimited tenure at an institution of higher education.[37] However, effective July 18, 1990, the statute was amended to limit this exception to nonpublic institutions of higher education.

The second element of the prima facie case requires a showing that the plaintiff was qualified for the job. To satisfy this element, the plaintiff need only demonstrate that he or she possesses the basic skills that are necessary for performance of the job,[38] (Proof of competence sufficient to make out a prima facie case does not require proof of superiority or flawless performance). In discriminatory discharge cases as opposed to discriminatory hiring cases, the focus is on the plaintiff's job performance rather than on plaintiff's job skills.[39] To satisfy the job performance requirement, the plaintiff only has to show that plaintiff was doing the job well enough to meet the employer's legitimate expectations.[40]

The third element of the prima facie case requires that plaintiff to show that plaintiff was discharged or denied a promotion or was the victim of any other adverse employment decision.

For the fourth element, the Supreme Court has held that the fact that the plaintiff was replaced by someone outside the protected class is not a necessary element of the prima facie case.[41] On the other hand, courts have held that the fact that the replacement is a member of the protected class does not necessarily defeat the claim. Nonetheless, insignificant age disparities of 6 years or less between the plaintiff and plaintiff's replacement are generally insufficient to support an age discrimination claim.[42]

An inference of discrimination may arise from direct evidence, from statistical evidence, or merely from the fact that the position was filled or held open for a person not in the protected class.[43] Where the plaintiff relies on statistical evidence, the sample must be sufficiently large enough to allow an inference that age was a decisive factor in the employer's decision.[44]

Once the plaintiff makes out a prima facie case, the second stage for establishing an employment discrimination claim is reached. In this second stage, the burden shifts to the defendant must come forward with evidence of a legitimate, independent, and nondiscriminatory reason for its employment decision.[45] Reorganization, reductions in personnel due to economic conditions, and layoffs because of serious financial crises have been found to be legitimate, independent, and nondiscriminatory reasons for an employer's adverse employment decision. However, even during reorganizations and staff reductions, an employer may not discharge an employee for unlawful, discriminatory reasons such as age.[46]

The employer may also rebut the plaintiff's prima facie case by presenting evidence of poor work performance and/or lack of qualifications or skills. The employer's burden is that of going forward with evidence of a legitimate and nondiscriminatory reason; it is not the burden of persuasion, which remains with the plaintiff at all times.[47] Hence, it is important that the legitimate and nondiscriminatory reason be pleaded by the employer.

Once the employer assets a legitimate, nondiscriminatory reason for the discharge or denial of the promotion or other adverse employment decision, the third stage of establishing an employment discrimination claim is realized. In this third stage, plaintiff has the burden of demonstrating by a preponderance of the evidence that the legitimate reasons offered by the employer were not its true reasons, but a mere pretext for discrimination.[48] Plaintiff retains the burden of proving that the decision would not have been made but for the employer's discriminatory motivation and that age was a determining factor in the employment decision.[49] Under federal law, the Supreme Court has held that the plaintiff's burden is not automatically met by proving defendant's reason is false.[50]

In a mixed motive case, there is evidence of both lawful and unlawful motivations. In such a case, the plaintiff must demonstrate that a discriminatory reason was a motivating factor in the adverse employment decision.[51] Then, the burden of proof shifts to the employer to establish that it would have made the same decision without the discriminatory reason.

The Civil Rights Act of 1991 amended Title VII by, inter alia, expressly incorporating the "motivating factor" standard in mixed motive cases.[52] The amendment also changes the remedies that are available: If a plaintiff demonstrates that discrimination was a motivating factor but the defendant establishes that it would have taken the same action in the absence of the discriminatory reason, liability is established entitling the plaintiff to declaratory and injunctive relief, attorneys' fees and costs, but not to reinstatement or damages. However, if the defendant is unable to prove its affirmative defense, the plaintiff is entitled to full relief, including damages. The cases do not yet indicate what effect, if any, this amendment will have on the New York Human Rights law since New York employment discrimination law has never limited plaintiffs to equitable relief.

The mixed motive analysis is not used in cases involving after acquired evidence, i.e., where the real reason was discovered after the discriminatory actions. In this scenario, after the employee has been discriminated against for a discriminatory reason, the employer learns that the plaintiff engaged in misconduct, which, if known, presumably would have justified denial of a promotion or discharge. In McKennon, the court held that in such cases the plaintiff is generally entitled to back pay up to the date the employer obtained the evidence but is not entitled to front pay or reinstatement. Thus, the employer's presentation of after acquired evidence of misconduct does not defeat the plaintiff's claim but affects the determination of available remedies.[53]

It should be noted that an employment discrimination disparate impact claim differs significantly from a disparate treatment case. In a disparate impact case, the plaintiff does not have to prove discriminatory intent. This type of claim is based on a facially neutral employment policy that adversely and disproportionately affects members of a protected group and that cannot be justified as a business requirement.[54]

Pursuant to the Supreme Court's decision in Griggs v. Duke Power Co.[55] a plaintiff makes out a prima facie case of disparate impact employment discrimination by proving that an employment practice has a disparate impact on a protected group. Such a prima facie showing may be made through statistical evidence disclosing a disparity so great that it cannot reasonably be attributable to chance. Two widely accepted formulas for evaluating disparate impact are the standard deviation formula set forth in the Supreme Court's decision in Casteneda v. Partida,[56] and the "4/5 rule" promulgated by the EEOC in its Uniform Guidelines on Employee Selection Procedures.[57]

Castaneda stated that, in cases involving large samples, "if the difference between the expected value (from a random selection) and the observed number is greater than two or three standard deviations," a prima facie case of discrimination is established.[58]

The Uniform Guidelines provide that "(a) selection rate for any race, sex, or ethnic group which is less than four-fifths (4/5) (or eighty percent) of the rate for the group with the highest rate will generally be regarded by the Federal enforcement agencies as evidence of adverse impact."[59] Although not binding, the courts generally accord the guidelines "great difference".[60]

If the plaintiff makes out a prima facie case of disparate impact, then the burden shifts to the employer to establish that the alleged disparate impact practice is necessary to the operation of the business or is related to job performance. If the employer makes such a showing, the plaintiff will prevail if it can show a reasonable, nondiscriminatory, alternative employment practice that would satisfy the employer's legitimate business interests.[61] Although the Supreme Court modified the Griggs formula in Wards Cove Packing Co. v. Antonio,[62] Congress amended Title VII in 1991 to make its intent clear that Griggs provides the proper evidentiary framework for a disparate impact case.[63]

In sum, in order for a plaintiff to recover in an action to recover damages for employment discrimination disparate treatment claim based on age, for example, the plaintiff must prove by a preponderance of the evidence that age was a determining factor in the defendant employer's decision to deny plaintiff the promotion. There can be more than one determining factor in any decision. Therefore, plaintiff need not prove that age was the only reason for defendant's decision. Age is a determining factor if plaintiff would have received the promotion except for age. In other words, age is a determining factor if it made a difference in determining whether or not the plaintiff would receive the promotion.

The plaintiff is not required to produce direct evidence that the defendant discriminated against him on the basis of age. Since the courts recognize that discrimination is rarely admitted, the cases hold that discrimination may be inferred from the existence of other facts.

In order to make out a prima facie case that age was a determining factor in the defendant's decision, the plaintiff must establish the following facts by the preponderance of the evidence:

1) First, plaintiff must prove that he applied for and was qualified for the promotion or for the position for which his employer was seeking applicants;

2) Second, plaintiff must prove that, despite his qualifications, he was denied the promotion or was rejected for the position;

3) Third, plaintiff must prove that after plaintiff's rejection, the position remained open and the employer continued to interview applicants with the same qualifications as the plaintiff; and

4) Fourth, plaintiff must establish that the denial or rejection occurred under circumstances giving rise to an inference of discrimination.

If the plaintiff is unable to prove any of the above elements, he fails to establish a prima facie case, and the defendant will prevail on liability.

If the plaintiff proves all of the above elements, then the burden shifts to the defendant to come forward with evidence of a legitimate and nondiscriminatory reason for the employee's rejection. If the defendant proffers such evidence, the burden shifts back to the plaintiff.

The plaintiff then must establish by a preponderance of the evidence that the reason offered by defendant was not really the reason the promotion was denied and that, more likely than not, plaintiff's age was a determining factor in the decision. The plaintiff has the ultimate burden of persuasion.

If the plaintiff fails to prove that the reason offered by defendant was not really the reason the promotion was denied, then the defendant will prevail on the issue of liability. However, if the plaintiff proves that the reason offered by the defendant was an excuse or pretext for discrimination, then the plaintiff will prevail on the issue of liability.

In order to establish a disparate impact case, the evidentiary formula set forth in Griggs[64] is the one that must be followed. The plaintiff may make a prima facie showing of age discrimination based on statistical evidence by using the Castaneda[65] standard deviation formula and/or the "4/5 rule".

Some of the more prohibited employment practices in connection with unlawful age discrimination are set forth in Section 4(a) of The Age Discrimination in Employment Act of 1967 (ADEA). Under the Act the employer's failure to engage and hire and discharge because of age are events which result in a violation of the Act. In addition, labor organizations are prohibited from discriminating because of age by violating Section 4(b) of the ADEA.

In the case of EEOC v. Ligget & Meyers, Inc.,[66] the employer was ordered to pay back wages and benefits plus liquidated damages because of their actions to more than 100 terminated employees. The Rhodes v. Guiberson Oil Tools[67] case reflected the continuing problem of age discrimination by employers to their employees.

Liability under the ADEA depends on whether the protected trait - age - actually motivated the employer's decision. In one of the cases before the Supreme Court, Hazen Paper Co. v. Biggin,[68] the court held that an employer did not violate the ADEA just by interfering with an older employee's pension benefits that would have vested by virtue of the employee's years of service. Additional evidence was required that age was the motivating factor under the ADEA. The employer's decision to terminate an older employee solely because he had put in more than nine years of service and was close to having his pension vested upon completion of ten years of service was not discrimination based on "age." It was, however, a violation of another statute, Section 510 of ERISA, to terminate the employee in order to prevent the individual's pension from vesting.

The measure of damages can be assessed by the court under Section 7(b) of the ADEA. This allows for the doubling of damages in cases of "willful violations" of the Act. Therefore, an employer who willfully violates the Act is liable not only for back wages and benefits but also for "an additional amount as liquidated damages."

In connection with the monetary awards received by the employees, the Internal Revenue Service (IRS) has considered these sums as being ordinary income and taxable. In the case of I.R.S. Commissioner v. Schleier,[69] the United States Supreme Court ruled that back pay and liquidated damages recovered under the Age Discrimination cases are includible and not excludable from gross income under the Internal Revenue Code (IRC). The Court stated that damages were not considered "tort rights" which would have qualified for the exclusion under the IRC's definition of gross income.

Thereafter, the ADEA was amended by the Older Workers Benefit Protection Act (OWBPA) of 1990 which prohibited age discrimination in employee benefits and established minimum standards for determining the validity of waivers of age claims entered into by the employee. The OWBPA established that the ADEA prohibition of discrimination in "compensation, terms, conditions, or privileges of employment" encompasses all employee and fringe benefits, including those provided under a bona fide employee benefit plan. The 1990 Act amends the ADEA by adopting an "equal benefit or equal cost" standard which provides that "older" workers must be given benefits which are at least equal to those provided to their younger counterparts, unless the employer can prove that the cost of providing an equal benefit would be greater for an older employee than for a younger employee.

Early retirement incentive plans are exempted from the "equal benefit or equal cost" standard, so long as the plans are bona fide. Employers may make Social Security "bridge" payments to early retirees until the affected individuals reach eligibility age.

Section 4(f) of the ADEA sets forth certain exemptions from the strict construction of the Act for employers. Thus, where an individual is terminated because of a bona fide seniority plan, the employer is not responsible for an ADEA violation. Also, if the employer discharges or disciplines an employee for "good cause," the employer is not in violation of the Act. Thus, if an older employee is discovered stealing from an employer, the employer may terminate that individual without being in violation of the Act.

For the past several years we have had substantial reductions in forces (RIFs)) which have taken place in many industries and in public-sector occupations such as schoolteachers, police, fire and sanitation personnel. When such RIF's take place according to a bona fide seniority plan, no violation of the Act occurs. Where no collective bargaining agreement restricts an employer as to the manner of a RIF, the employer has the right to use other reasonable factors other than age in reducing its force. For example, the employer may consider the relative performances of employees in each classification in deciding which employee to terminate. However, the risks are high that an employer may be found to be in violation of the ADEA because statistical and other evidence of discrimination may be developed, as cost-cutting reductions in the workforce usually affect higher paid experienced older employees.

Today many employers faced with the need to reduce labor costs, the risks of ADEA lawsuits, and the desire to treat older workers properly, many employers have opted to provide early retirement incentive programs under these circumstances. Employers commonly require that employees electing to take early retirement waive all claims against the employer, including their rights or claims under the ADEA. Congress recognized the utility of these programs in the Older Workers Benefit Protection Act of 1990, but wanted to make sure that employees fully understood that they were making knowing and voluntary waivers of ADEA claims. Congress established specific statutory requirements which must be met before an employee can waive the right to litigate ADEA claims. The burden of proof for establishing such a waiver rests with the employer, who must establish that all of the requirements have been met. The requirements include that:

1. The waiver is part of a written agreement.
2. It makes specific reference to rights or claims under the ADEA and may refer to Title VII and all other claims.
3. It does not apply to rights or claims which may occur after the agreement had been signed.
4. It is exchanged for value that is in addition to what the employee would otherwise be entitled to receive.
5. The employee is given written advice from the employer to consult with an attorney.
6. The employee is given a 21-day waiting period to consider the agreement, and a 7-day period to revoke the agreement. For an agreement in connection with an early retirement program offered to a group of employees, the waiting period is 45 days rather than 21 and the employer must disclose all eligibility factors and the terms and inclusions of the program.

CONCLUSION

There are many problems of concern for tenured faculty, e.g., enrollment is diminishing and when new faculty are hired their salaries are at current market rates. Professors who have been at the colleges and universities for many years "old timers" or "long timers" salaries are out of proportion and in many instances lower, because of the market conditions, then new liberal arts types are subject to the enrollment factor and overabundance of qualified persons.

Administrators of colleges and universities must therefore give more thought to education's ethical positions and to presenting those positions accurately to our donors and our publics. We must speak and act not only for what is economically and educationally sound, but also for what is right."

While the mandatory retirement issue may not be one on which there is a clearly "right" or "wrong" position for the higher education community, nevertheless advice was given of greater sensitivity to the moral implications of whatever positions are taken should be heeded. Otherwise, higher education stands to lose credibility with its many and varied publics.

ENDNOTES

1. 345 F.Supp.1140 (1972); 376 F.Supp. 753 (1974); 421 U.S. 974 (1975).

2. 324 F.Supp.75 (S.D.N.Y. 1971).

3. *Id.* at 77.

4. 461 F.Supp.2d 846 (1972).

5. 409 U.S. 1129 (1973).

6. 56 Hawaii 601 56 Pac 2nd 1005 81 ALR 3rd 799 (1976).

7. 376 F.Supp. 753 (1974).

8. 421 U.S. 974 (1975).

9. 427 U.S. 307.

10. San Antonio Independent School District v. Rodriguez, 411 U.S. 1 (1973).

11. Oyama v. California, 332 U.S. 633 (1948).

12. McLaughlin v. Florida, 379 U.S. 184 (1964).

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13. Graham v. Richardson, 403 U.S. 365 (1971).

14. Frontiero v. Richardson, 411 U.S. 677 (1973).

15. San Antonio, 411 U.S. 1; Lindsey v. Normet, 405 U.S. 56 (1972); and Dandridge v. Williams, 397 U.S. 471, 485 (1970).

16. *Id.*at 314.

17. *Id.* at 315-316.

18. *Id.* at 320.

19. Murgia, *supra*, *Id.* at 327, Note 8.

20. Palmer v.Ticcione, 433 F.Supp.; 653 E.D.N.Y. 1977 aff'd., 576 F.2nd 459, Second Circuit (1978).

21. Hagans v. Lavine, 415 U.S. 528, 538 (1974).

22. Johnson v,. Lefkowitz, 566 F.2nd 866, Second Circuit 1977.

23. *Id.* at 869.

24. See note, The Irrebuttable Presumption Doctrine in the Supreme Court, 87 HARV. L. REV. 1534 (1974).

25. N.Y. C.L.S. Human Rights Law Sec. 296 (1998).

26. N.Y. C.L.S. Human Rights Law Sec. 300.

27. 29 U.S.C. Sec. 623(a)(1)(1997).

28. Sogg v. American Airlines, 193 A.D.2d 153,603 N.Y.S.2d 21 (1st Dept. 1993), lv. to app. denied, 83 N.Y.2d 954 (1994).

29. Miller Brewing Co. v. State Div. of Human Rights, 66 N.Y.2d 937, 498 N.Y.S.2d 776, 489 N.E.2d 745 (1985).

30. Furnco Constr. Corp. v. Waters, 438 U.S. 567, 98 S.Ct. 2943, 57 L.Ed.2d 957 (1978).

31. Guntur v. Union College, 1992 U.S. Dist. LEXIS 12499 (N.D.N.Y. 1992) at *14. See also, O'Connor v. Consolidated Coin Caterers Corp., 116 S.Ct. 1307 (1996); Miller Brewing Co. v. State Div. of Human Rights, *supra*.

32. N.Y. C.L.S. Human Rights Law, Sec. 296(1)[d](1997).

33. McDonnell Douglas Corp. v. Green, 411 U.S. 792, 92 S.Ct. 1817, 36 L.Ed.2d 668 (1973). See, e.g., Fisher v. Vassar College, 114 F3d 1332, 1335 (2nd Cir. 1997), pet. for cert. filed, 66 U.S.L.W. 3178 (9/2/97) No. 97-404; Rosen v. Feldman & Columbia University, 1996 U.SD. App. LEXIS 4516 (2nd Cir. 1996) at *3; Rosen v. Feldman & Columbia Univers 1991) at *38-40.

34. Fisher, *supra*; Rosen v. Feldman & Columbia University, 1996 U.S. App. LEXIS 4516 at *4; Weiner v. City College of CUNY, 1997 U.S. Dist. LEXIS 9705 (S.D.N.Y. 1997) at *13; Rosen v. Feldman & Columbia University, 1995 U.S. Dist. LEXIS 11111 at *12-14; Guntur v. Union College, *supra*, at *15-16;Falu v. SUNY,, *supra* at *43-45; McCarthy v. Bd. of Trustees of Jefferson Community College, 1991 U.S. Dist. LEXIS 3698 (N.D.N.Y. 1991) at *29. See also, McDonnell Douglas Corp. v. Green, *supra*.

35. N.Y. Executive Law Sec. 296(3-a)(a).

36. 29 U.S.C. Sec. 631(a). Weiner v. City College of CUNY, *supra*, at *13.

37. N.Y. Executive Law Sec. 296(3-1)(f). See, e.g., Seaman v. State, 199 A.D.2d 884,606 N.Y.S.2d 70 (3rd Dept. 1993).

38. Powell v. Syracuse University, 580 F.2d 1150 (Second Circuit, 1978).

39. Song v. Ives Laboratories, Inc., 957 F.2d 1041 (Second Circuit 1992).

40. Charrette v. S.M. Flickinger Co., 806 F. Supp. 1045 (N.D.N.Y 1992).

41. O'Connor v. Consolidated Coin Caterers Corp.,.

42. Sogg v. American Airlines, *supra*.

43. Promisel v. First Am. Artificial Flowers, 943 F.2d 251 (2nd Cir. 1991); Sogg v. American Airlines, *supra*.

44. Weiner v. Cataldo Waters & Griffith Architects, P.C., 200 A.D.2d 942, 607 N.Y.S.2d 163 (3rd Dept. 1994).

45. Fisher, *supra*, at 1335-37; Rosen v. Feldman & Columbia University, 1996 U.S. App. LEXIS 4516 at *4; Rosen v. Feldman & Columbia University, 1995 U.S. Dist. LEXIS

11111 at *12-14; Guntar v. Union College, *supra*, at *16. See also, Texas Dept. of Commmunity Affairs v. Vurdine, 450 U.S. 248, 101 S.Ct. 1089, 67 L.Ed.2d 207 (1981); McDonnell Douglas N.E.2d 745; Sogg v. American Airlines, *supra*.

46. Hagelthorn v. Kennecott Corp., 710 F.2d 76 (2nd Cir. 1983).

47. Sogg v. American Airlines, *supra*.

48. Fisher, *supra*, at 1337-38. See also, Texas Dept. of Community Affairs & Burdine, *supra*; Miller Brewing Co. v. State Div. of Human Rights, *supra*; Sogg v. American Airline

49. Fisher, *supra*, at 1337-39; Rosen v. Feldman & Columbia University, 1996 U.S. App. LEXIS 4516 at *4; Rosen v. Feldman & Columbia University, 1995 U.S. Dist. LEXIS 11111 at *12-14. See also, Ioele v. Alden Press, Inc., 145 A.D.2d 29, 536 N.Y.S.2d 1000 (1st Dept. 1989), rearg. denied, 1989 N.Y. App. Div. LEXIS 8689 (1st Dept. 1989).

50. Fisher, *supra*, at 1337-39. See also, Saint Mary's Honor Ctr. v. Hicks, 509 U.S. 502, 113 S.Ct. 2742, 125 L.Ed.2d 407 (1993).

51. Price Waterhouse v. Hopkins, 490 U.S. 228, 109 S.Ct. 1775, 104 L.Ed.2d 268 (1989).

52. See, 42 U.S.C. Secs. 2000e-5(g)(2)(B)(I).

53. McKennon v. Nashville Banner Publishing Co., 513 U.S. 352, 130 L.Ed.2d 852, 115 S.Ct. 879 (1995).

54. Sontage v. Bronstein, 33 N.Y.2d 197, 351 N.Y.S.2d 389, 306 N.E.2d 405 (1973).

55. 401 U.S. 424, 91 S.Ct. 849, 28 L.Ed.2d 158 (1971).

56. 430 U.S. 482, 97 S.Ct. 1272, 51 L.Ed.2d 498 (1977).

57. 29 C.F.R. Sec. 1607.4(D).

58. 430 U.S. at 496 n.17.

59. 29 C.F.R. Sec. 1607.4(D).

60. Griggs, *supra* at 433-434.

61. Dothard v. Rawlinson, 433 U.S. 321, 97 S.Ct. 2720, 53 L.Ed.2d 786 (1977).

33. McDonnell Douglas Corp. v. Green, 411 U.S. 792, 92 S.Ct. 1817, 36 L.Ed.2d 668 (1973). See, e.g., Fisher v. Vassar College, 114 F3d 1332, 1335 (2nd Cir. 1997), pet. for cert. filed, 66 U.S.L.W. 3178 (9/2/97) No. 97-404; Rosen v. Feldman & Columbia University, 1996 U.SD. App. LEXIS 4516 (2nd Cir. 1996) at *3; Rosen v. Feldman & Columbia Univers 1991) at *38-40.

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11111 at *12-14; Guntar v. Union College, *supra*, at *16. See also, Texas Dept. of Commmunity Affairs v. Vurdine, 450 U.S. 248, 101 S.Ct. 1089, 67 L.Ed.2d 207 (1981); McDonnell Douglas N.E.2d 745; Sogg v. American Airlines, *supra*.

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47. Sogg v. American Airlines, *supra*.

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49. Fisher, *supra*, at 1337-39; Rosen v. Feldman & Columbia University, 1996 U.S. App. LEXIS 4516 at *4; Rosen v. Feldman & Columbia University, 1995 U.S. Dist. LEXIS 11111 at *12-14. See also, Ioele v. Alden Press, Inc., 145 A.D.2d 29, 536 N.Y.S.2d 1000 (1st Dept. 1989), rearg. denied, 1989 N.Y. App. Div. LEXIS 8689 (1st Dept. 1989).

50. Fisher, *supra*, at 1337-39. See also, Saint Mary's Honor Ctr. v. Hicks, 509 U.S. 502, 113 S.Ct. 2742, 125 L.Ed.2d 407 (1993).

51. Price Waterhouse v. Hopkins, 490 U.S. 228, 109 S.Ct. 1775, 104 L.Ed.2d 268 (1989).

52. See, 42 U.S.C. Secs. 2000e-5(g)(2)(B)(I).

53. McKennon v. Nashville Banner Publishing Co., 513 U.S. 352, 130 L.Ed.2d 852, 115 S.Ct. 879 (1995).

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55. 401 U.S. 424, 91 S.Ct. 849, 28 L.Ed.2d 158 (1971).

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57. 29 C.F.R. Sec. 1607.4(D).

58. 430 U.S. at 496 n.17.

59. 29 C.F.R. Sec. 1607.4(D).

60. Griggs, *supra* at 433-434.

61. Dothard v. Rawlinson, 433 U.S. 321, 97 S.Ct. 2720, 53 L.Ed.2d 786 (1977).

62. 490 U.S. 642, 109 S.Ct. 2115,104 L.Ed.2d 733 (1989).

63. Griggs, *supra*.

64. Griggs, *supra*.

65. Castaneda, *supra*.

66. 29 FEP 1611 (1982).

67. 75 F.3d 989 (1996).

68. DLR No.75, D-1 (1993).

69. 67 FEP 1745 (1996).

PART II

RECENT UPDATES AND DECISIONS ON AGE AND GENDER EMPLOYMENT DISCRIMINATION

By
Saul S. Le Vine *

As a follow-up to a prior presentation, I am reviewing the recent decisions affecting age and gender employment discrimination.

There has been a substantial amount of diversity between the various Circuits as to the effect of disparate impact claims under the Age Discrimination and Employment Act (ADEA). [1]

The original case referred to is *Wanda L. Adams, Leo L. Floyd et al. v. Florida Power Corp., Florida Progress Corp. US District Court for the Middle District of Florida D.C. Docket No. 95-00123-CV-0C-10A.*

INTRODUCTION

There are two basic types of employment discrimination cases. The first, disparate treatment, involves intentional discrimination. The second, disparate impact, involves unintentional discrimination and occurs when an employer makes an employment decision based upon a facially neutral criterion, such as education or physical strength, that has the effect of disproportionately excluding applicants who would otherwise fall within a protected criterion, such as race or sex. [2]

Since its enactment in 1967, the Age Discrimination in Employment Act ("ADEA") has provided federal protection against age discrimination in the workplace.[3]

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Modeled after and almost identical to Title VII of the Civil Rights Act of 1964 ("Title VII"), [4] the ADEA, generally has been interpreted similarly to Title VII. [5]

The ADEA, essentially using the exact wording of Title VII' [6] prohibits employers from failing or refusing "to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions or privileges of employment because of such individual's age". [7]

Likewise, the ADEA makes it unlawful for an employer "to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee because of such individual's age. [8]

On Monday, April 1, 2002, the United States Supreme Court ruled on the *"Adams et al v. Florida Power Corp. et al".* [9] Decided in July of 2001, this case is now being appealed from the United States District Court of Appeals for the Eleventh Circuit. The case is being closely watched in connection with age discrimination. In the District

Court case, [10] the Court ruled as a matter of law, that disparate impact claims cannot be brought under the Age Discrimination and Employment Act of 1967 (ADEA).

After the ruling by the District Court Judge, the question presented a controlling issue of law in the case, and the Judge stated that there was substantial grounds for disagreement over his decision, and certified the question to the United States Court of Appeals. [11]

The United States Court of Appeals for the Eleventh Circuit exercised their discretion to take the case and affirmed the District Court. The question raised to the United States Supreme Court which had accepted the case for hearing, was "whether older employees have rights similar to those of minorities when it comes to discrimination claims". After hearing the case, the Court on April 1, 2002, **without explanation**, dismissed the case it heard, argued and effectively changed their minds and decided not to rule on the type of evidence necessary to prove a violation of the ADEA. [12]

The case presents an issue in the Eleventh Circuit whether a disparate impact theory of liability is available to plaintiffs suing for age discrimination under the ADEA. The District Court ruled as a matter of law that the disparate impact claims cannot be brought under the ADEA. As a result of this decision, the District Court Judge recognized that there was a controlling issue of law in the case and there was substantial disagreement over his decision. He certified the question to the United States Court of Appeals for the Eleventh Circuit.

The case deals with whether a law prohibiting age bias at work allows law status that charge an employer's action inordinately harmed older workers. The High Court had agreed to consider the question in December, 2001, when the country was in a recession and thousands of jobs were being cut. It dismissed the case April 1, 2002 with a one-sentence ruling. The unanimous, unsigned decision did not explain the Court's reasoning, saying only that it had acted "improvidently" when it chose to hear the case.

The case involved about 120 Florida Power Corp. employees. They contended that their dismissal was part of a company effort to change its image and to reduce salary and pension costs. More than 70% of those laid off were forty (40) years of age or older.

The legal question was whether an ADEA 1967 law that bars on-the-job age bias, allowed law status on grounds that an employment action had a disproportionate impact on older workers. The justices had already settled that impact status is allowed under the 1964 Civil Rights Act Title VII which bans discrimination based on worker's sex, religion or race.

The case raises the question whether policies that had a disproportionate negative impact on older workers, violates the law without proof of intentional discrimination.

BACKGROUND

Florida Power Corp. (FPC) operated as a publicly regulated electric utility monopoly until 1992. That year Congress passed the Energy Policy Act of 1992 which effectively opened the industry to competition. In this situation, Florida Progress Corp. is its parent Corporation. The company undertook a series of reorganizations which it contends were necessary for it to maintain its competitiveness in the newly regulated market. This restructuring resulted in the dismissal of a number of employees between 1992 and 1996. This group led by Wanda Adams, and now known as the "Adams

Class", became the plaintiffs in the (class action) suit against FPC and the parent corporation for age discrimination in violation of the ADEA.

In 1996, the District Court continually certified a class of FPC employees claiming age discrimination. In August of 1999, the District Court decertified and ruled as a matter of law that a disparate impact theory of liability is not available to plaintiffs bringing suit under the ADEA. [13] The Court also found that the plaintiffs' disparate treatment claims were not sufficiently similar to support proceeding as a class. Accordingly, the court held that the Adams Class members would each have to pursue separate individual remedies.

Because of the conflict that existed among the circuits, the Appellate Courts had not yet definitively ruled on the availability of disparate impact claims under the ADEA; the District Court certified the question to the Eleventh Circuit Court of Appeals. At the time the Court was careful to note that the Judge had made no findings or assessment of whether the Adams Class could produce evidence sufficient to set a claim for disparate impact. The sole question presented to the Court, whether as a matter of law, disparate impact claims may be brought under the ADEA.

A disparate impact claim is one that "involves employment practices that are facially neutral in their treatment of different groups, but that in effect, fall more harshly on one group than another and cannot be justified by business necessity". [14]

Several Circuits have relied upon the holding in the Griggs Case [15] to find that because the language of the ADEA parallels Title VII, disparate impact claims should be allowed under the ADEA. In a case involving liquidated damages under the ADEA, the Supreme Court explicitly left open the question of "whether a disparate impact theory of liability is available under the ADEA". [16]

The Second, Eighth and Ninth Circuits have ruled the Hazen case literally and continue to allow disparate impact claims. [17] In contrast, the First, Third, Sixth, Seventh and Tenth Circuits have questioned the viability of disparate impact claims under the ADEA post-Hazen. [18] These cases rely on language on Hazen and other factors that suggest that the disparate impact claims are not viable under the ADEA. The Fourth, Fifth and DC Circuits have not addressed the issue.

First, courts that question the viability of a disparate impact claim under the ADEA note that the text of the ADEA differs from Title VII in an important respect. Sec. 623(f)(1) of the ADEA explicitly provides that an employer may "take any action otherwise prohibited...where the differentiation is based on reasonable factors other than age". [19]

The Court in the Hazen case left open the question of whether a disparate impact claim can be brought under the ADEA. The language in the opinion suggests that it cannot. The Court noted that disparate treatment captures the essence of what Congress fought to prohibit in the ADEA. In addition, the Court reiterated that in making the employment decision, the use of factors correlated with age, such as pension status, did not rely on "inaccurate and stigmatizing stereotypes" and was acceptable. That concept and position is inconsistent with the viability with the disparate impact theory of liability which requires no demonstration of intent, but relies instead on the very correlation between the factor used and the age and those employees harmed by the employment decision to prove liability. [20]

CONCLUSION

The Court stated that the Second, Eighth and Ninth Circuits allowed disparate impact claims under the ADEA. The First, Third, Sixth, Seventh and Tenth do not. The Eleventh Circuit Court finds the reasoning of the Tenth Circuit in the Ellis Case [21] and the First Circuit in the Mollen Case [22] persuasive. Accordingly, the Court finds that disparate impact claims may not be brought under the ADEA and affirmed the District Court.

Several commentators who attended the arguments presented to the Supreme Court stated that for the older worker the Court's decision not to hear (take) their case is preferable to a ruling against them. To these observers, it appeared that the conservative justices had a majority to rule against the appeal on behalf of these workers. The more liberal members of the Court appeared, to several commentators, to be seeking reasons to dismiss the case. This would permit a future court, perhaps more friendly to employee protection, to hear the arguments in favor of disparate impact theory appealing to the ADEA.

Currently it allows each jurisdiction to have a different ruling. One day the United States Supreme Court will confront the issue and not opt out and dismiss the case on whether or not the type of evidence necessary could prove a violation of the ADEA disproportionately had a negative impact on older workers and could violate the law without proof of intentional discrimination.

ENDNOTES

1. 29 U.S.C. Secs. 621 et seq (1994)
2. Griggs v. Duke Power Co., 401 US 424 (1971)
3. 29 U.S.C. Secs. 621-634 (1994)
4. 42 U.S.C. Secs. 2000e-2000e17 (1994)
5. Geller v. Markham 635 F.2d 1027, 1032 (2d Cir.1980)
6. 42 U.S.C. Secs. 2000e2(A)(1)-(2) (1994)
7. 29 U.S.C. Sec. 623 (a)(1) (1994)
8. Id. Sec. 623 (a)(2)
9. 255 F. 3d 1322
10. USDC Fla..D.C. Docket No. 95-00123-CV-OC-10A
11. 28 U.S.C. Sec. 1292(b)
12. ___________US ___________Adams v. Florida Power Corp., et al.

13. USDC Fla..D.C. Docket No. 95-00123-CV-OC-10A
14. Hazen Paper Co. v. Biggins, 507 U.S.604,609 (1993)
15. Griggs v. Duke Power Co. 401 U.S. 424,431 (1971)
16. Geller v. Markham, 635 F.2d 1027,1032 (2d Cir.1980); Smith v. City of Des Moines, 99 F.3d 1466, 1469-70 (8th Cir.1996); E.E.O.C. v. Borden's Inc. 724 F.2d 1390-95 (9th Cir.1984).
17. Criley v. Delta Airlines, Inc., 119 F.3d 102,105 (2d Cir.1997); Lewis v.Aerospace Cmty. Credit Union, 114 F.3d 745, 750 (8th Cir.1997); Frank v. United Airlines, Inc. 216 F.3d 845,856 (9th Cir.2000); E.E.O.C. v. Local 350, 998 F.2d 641,648 (9th Cir.1993).
18. Mullin v. Raytheon Co., 164 F.3d 696, 700-01 (1st Cir.)cert. denied, 528 U.S.811, (1999); E.E.O.C. v. Francis W. Parker School, 41 F.3d 1073, 1076-77 (7th Cir.1994); Ellis v. United Airlines Inc. 73F.3d 999, 1006-07 (10th Cir. 1996); DiBiase v. Smithkline Beecham Corp., 48 F.3d 719,732 (3d Cir. 1995); Lyon v. Ohio Educ. Ass'n and Prof'l Staff Union, 53F.3d 135,139 (6thCir. 1995).
19. 29 U.S.C. Sec. 623(f)(1).
20. Hazen Paper v. Biggins, 507 U.S.at 610-11 (1993)
21. Ellis v. United Airlines, Inc. 73F.3d 999, (10th Cir. 1996)
22. Mullin v. Raytheon Co. 164 F.3d 696,70001 (1st Cir.), cert. denied 528 U.S.811

THE LEGAL ENVIRONMENT OF SHOW BUSINESS

by

Dr. Sharlene A. McEvoy* and Dr. William Windom**

INTRODUCTION

Among the challenges faced by law professors in business schools is to make interesting the somewhat dry material taught in Legal Environment of Business and advanced Business Law courses. Often the subject matter of cases presented in the textbooks is pedantic and not particularly helpful in explicating the legal principles students need to know. This paper proposes a way to teach such areas of law as agency, labor unions, government regulation, torts, contracts and employment discrimination by using cases from the entertainment industry that an instructor may find useful in class.

TORTS

There are several cases students will find helpful in studying the right of publicity. Among the cases that deal with celebrities' rights in this area are Lugosi v. Universal Pictures[1] and Comedy III Productions v. Saderup[2] both of which can be used in a business law class to cover such issues as the descendible right of privacy, the common law right of publicity and the impact of the passage of statutes on common law rules.

Bela Lugosi first portrayed Dracula in a movie produced by Universal Pictures in 1930. Later, the studio licensed a series of toys portraying such horror movie characters as Wolfman, Frankenstein and Dracula. The latter doll, produced in the early 1960's, bore Lugosi's likeness despite the fact that he had died in 1956. The studio did not compensate Lugosi's widow and surviving son for the use of their famous relative's likeness. Ultimately the case was decided by the California Supreme Court in favor of Universal. Students still enjoy debating the positions taken by the majority and dissenting opinions which include such concepts as right of privacy, the property right to one's name and the nature of the contract Lugosi signed when he first portrayed the Dracula character in an era in which movie tie-ins were unheard of.

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As a follow-up to the Lugosi case, students will find the Saderup case of interest because it analyses the California statutes which create an enforceable right to publicity by living persons and a descendible right of publicity to the heirs and assignees of dead celebrities. Saderup drew a charcoal drawing of the original "Stooges," Larry Fine, Moe Howard and "Curly" Joe DeRita and sold lithographs for $20 to $250 and shirts for $20. from a temporary booth at a shopping mall in suburban Los Angeles garnering approximately $75,000 in profits.[3] The "Stooges" heirs sued Saderup to recoup the proceeds.

The California Supreme Court held that Saderup's rendition of the Three Stooges was merchandise and not art, thus not "transformative" because it relied solely on the "Stooges" fame.[4] The decision established the principle that the right of publicity is a constitutional one, an important finding not only for the "Stooges'" heirs but also to the heirs of other deceased celebrities who may find the images of their famous relatives exploited.

Like sixteen other states, California gives celebrity heirs the rights to publicity about their famous relatives and the right to control the use of the latters' likenesses, names, voices, signatures and photographs for up to seventy years after their death.[5]

A case similar to Lugosi and Saderup is now wending its way through the New York courts. Pamela Everett, a former Rockette, is suing Radio City Music Hall for $2.5 million claiming that, it violated her civil rights by using a close-up of her and other Rockettes for advertising without first obtaining permission. Purportedly, photographs taken in 1995 were to be used only in handbills promoting the Christmas and Easter shows but instead were used to adorn dolls, postcards, pens, pencils, MacDonalds' placemats, Federal Express ads, calling cards, disposable cameras, puzzles, subway maps, souvenir programs, soda and milk containers. Everett also claims that Radio City digitally altered her teeth, eyes, nose, hair and eyebrows, placed her head on a different body and put non-matching hands on her arms. Radio City contends that under its collective bargaining agreement with the dancers it has the rights to photos of the Rockettes in perpetuity.[6]

The issue of the right of publicity also comes up in the context of commercial speech which is a topic often covered in Legal Environment classes. There have been cases in which the use of a celebrity likeness creates the false and misleading impression that the celebrity is endorsing a product. Among cases that can be used to illustrate this concept is Midler vs. Ford Motor Co. in which Bette Midler complained about an advertisement that created the mistaken impression that the singer endorsed the car manufacturer's products.[7] This case may be used in conjunction with the landmark commercial speech case Central Hudson Gas and Electric Corp. vs. Public Service Corporation.[8]

Another area of tort law often covered when defamation is considered is that of the conditional privileges available to critics of movies, television and theater. A recent case tests the notion that critics have a conditional privilege freeing them from suits for defamation.

Actor David Soul won a libel suit against journalist, Matthew Wright of the Mirror, who criticized a play that Soul appeared in "The Dead Monkey" as the worst he had ever seen. Soul contended that Wright did not see the play himself but sent a free lance journalist to review it on his behalf. Soul was awarded $29,000 in libel damages plus $215,000 in legal fees.[9] In light of the conditional privilege afforded theater critics, students will enjoy discussing whether or not such a jury verdict will withstand an appeal.

GOVERNMENT REGULATION

Legal Environment texts typically include a chapter of the role of the federal administrative agencies. The independent agency that is intimately involved with the entertainment industry is the Federal Communication Commission. There are several cases that students will find instructive about the workings of the FCC and other agencies. One of the most prominent is FCC v. Pacifica Broadcasting Company.[10] At issue was the monologue delivered by George Carlin called "Seven Dirty Words," which was aired by a station owned by Pacifica as part of an afternoon program called "The Contemporary Use of Language." The case is a useful springboard for discussion of the rights of listeners, the responsibility of FCC licensees, FCC rules about the kind of language that cannot be heard on the airwaves and the role a government agency led by unelected commissioners should have in making such judgments.

While the George Carlin case is a landmark decision, of more recent vintage is a case involving a complaint about the Fox Networks show, "Boston Public" brought by a coalition of family and religious groups. The latter complained to the FCC about several episodes of the show which they termed outrageous because of the following situations:

- A female candidate for class president purportedly performed a sexual act on a male opponent in exchange for his support.
- A student earned extra cash by working as a stripper.
- A teacher has a prolonged sexual affair with a student.[11]

In a letter to FCC Chairman, Michael Powell, the groups stated that "Boston Public" does not belong in prime time where children can see it and accused Fox of trying to compete with such explicit shows as "Sex and the City"on HBO, while the groups claim "The public airwaves belong to the public." Fox has countered by arguing that the show, created by David E. Kelley, which airs on Mondays at 8 p.m., "deals dramatically and responsibly with real issues, often sensitive issues that face our children every day in our schools."[12] The students can view an episode of the show in class and debate the appropriateness of its content in an 8 to 8:30 p.m. time slot.

While most cases involving the FCC concern the agency sanctioning a station, a recent case involves a poet and performance artist, Sarah Jones, who filed a lawsuit in January 2002, charging that the FCC violated her First Amendment rights when it fined a radio station for playing her spoken-word song which was filled with "vivid sexual imagery."[13]

The case began in October 1999 when Jones' song, "Your Revolution" was aired during a program called "Sound Box" on Station KB00-FM in Portland, Oregon, offending a listener who later complained to the FCC. In May 2001, the FCC fined KB00 $7,000 for broadcasting "unmistakable patently offensive, sexual references" that appear designed to pander and shock."[14] Not only does the FCC prohibit the seven objectionable words, it also bars material that it deems patently offensive as measured by contemporary community standards, especially references to "sexual or excretory functions and organs."[15]

"Your Revolution" does not contain any of the seven "dirty" words but does make explicit sexual references which paraphrase lyrics from rap songs castigating them as misogynist and shallow.[16]

Jones claims that the FCC violated her First Amendment rights when it fined the station for playing her song and seeks an injunction preventing the agency from enforcing the fine against KBOO.[17] Students can listen to the song and discuss the role of the FCC in enforcing indecency rules as well as the issue of whether or not Jones has standing to pursue an action against the FCC for action it took against one of its licensees.

CONTRACTS

The instruction of contracts can be a somewhat dry process because there are so many rules that students need to absorb. There are three show business cases that make this task more palatable. One of the more famous ones that has appeared in many editions of textbooks is Parker v. Twentieth Century Fox.[18] Parker was hired by the Film Company to appear in a film called "Bloomer Girl" for a fee of $750,000, when the film was subsequently cancelled, Parker was offered a role for the same salary in a Western feature called "Big Country, Big Man" which was to be filmed on location in Australia. She declined the latter role and later sued the studio for payment for the cancelled "Bloomer Girl". The studio raised the affirmative defense that by the declining the alternative role, Parker failed to mitigate her damages.

The California court held that the roles offered to Parker were not comparable. "Bloomer Girl," which was to have been filmed in Los Angeles, called on her talents as a musical and dance performer while "Big Country" was a straight dramatic role which was to take place in an opal mine. Because the roles were so different the court found the substitution offered the actor inferior employment and therefore there was no requirement that she had to take it.

Another celebrity case can be used to illustrate the concept of temporary impossibility. Under the law, impossibility which is temporary rather than permanent, suspends but does not discharge the promise to perform. The duty is suspended while the impossibility continues but after it ends, the duty to perform can reattach, but only if performance thereafter would not substantially increase the burden on either party, or make it different from that which was promised. In Autry v. Republic Productions,[19] the facts were that Gene Autry who had starred in numerous Western movies for the studio signed a contract in 1938 was to have run until 1943. In 1942, however, Autry joined the Army which precluded his appearing in films for the studio during his Army service (1942-1945). When Autry returned, Republic sought to have him appear in movies to make-up for the time lost. Autry balked because the contract was less valuable due to the passage of time and changes in the tax laws. The court found in favor of Autry stating that although Autry's situation was one of temporary impossibility, the duty to perform the contract did not re-attach because of changes in the law which neither party could have contemplated when the deal was originally signed in 1938.

Another case that is instructive in teaching contract law is Marvin v. Marvin[20] which involved a well-publicized case of movie actor Lee Marvin who began living with partner, Michelle in 1964. They held themselves out to the public as being married when in fact they were not. The pair orally agreed that they would share equally all property and earnings as a result of their individual and joint efforts. Michelle "Marvin's" primary contributions to the relationship were her services as a companion, homemaker, housekeeper and cook, and the fact that she had given up a lucrative entertainment career to pursue a relationship with the actor. In return Lee Marvin agreed to provide her with financial support for the rest of her life. In 1970 when the couple broke up, Michelle left the couples' home. For a year, Lee Marvin continued to provide support but in late 1971, he discontinued the payments and Michelle sued to reinstate them and for half of the property acquired during the relationship. Lee Marvin later argued that the agreement was related to the immoral character of their relationship and that to enforce it would be contrary to public policy. The court ruled that partners can voluntarily live together, engage in a sexual relationship, and make arrangements concerning their earnings and property as long as there is not a contract to pay for sexual services because the latter would be an illegal contract for prostitution. The court, therefore, held their agreement not to be in violation of public policy.

WORKER SAFETY

Accidents on movie sets are not uncommon. One of the most notorious was the death of actor Vic Morrow and two child actors during the filming of the "Twilight Zone" movie in 1983. But what of diseases supposedly contracted during the filming of movies? One of the more famous examples was the 1956 film, "The Searchers" which was made near an above ground nuclear testing site. During the following decades many members of the cast and crew suffered from cancer: John Wayne, Patrick Wayne, Pedro Armendariz and Agnes Moorehead. Because the relationship between exposure to radiation and cancer was less understood in the 1950s and 60s, the victims brought no suits in the case.

In 2002, a case was brought by Jeffrey Clark who was an extra on the set of "Planet of the Apes"a remake of the 1968 movie. He is suing News Corp, an affiliate of 20th Century Fox claiming that the producers exposed actors to 80,000 pounds of crystalline silica, a hazardous substance which can cause cancer or lung injury, to simulate a heavy dust storm.[21] Clark's class action suit on behalf of hundreds of extras used in the film claim that there is a high probability that many of them will die prematurely or "have severe restrictions on their quality of life." The suit claims that the actors engaged in physically taxing battle scenes for hours at a time during the twelve-day filming period while the dust was blown on them.[22]

Students will perhaps have seen the movie which was released in July 2001 or clips can be shown featuring the scenes complained of to demonstrate the basis for the claim.

UNIONS

When students think about unions, they customarily think about blue-collar workers or public employees who are traditionally members of collective bargaining units. Few students understand that actors who appear on stage, television or in the movies are members of such entertainment unions as Actors' Equity (stage), AFTRA, American Federation of Television and Radio Artists (which has jurisdiction over radio, taped programs, daytime soap operas and game shows), and Screen Actors Guild (with jurisdiction over filmed television programs shown on the prime time network schedule, and movies).

The latter union, Screen Actors Guild, includes 98,000 in numbers, 85% of whom are unemployed at any given time. The history of this union is covered in a book called: The Politics of Glamour: Ideology and Democracy in the Screen Actors Guild[23] by David F. Prindle which traces the travails in the formation of the Screen Actors Guild in the 1930's, paralleling the birth of other unions in the wake of the passage of the Wagner Act, the political woes suffered during the black-listing of the late 1940's and 1950's, and the struggles over residuals in the 1960's.

More recent union issues relate to mergers of the Screen Actors Guild with the Screen Extras Guild. Students may enjoy discussing the issue of how manageable such an unwieldy bargaining unit can be and ways in which the number of union members might be diminished. In 1970, the so called Briggs Proposal urged that entrance requirements for membership in SAG be tightened so that there would be fewer members vying for the limited number of jobs available to actors.[24] It has also been suggested that the odds of finding acting jobs would be improved if the SAG rolls were purged every year of those who did not work in any media during the previous two years.

Another issue that may be of interest for student discussion is that of merging the Screen Actors' Guild and AFTRA which have overlapping membership. While such a merger was approved by AFTRA in 1999, it was rejected by SAG.[25] It has also been proposed that all entertainers' unions should be merged to create one powerful entity. Students can discuss the pros and cons of whether such a large bargaining unit would be too unwieldy to manage and whether the interests of the stage, television and movie actors are so disparate that the union would be too difficult to manage. An argument in favor of merger is that actors pursue their careers among a variety of venues – stage, television and movies – and that one union would avoid multiple payment of dues for members and a multiplicity of pension checks at the end of one's career. In addition, each union operates a separate health plan for members. A unified system may prove to be more cost effective.[26]

Other unique issues regarding the entertainment unions are that the president and other union officials of the Screen Actors Guild remain working actors (if, indeed they can find work while filling these positions), but they are not paid for their services. The positions of the Screen Actors Guild officers are filled by actors who are generally not working and may not work after their terms have ended.

Despite an overall decline in union membership generally, and the fact that fewer workplaces are represented by collective bargaining agreements, the entertainment unions, and those representing professional athletes remain among the strongest in the United States in terms of their ability to win gains in wages and benefits. Students may want to ponder the irony that the strongest unions represent some of the most highly paid people – actors and athletes while most members of the working class are either not covered by collective bargaining agreements or are members of unions that have grown weaker during the past three decades.

The Screen Actors Guild is also unique among labor unions in that it has 8,000 minors as members. One issue related to minor-actors that might provide for class discussion is that of emancipation. By law young actors who are sixteen must work limited hours. Because of this requirement many producers will hire an actor who is eighteen to play a younger part. Younger actors therefore are graduating from school early and emancipating from their parents so they will be eligible for the roles.[27]

SAG is proposing to amend the law so young actors can remain in school. Students can debate whether it is advisable for 16 year olds to work more hours just so they can be eligible for more acting jobs.

DISCRIMINATION ISSUES

In addition to the financial issues facing actors, there are also the problems of Ageism and sexism which plague the profession. It is well known that there are few jobs available for female actors over the age of 40.[28] What, if anything, can the entertainment unions do to stem the skewing of roles toward younger performers is unclear.

TABLE [29]

Screen Actor's Guild Survey of Working Actors – 1998

Age	Males	Females
30s	17,202	14,407
40s	15,651	10,882
50s	9,157	5,300
60s	5,105	2,448
70s	2,999	1,563

Ageism also affects male performers, because after age 60, male actors find fewer roles. (see Table) Students may debate whether this is due to the fact that it is the 18-30 age group that makes up the bulk of television viewers and movie goers, as well as being the coveted age group for advertisers, or is it because so little of what is available on television and movies appeals to the over 60 age group. The dearth of television programs and movies with actors that reflect their own age results in the older generation seeking its entertainment elsewhere.

A case that can be used to illustrate both handicap and age discrimination is that of "All My Children" star, Michael Nader who filed a lawsuit against ABC claiming that the network fired him from his role as Dimitri Marick, Susan Lucci's love interest after he went into drug rehabilitation in 2001 after his arrest during an early morning drug raid at an after-hours club in New York's East Village. The 57 year old Nader played "Marick" for ten years on "All My Children" and was replaced by a much younger actor, Anthony Addabo until the character was written out of the story line.[30]

AGENCY LAW

The law of agency is an integral part of any business law syllabus and its principles can be taught by using the example of the professional talent agency which represents a variety of principals, in this case, actors.

The Screen Actors Guild franchises 600 agencies to represent its members. To become an "official" agent, agents must sign an agreement known as SAG Agency Regulations, which require ethical conduct and licenses in some states. Union regulations prohibit agents from seeking more than 10% of actors' salaries.[31]

Entertainment industry lore holds that talent agents are "cunning and unscrupulous, ruthless, conniving and heartless"[32] and Fred Allen, the comedian is reported to have said, "You can take all the integrity in Hollywood, put it in a flea's navel, and there'll still be room enough for two caraway seeds and the heart of an agent."[33]

[The Screen Actors Guild's master franchise rules, which have been in place since 1972, "prohibit agencies from taking a substantial stake in outside companies or visa versa."][34] The rules have required that agents not cast, produce, or act in any SAG production, but in February 2002, SAG and the Association of Talent Agents (ATA) agreed to the rule change to allow agents to enhance their roles in productions.[35]

A recent agreement between SAG and ATA allows agencies to invest in or sell as much as a 20% stake to production companies if they are not of major networks and studios.[36]

This development has some actors concerned that agents may become partners with production companies and that actors will become their agents' employees instead of the reverse. Large agents such as Creative Artist Agency and International Creative Management (ICM) and William Morris have the most to gain from a rules change.[37] Smaller talent agencies will benefit little from loosening of financial interest rules because their clients are not involved in expensive production packages.[38] Since managers are now allowed to have a financial stake in their clients' work,[39] some agents became managers to gain more financial opportunities.

As actors view themselves primarily as artists, and agents see themselves as business people, the conflict between them is inevitable.[40]

Some SAG members fear that there will be a return to pre-1962 days when Lew Wasserman headed both a studio and a talent agency before the Justice Department ended the arrangement by a consent decree.[41] The latter can be a fruitful source for discussion on antitrust laws.

CONCLUSION

As instructors in Business Law classes face challenges in keeping students interested in complex materials, use of cases and examples from the entertainment industry can provide a paradigm for teaching various areas of Business Law. Recordings and videotapes of television shows and movies discussed in these pages can be used to enhance student understanding.

Despite the fact that entertainment is a form of art, at bottom it is a business, and examples drawn from the business can enliven even the dullest course materials and provide fodder for class discussions. Some of the cases discussed herein are appellate cases, but many are examples of current issues culled from the entertainment trade papers: Variety and The Hollywood Reporter.[42]

ENDNOTES

[1] 25 Cal 3d 813, 603 P. 2d 425, 160 Cal Rptr 323 (1979). See also such cases as Maritote v. Desilu Productions 345 F. 2d 418 (7th Cir. 1965) cert den 382 U.S. 833 86 s. Ct 176 L5 L.Ed 2d 124 (use of name and likenesses of Al Capone in "The Untouchables") Schumann v. Loews, Inc. 135 N.Y.S. 2d 361 (1954) (Grandchildren of composer, Robert Schumann sued for misappropriation of property rights). James v. Screen Gens 174 Cal App 2nd 650, 344 P. 2d. 719 (1959), (Widow of Jessie James, Jr. sued television producer for exploitation of James' personality and name for commercial purposes).

[2] 25 Cal 4th 387, 21 P.3d 797, 106 Cal Rptr 2d 126 (2001).

[3] Id.

[4] Brooks Bolick, "Judges Smack 'Three Stooges' Case," The Hollywood Reporter, Jan. 8-14, 2002 at 94.

[5] Id. See also Paramount v. Wendt et al 1997 US App LEXIS 25584 (The "Cheers" case).

[6] "Helen Peterson, Ex-Rockette Puts Foot Down in Suit," Daily News, Feb. 2, 2002 at 5.

[7] 849 F. 2d 460 (9th Cir 1988).

[8] 447 U.S. 557, 65 L.Ed 2d. 341, 100 S.Ct 2343 (1980).

[9] "Case Closed," The Hollywood Reporter, Dec. 12, 2001 at 4.

[10] 438 U.S. 10, 98 S Ct. 3026 56 L.Ed. 2d 57 (1978).

[11] Suzanne C. Ryan, "FCC Gets Boston Public Letter" The Boston Globe, Feb. 6, 2002 at A-14.

[12] Id.

[13] Neil Strauss, "Songwriter, Citing First Amendment, Sues Over Radio Sanctions," The New York Times, Jan. 30, 2002 at 1 (Arts Page).

[14] Id.

[15] Id.

[16] Id.

[17] Id.

[18] 89 Cal. Rptr 737 (1970).

[19] 170 P. 2d. 977 (Cal App. 2d. 1945). Subsequent opinion: 30 Cal 2d. 144, 180 P. 2d 888 (1946).

[20] 18 Cal 3d. 660, 134 Cal Rptr. 815, 557 P 2d 106 (1976).

[21] "Ape Extra Sues Over Dusty Planet Scene" Waterbury Republican, Feb. 1, 2002 at 2A.

[22] Id.

[23] Univ. of Wisconsin Press, 1988.

[24] Id. at 97.

[25] "SAG/AFTRA Merger Rumors Heating Up After Dinner Date." The Hollywood Reporter, Nov 28, 2001 at 2. See also Peter Kiefer, "Gilbert's Task: Restoring the Unity of SAG," The Hollywood Reporter, Dec 8, 2001 at 21.

[26] Telephone Interview with Dr. William Windom, Oct. 2, 2001.

[27] Stephen Galloway, "Showbiz Kids: Melissa Gilbert: Q and A." The Hollywood Reporter, Nov 20-26, 2001 at S-10

[28] Natalie Angier, "In the Movies, Women Age Faster," New York Times, Dec. 9, 2001 at WK 3. See also Barbara Whitaker, "In Hollywood, No One Gets a Casting Call for This Role," New York Times, March 12, 2002 at 8; hereinafter, "No One Gets a Casting Call."

[29] "No One Gets a Casting Call," supra, note 28, New York Times, March 12, 2002.

[30] John W. Morgan "Fired After Drug Bust, Nader Plans on Suing ABC," Conn. Post, Apr 5, 2002 at B6.

[31] "Acting In Your Interest," Basic Benefits Screen Actors Guild, Oct. 2000 at 8.

[32] Tony Randall and Michael Mindlin, Which Reminds Me, Dell, 1989 at 153

[33] Id.

[34]Peter Kiefer and Tamara Conniff, "SAG/ATA Standoff Fuels Worry," The Hollywood Reporter, Jan 4-6, 2002 at 86.

[35] Claude Brodesser and Dave McNary, "Agents' Dates of Wrath," Variety, Dec. 10-16, 2001 at 1.

[36] Peter Kiefer and Cynthia Littleton, SAG, ATA Strike New Deal," The Hollywood Reporter, Feb. 25, 2002 at 1.

[37] Agents' Dates of Wrath supra, note 34.

[38] Id.

[39] "The 10% Dissolution" Variety, Dec. 10-16, 2001 at 63.

[40] SAG/ATA Standoff Fuels Worry," supra Note 32. See also Dan E. Moldea, Dark Victory: Ronald Regan, MCA and The Mob. Penguin Books, 1987.

[41] For the Hollywood Reporter on-line: www.Hollywood Reporter.com.

[42] Id.

Rendering Consequential and Incidental Damage Limitations and Exclusions Contained in Warranty Provisions Void Pursuant to the Uniform Commercial Code in Certain Instances for Commercial Cases

By Mitchell J. Kassoff, Esq.[1]

This article examines the situation in which a non-consumer purchases a product from a manufacturer who has explicitly stated that no consequential and incidental damages will be paid if there is any defect or other problem with its product. The article posits that the purchaser has or is considering suing the manufacturer for his damages.

Standard for the Granting of Summary Judgment

It is assumed that the manufacturer will make a motion for summary judgment to dispose of a lawsuit instituted by a purchaser for damages. It must be noted that such damage limitations are specifically permitted by the Uniform Commercial Code.[2] The first tactic that the manufacturer might take is that its exclusion entitles it to prevail on a motion for Summary Judgment.

As the U.S. Supreme Court clearly stated in *H. J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 106 L. Ed. 2d 195, 1989 U.S. LEXIS 3239, 109 S. Ct. 2893, 57 U.S.L.W. 4951 (1989):

> Indeed it may appear on the face of the pleadings that a recovery is very remote and unlikely but that is not the test. . . .'In appraising

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2 Uniform Commercial Code

> the sufficiency of the complaint we follow, of course, the accepted rule that *a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.*' [Citations omitted]. [Emphasis added]). 492 U.S. at 249-250.

In *Consarc Corp. v. Marine Midland Bank, N.A.*, 996 F.2d 568 (2nd Cir. 1993) the Second Circuit held that:

> Extensive jurisprudence developed in the Supreme Court and in our Circuit provides well-established standards governing review of a Rule 56 motion for summary judgment. *A party moving for summary judgment bears the burden of establishing that no genuine issue of material fact remains for trial.* See Adickes v. S.H. Kress & Co., 398 U.S. 144, 157, 26 L. Ed. 2d 142, 90 S. Ct. 1598 (1970); Eastman Mach. Co. v. United States, 841 F.2d 469, 473 (2d Cir. 1988).
>
> The district court's role -- and our role on appeal -- requires the court not to resolve disputed issues of fact itself, but rather to see if there are issues of fact to be resolved by the factfinder at trial. See Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 249, 91 L. Ed. 2d 202, 106 S. Ct. 2505 (1986). That is to say, when examining the record before it to see if there are any genuine issues of material fact, the court's focus is on issue-finding, not on issue-resolution. *In making its assessment, the trial court must view the evidence in the light most favorable to the non-moving party and draw all reasonable inferences in its favor.* See United States v. Diebold, 369 U.S. 654, 655, 8 L. Ed. 2d 176, 82 S. Ct. 993 (1962) (per curiam). [Emphasis added]. 996 F.2d at 572.

In *Donahue v. Windsor Locks Bd. of Fire Comm'rs*, 834 F.2d 54 (2nd Cir. 1987) the Second Circuit held that:

> The Roman philosopher Plautus warned us that there is no smoke without fire but, if this were always true, federal courts would not be able to distinguish between meritless and meritorious suits. Here, however, Plautus's advice is most appropriate. *Although Donahue's complaint raises mostly smoke, it also reveals a flame that should have precluded summary judgment against him.*
>
> Although the basic principles for granting summary judgment are well-settled, the frequency of cases in which it is granted

> improvidently persuades us that these tenets bear repetition. Fed. R. Civ. P. 56(c) provides, in part, that summary judgment shall be rendered only when a review of the entire record demonstrates "that there is no genuine issue as to any material fact." *The burden falls on the moving party to establish that no relevant facts are in dispute.* *Heyman v. Commerce & Industry Ins. Co.*, 524 F.2d 1317, 1319-20 (2d Cir. 1975); *accord, Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 157, 90 S. Ct. 1598, 26 L. Ed. 2d 142 (1970). Moreover, in determining whether a genuine issue has been raised, a court must resolve all ambiguities and draw all reasonable inferences against the moving party. *United States v. Diebold, Inc.*, 369 U.S. 654, 655, 82 S. Ct. 993, 8 L. Ed. 2d 176 (1962) (*per curiam*); *Quinn v. Syracuse Model Neighborhood Corp.*, 613 F.2d 438, 445 (2d Cir. 1980). *Therefore, not only must there be no genuine issue as to the evidentiary facts, but there must also be no controversy regarding the inferences to be drawn from them.* *Schwabenbauer v. Bd. of Educ.*, 667 F.2d 305, 313 (2d Cir. 1981), *accord Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 106 S. Ct. 2505, 2513, 91 L. Ed. 2d 202 (1986).
>
> Properly employed, summary judgment allows the court to dispose of meritless claims before becoming entrenched in a frivolous and costly trial. *Knight v. U.S. Fire Ins. Co.*, 804 F.2d 9 (2d Cir. 1986), *cert. denied*, 480 U.S. 932, 107 S. Ct. 1570, 94 L. Ed. 2d 762 (1987). *It must, however, be used selectively to avoid trial by affidavit.* *Judge v. Buffalo*, 524 F.2d 1321 (2d Cir. 1975). Hence, the fundamental maxim remains that on a motion for summary judgment a court "cannot try issues of fact; it can only determine whether there are issues to be tried." *Heyman*, 524 F.2d at 1319-20. *As long as the plaintiff has adduced sufficient facts to substantiate the elements of his claim, summary judgment is inappropriate. Celotex Corp. v. Catrett*, 477 U.S. 317, 106 S. Ct. 2548, 2554, 91 L. Ed. 2d 265 (1986). [Emphasis added]. 834 F.2d at 57- 58.

In *Bickhardt v. Ratner*, 871 F. Supp. 613, Fed. Sec. L. Rep. (CCH) ¶98780 (S.D.N.Y. 1994) the Court held that:

> Summary judgment may be granted if, upon reviewing the evidence in the light most favorable to the non-movant, the court determines that there is no genuine issue of material fact and that the movant is entitled to judgment as a matter of law." Richardson v. Selsky, 5 F.3d 616, 621 (2d Cir. 1993). In deciding the motion, "the court is required to draw all factual inferences in favor of the party against whom summary judgment is sought." Balderman v.

> U.S. Veterans Administration, 870 F.2d 57, 60 (2d Cir. 1989). *"Only when no reasonable trier of fact could find in favor of the nonmoving party should summary judgment be granted."* Cruden v. Bank of New York, 957 F.2d 961, 975 (2d Cir. 1992); accord Taggart v. Time, Inc., 924 F.2d 43, 46 (2d Cir. 1991). [Emphasis added]. 871 F. Supp. at 616.

In *PC Com v. Proteon, Inc.*, 946 F.Supp. 1125, 32 U.C.C. Rep. Serv. 2d (Callaghan) 663 (S.D.N.Y. 1996) the Court held that:

> Summary judgment is appropriate if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." FED. R. CIV. P. 56(d). A court may grant summary judgment "only if the evidence, viewed in the light most favorable to the party opposing the motion, presents no genuine issue of material fact." Cable Science Corp. v. Rochdale Village, Inc., 920 F.2d 147, 151 (2d Cir. 1990). On a motion for summary judgment, all evidence must be viewed and all inferences must be drawn in the light most favorable to the nonmoving party. United States v. Diebold, Inc., 369 U.S. 654, 655, 8 L. Ed. 2d 176, 82 S. Ct. 993 (1962); City of Yonkers v. Otis Elevator Co., 844 F.2d 42, 45 (2d Cir. 1988). 946 F.Supp. at 1129.

In *Pactel Finance v D.C. Marine Service Corp.*, 136 Misc.2d 194, 518 N.Y.S.2d 317, 4 U.C.C. Rep. Serv. 2d (CBC) 665 (1987) the Court held in an action for breach of contract to supply both goods and services, there was sufficient potential unconscionability to preclude summary judgment for seller where contract purported to exclude warranties and obligated buyer to make payment even where bargained-for services were not provided; U.C.C. §2-302 provides that where reliance is placed on alleged unconscionability of contract provision, parties shall be afforded reasonable opportunity to present relevant evidence, and statute applies to warranty exclusions.

The Provisions Of The Uniform Commercial Code Permit The Recovery Of Damages

The first method of obtaining damages is to show that the alleged limitation of damages were not properly prepared or documented by a manufacturer or accepted or agreed to by a purchaser.

To do this the agreement in question must be examined. Since this agreement will virtually always be prepared by the manufacturer, all ambiguities must be construed against manufacturer. Many time the Terms and Conditions section provides for a signature by the purchaser agreeing to its terms. Quite frequently the purchaser will not have signed this section nor agreed to its terms. This would make a strong case for denying the limitation of damages stated therein.

The case of *Nassau Suffolk White Trucks, Inc. v Twin County Transit Mix Corp.*, 62 A.D.2d 982, 403 N.Y.S.2d 322, 24 UCCRS 84 (2nd Dep't 1978) held that the requirement of UCC §2-316(2) and §1-201(10) that language in a warranty disclaimer be conspicuous was not satisfied where provisions of disclaimer were printed in type which was no larger than any other type on the entire page and actually was smaller than some of such other type. The case of *Minikes v. Admiral Corp.*, 48 Misc.2d 1012, 266 N.Y.S.2d 461, 3 UCCRS 169 (1966) also held that a disclaimer of implied warranties printed in smaller type than the rest of the purchase order was ineffective.

Based upon the holdings of *Nassau Suffolk White Trucks* and *Minikes* the placement and size of the type of the Terms and Conditions section is also important to this analysis. These cases and virtually all other authority state that for a disclaimer to have effect it must be very obvious. Other items that are required that it be bold or larger type.

Argument Can Be Made That A Large Number Of Defects That Had To Be Remedied And Manufacturer's Failure To Do So In A Timely Manner Voided Any Possible Damage Limitation That Might Have Existed Since Purchaser's Exclusive Remedy Failed Of Its Essential Purpose

The Oklahoma Supreme Court has discussed this issue. In the case of *Osburn v. Bendix Home Systems, Inc.*, 1980 OK 86, 613 P.2d 445, CCH Prod.Liab. Rep. ¶8732, 29 U.C.C. Rep. Serv. (Callaghan) 119 (1980) the Court stated in its overview:

> The buyers of a new mobile home manufactured by the manufacturer brought suit pursuant to § 2-105 of the Uniform Commercial Code (Code), *12A O.S. § 2-105* (1971), after deficiencies in parts and materials were not corrected on a timely basis. The manufacturer appealed the judgment of the trial court finding breach of express warranty and argued that the buyers' recovery was limited by the warranty which restricted the right of recovery for breach to repair or replacement of defective parts. On appeal, the court affirmed the judgment of the trial court. The court held that when the home was not made to conform to the warranty within a reasonable time, the buyer, left without the substantial value of his bargain, was relieved by the Code of the warranty-imposed limitation and hence was able to seek broader recovery.

Uniform Commercial Code Section 2-719(3) states that "[c]onsequential damages may be limited or excluded *unless the limitation or exclusion is unconscionable*. [Emphasis added]. Uniform Commercial Code Section 2-316(1) states that "[w]ords or conduct relevant to the creation of an express warranty and words or conduct tending to negate or limit warranty shall be construed wherever reasonable as consistent with each other; but subject to the provisions of this Article on parol or extrinsic evidence (Section 2-202) *negation or limitation is inoperative to the extent that such construction is unreasonable*. [Emphasis added]. It would be the contention of purchaser that to allow manufacturer to limit the damages that it caused would be unconscionable.

The case of *Perlmutter v. Don's Ford, Inc.*, 96 Misc.2d 719, 409 N.Y.S.2d 628, 25 UCCRS 675 (1978) dealt with facts that are analogous to this issue. The Court held that manufacturer auto dealer, which improperly applied a manufacturer's rust proofing material to purchaser's automobile resulting in rust damage, was liable to the purchaser for consequential damages, i.e., the cost of repairing his car, since the application of the rust proofing material was a contract between the purchaser and manufacturer which the manufacturer breached by improper application and inadequate inspection and the manufacturer cannot claim as a defense the terms of section 2-719 of the Uniform Commercial Code that limits a buyer's remedies to the return of the goods and repayment of the price since the contract is for services.

Consolidated Data Terminals v. Applied Digital Data Sys., 708 F.2d 385, 36 UCCRS 59 (9^{th} Cir. 1983) (among conflicting authorities noted in *Employers Ins. v. Suwannee River Spa Lines*, 866 F.2d 752, 1990 AMC 447, 8 UCCRS2d 659 (5^{th} Cir. 1989) in applying the New York Uniform Commercial code in a breach of warranty action for damages by distributor-buyer of computer terminals against manufacturer-seller death with a similar issue. The Court held (1) that manufacturer had breached its warranty concerning terminals sold to purchaser; (2) that under UCC § 2-316(1), manufacturer's disclaimer of all warranties, express or implied--except for limited warranty of repair and replacement of defective parts--would not be permitted to override highly particularized warranty created by terminals' operating specifications; (3) that since purchaser's sole remedy of repair and replacement of defective parts had failed in its essential purpose under UCC § 2-719(2), purchaser could resort to all breach-of-contract remedies available under Uniform Commercial Code; (4) that terms of parties' contract did not bar purchaser from recovering consequential damages; (5) that purchaser was not entitled to direct damages under UCC § 2-714(2) for difference between terminals' value as warranted and as delivered, since purchaser had not been forced to make price concessions to any of its customers who had purchased terminals manufactured by manufacturer; (6) that purchaser could recover consequential damages under UCC § 2-715(2)(a) for customer-service calls necessitated by terminals' defects and (7) that purchaser could not recover consequential damages for profits allegedly lost as result of purchaser's voluntary termination of its computer-terminal-distributorship contract with manufacturer, since purchaser had not in fact lost any such profits as result of manufacturer's breach of warranty.

When the exclusive remedy under a contract fails of its essential purpose then the exclusion as to consequential and other damages also fails.[3] Manufacturer's exclusive remedy is usually stated to repair or replacement of the defective materials and parts it manufactured.

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3 See, e.g., *Ragen Corp. v. Kearney & Trecker Corp.*, 912 F.2d 619, 625 (3rd Cir. 1990) (stating that since the buyer's exclusive remedy failed of its essential purpose, the buyer could recover consequential damages, despite a provision in the contract which excluded them); *Murray v. Holiday Rambler*, 265 N.W.2d 513, 525 (Wis. 1978) (When the limited remedy fails of its essential purpose, the buyer is entitled to any remedy that the U.C.C. provides. This includes consequential damages under 2-715.). See generally *Riley v. Ford Motor Co.*, 442 F.2d 670 (5th Cir. 1971); *Fargo Mach. & Tool Co. v. Kearney & Trecker Corp.*, 428 F. Supp. 364 (E.D. Mich. 1977); *Koehring v. A.P.I. Inc.*, 369 F. Supp. 882 (E.D. Mich. 1974); *Beal v. General Motors Corp.*, 354 F. Supp. 423 (D. Del. 1973); *Clark v. International Harvester Co.*, 581 P.2d 784 (Idaho 1978); *Adams v. J.I. Case Co.*, 261 N.E.2d 1 (Ill. App. Ct. 1970); *Massey-Ferguson, Inc. v. Evans*, 406 So.2d 15 (Miss. 1981); *Ehlers v. Chrysler Motor Corp.*, 226 N.W.2d 157 (S.D. 1975). *Milgard Tempering, Inc. v. Selas Corp.*, 902 F.2d 703, 709 (9th Cir. 1990) (holding that the purchaser could recover consequential damages because two and one half years of unsuccessful repair efforts were not part of the bargained for allocation of risk); *RRX Indus., Inc. v. Lab-Con, Inc.*, 772 F.2d 543, 547 (9th Cir. 1985) (holding that the buyer was entitled to consequential damages because "the facts justify the result"); *Fiorito Bros., Inc. v. Freuhauf Corp.*, 747 F.2d 1309, 1315 (9th Cir. 1984) ("Judging each case and each contract on its own merits will better allow courts to give effect to the parties' intentions regarding the risk allocation and will lead less frequently to unjust results."); *Smith v. Navimanufacturer Int'l Transp. Corp.*, 714 F. Supp. 303 (N.D. Ill. 1989) ("The rationale underlying the case-by-case approach is compelling" and "[a]ccordingly, . . . a buyer may seek consequential damages . . . despite a disclaimer to the contrary if the buyer can demonstrate that the warranty fails of its essential purpose and the parties did not contractually allocate all attendant risks."). See generally, *Mid Continent Cabinetry, Inc. v. George Koch Sons, Inc.*, No. 87-1248-C, 1991 U.S. Dist. LEXIS 10644 (D. Kan. July 11, 1991).

Argument can be made that this is inadequate since the time manufacturer took to take this action was commercially unreasonable and ineffective. When a remedy fails in its purpose, to-wit: replacement of improperly manufactured materials and parts, any limitation of damages also fails.[4]

The Court in *PC Com*, *supra*, held that:

> in order to decide this [summary judgment] motion the court must determine whether (1) whether a minimum adequate remedy exists and (2) whether the limitation of consequential damages is unconscionable. *See* M.G.L.A. 106 § 2-719; *Canal Elec.*, 548 N.E.2d at 183-85. However, answering those two questions does not complete the analysis. Many courts impose an additional obligation of good faith under U.C.C. § 2-203 upon parties seeking to rely upon favorable contract provisions before they can invoke such provisions to their benefit. [omitting footnotes] 946 F.SUPP. at 1135- 36.

4 See, e.g., *R.W. Murray, Co. v. Shatterproof Glass Corp.*, 758 F.2d 266, 272 (8th Cir. 1985) (a failed limited remedy voids the consequential damage disclaimer); *Matco Mach. & Tool Co. v. Cincinnati Milacron Co.*, 727 F.2d 777, 780 (8th Cir. 1984) ("[W]here circumstances cause an exclusive remedy to fail of its essential purpose, the Buyer may recover direct damages as well as consequential damages notwithstanding an express provision excluding such damages); *Soo Line R.R. v. Freuhauf Corp.*, 547 F.2d 1365, 1373 (8th Cir. 1977) ("[D]espite the fact that limited remedy failed of its essential purpose, contract did not effectively bar consequential recovery.").

Any Contract Terms Limiting Manufacturer's Liability Must Fail When Agreements Were Presented On A Take It Or Leave It Basis By A Company With Vastly Superior Bargaining Power Making The Exclusion Of Liability Provisions Unenforceable As Contracts Of Adhesion

Before manufacturer would sell its products to purchaser, purchaser is usually required to execute the various agreements prepared by manufacturer. The agreements are usually presented on a take it or leave it basis and are not subject to negotiation.

Argument can be made that M ~~purchaser~~ is a much larger company, has vastly superior financial resources, has annual sales greatly in excess of those of purchaser, is one of a limited number of suppliers of the type of product that manufacturer wished to purchase and had greatly superior bargaining ability. Based on these characteristics, the contracts presented by manufacturer can be claimed to be contracts of adhesion. If the contracts were contracts of adhesion, manufacturer would not able to hide behind any alleged limitation of damages.

The opinion of the Oklahoma Attorney General (Opinion 01-17) is relevant to this issue. The opinion states:

> You first ask whether the arrangement between a contract grower and an integrator is a contract of adhesion. The Oklahoma Supreme Court has defined an "adhesion contract" as follows: *The term [adhesion contract] refers to a standardized contract prepared entirely by one party to the transaction for the acceptance of the other; such a contract, due to the disparity in bargaining power between the draftsman and the second party, must be accepted or rejected by the second party on a "take it or leave it" basis, without opportunity for bargaining . . . . Any ambiguities or uncertainties in the contract will be construed in favor of the party presented with the form contract.* See Dismuke v. Cseh, 830 P.2d 188, 190 (Okla. 1992); Brannon v. Boatmen's Nat'l Bank, 976 P.2d 1077, 1083 (Okla. Ct. App. 1998). *Indeed, even if the terms of the adhesion contract are clear and unambiguous they will not always be enforceable.* As the Supreme Court noted in Rodgers, adhesion contracts reflect an imbalance of bargaining power. See Rodgers, 756 P.2d at 1226. *When this*

> *imbalance of bargaining power rises to a sufficient level and is combined with contractual terms which are unreasonably favorable to the other party, the courts will refuse to enforce those terms on the grounds of unconscionability.* See Barnes v. Helfenbein, 548 P.2d 1014, 1020 (Okla. 1976). You have indicated that integrators typically offer to their growers form contracts which the growers must either accept or reject in their entirety. If this is the case, such contracts are contracts of adhesion. [Emphasis added].

The case of *McNally Wellman Co. v. New York State Elec. & Gas Corp.*, 63 F.3d 1188, 27 U.C.C. Rep. Serv. 2d (CBC) 289 (2nd Cir. 1995) holds that the court must first make:

> an inquiry into any inequities of bargaining power when the parties drafted the contract, a factor NYSEG cannot argue existed here. See American Dredging Co. v. Plaza Petroleum, 799 F.Supp. 1335, 1339 (E.D.N.Y. 1992), vacated in part, 845 F.Supp. 91 (E.D.N.Y. 1993). Further, an assessment of unconscionability "generally requires a showing that the contract was both procedurally and substantively unconscionable when made -- i.e., *some showing of an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.* [Emphasis added]. 63 F.3d at 1198.

The Court in *McNally* also stated that a breach of a fundamental obligation under a contract occurs where the contract fails in its essence: that is, where ordered goods are "delivered with significant faults rendering them inoperable." 63 F.3d at 1200.

Manufacturer's product was designed and built for this one specific project and manufacturer cannot state that it is not liable if its product is not good for the particular purpose for which it was specifically designed nor can it deny its implied warranty of merchantability

Cohen v. Bratt & Doxey Supply Co., 51 A.D.2d 719, 379 N.Y.S.2d 155, 18 UCCRS 651, (2nd Dept 1976), *appeal denied*, 39 N.Y.2d 706 (1976) involved an action by a homeowner against seller of bricks to recover damages for breach of warranty, (1) implied warranty of fitness for particular purpose attached to sale of bricks under UCC § 2-315, where intended purpose for which they were to be utilized was expressly made known to manufacturer's salesmen, where purchaser and his brick layer agent relied on judgment of manufacturer's salesmen in selecting suitable brick for stated purposes, and where salesman had reason to know that there was such reliance, (2) warranty was not excluded by usage of trade under UCC § 2-316(3)(c), and (3) since bricks clearly were not fit for use to which they were put and since purchaser's loss was proximate result thereof, he was clearly entitled to consequential damages under UCC §2-715(2)(b).

It would be stated that purchaser greatly relied on manufacturer's expertise in all aspects of the project involved in this action. Therefore, manufacturer cannot disclaim the implied warranty that their project was fit for a particular purpose since it was custom built for this one and only purpose.

When a remedy fails in its purpose, to-wit: replacement of improperly manufactured materials and parts, any limitation of damages also fails.[5]

5 See, e.g., *R.W. Murray, Co. v. Shatterproof Glass Corp.*, 758 F.2d 266, 272 (8th Cir. 1985) (a failed limited remedy voids the consequential damage disclaimer); *Matco Mach. & Tool Co. v. Cincinnati Milacron Co.*, 727 F.2d 777, 780 (8th Cir. 1984) ("[W]here circumstances cause an exclusive remedy to fail of its essential purpose, the Buyer may recover direct damages as well as consequential damages notwithstanding an express provision excluding such damages); *Soo*

Even If Manufacturer's Disclaimer Prohibited Damages Under A Theory Of Warranty, Manufacturer's Fraudulent And Tortuous Conduct Can Be Addressed

Purchaser would state that the number of significant and material errors on the part of manufacturer raises this case from not only a case sounding in contract, but also one also sounding in tort.

Any limitation of damages that manufacturer might have pursuant to a contract theory of damages would not protect manufacturer from its tortuous conduct. In no manner of analysis can these actions be deemed contractual in nature.

Sterner Aero Ab v. Page Airmotive, Inc., 499 F.2d 709 (10th Cir. 1974) held that:

> Although a party to a contract may limit or eliminate liability for his own negligence *if he is on an equal bargaining footing with the other contracting* parties, *see* Mohawk Drilling Co. v. McCullough Tool Co., 271 F.2d 627 (10th Cir. 1959), at the same time, *such contractual provisions are not the favorites of the law and hence are strictly construed.* Standard Ins. Co. of New York v. Ashland Oil and Refining Co., 186 F.2d 44 (10th Cir. 1950); Gulf C. & S. F. Ry. Co. v. Anderson, 120 Okla. 60, 250 P. 500 (1926). [Emphasis added]. 499 F.2d at 713- 14.

In *IKEA N. Am. Servs. v. Northeast Graphics, Inc.*, 56 F.Supp.2d 340 (S.D.N.Y. 1999) the Court stated that a claim for fraud can be maintained if purchaser can:

> (ii) demonstrate that manufacturer has made a fraudulent misrepresentation collateral or extraneous to the contract, or (iii) demonstrate the plaintiff is entitled to special damages caused by the fraud that are unrecoverable as contract damages. 56 F.Supp.2d at 342.

The Court went on to state that:

> additional duties of special care sounding in tort have been read into contractual relationships in certain circumstances (such as

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Line R.R. v. Freuhauf Corp., 547 F.2d 1365, 1373 (8th Cir. 1977) ("[D]espite the fact that limited remedy failed of its essential purpose, contract did not effectively bar consequential recovery.").

> where a party has obtained a position of special confidence or trust with respect to the other, or possesses specialized or unique expertise)... 56 F.Supp.2d at 343.

Based on *IKEA* the causes of action based upon both fraud and tort can be maintained. It would be stated that the case is anything but a simple breach of contract. Purchaser would state that it was induced into entering into the purchase of the product in question specifically upon the representations of manufacturer that it was capable of fulfilling its obligations in a timely and approproate manner. Purchaser would state that it relied upon manufacturer's special expertise in assisting in the design and manufacture of the building and represented that it had the experience and expertise upon which purchaser relied.

CONCLUSION

There are many ways to negate an attempt by a manufacturer to have its damages limited pursuant to the provisions of the Uniform Commercial Code.

CHURCH, STATE, AND THE VOUCHER DEBATE

by

John Houlihan*

This paper examines the tortuous history of Supreme Court cases involving the Establishment Clause of the First Amendment of the United States Constitution and how the Establishment Clause has been interpreted by the Supreme Court in recent years. Presently the Supreme Court is reviewing the *Simmons-Harris v. Zelman* case which involves an Ohio statute that provides parents of school children in educationally-challenged public school districts with vouchers which they can use to pay tuition costs in other public school districts or in private nonsectarian or sectarian schools. These vouchers provide only partial funding for a student switch to another public school district so the Ohio program's impact has been primarily on private schools and, indeed, on private sectarian schools. The United States Court of Appeals for the Sixth Circuit has declared this Ohio program to violate the Establishment Clause and has used the *Committee for Public Education v. Nyquist* case as the precedential linchpin for its decision. To further complicate matters, the Supreme Courts in both Wisconsin and Maine have recently resolved cases involving similar issues. The Wisconsin Supreme Court Upheld the validity of a voucher program quite similar to the Ohio program in *Jackson v. Benson* while the Maine Supreme Judicial Court upheld a Maine Statute which does not allow aid to sectarian schools in the *Bagley v. Raymond School Department* case. This paper will examine a forty year period of Supreme Court jurisprudence on the Establishment Clause, a period characterized by deeply divided Court opinions and a search for effective standards of analysis.

The Supreme Court has clearly struggled with this Establishment Clause issue. In fact, many lower courts have struggled to apply Supreme Court analysis of the Establishment Clause and have accused the Supreme Court of creating a quagmire of quicksand in its numerous precedent-setting rulings on Establishment Clause issues. These issues are extremely convoluted and the Supreme Court has endeavored mightily to reach effective consensus. At present, the legal standards require the State statute to be clearly neutral in design and implementation and not to favor in any way one religion or even religion at all. The present standards also require funding to not be given directly to the secular institution but to be given directly to parents or to students who then have legitimate choices to use this funding for either a sectarian or a nonsectarian purpose. This paper attempts to shed some light on this legal morass involving Establishment Clause interpretation.

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THE NYQUIST CASE

In 1973 the Supreme Court confronted the issue of whether a New York State statute which provided aid to sectarian schools was an unconstitutional violation of the Establishment Clause of the First Amendment of the United States Constitution. The New York law provided three different types of reimbursement to sectarian schools or to parents who chose to send their children to sectarian schools. The first type of reimbursement provided limited direct aid to private schools for maintenance and repair expenses. The majority opinion of Justice Powell noted that:

> "No attempt is made to restrict payments to those expenditures related to the upkeep of facilities used exclusively for secular activities, nor do we think it possible within the context of these religiously-oriented institutions to impose such restrictions." [1]

The Court distinguished the *Everson*[2] case, where it was permissible to provide transportation reimbursement to parents of children in sectarian schools, and the *Allen*[3] case, where textbooks for secular courses were purchased for sectarian schools by the State, by noting that in both those cases there was a clear secular purpose which neither advanced nor inhibited religion and did not result in excessive government entanglement with religious schools or religion. The *Nyquist* Court accepted the State's argument that reimbursement for maintenance and repair costs was premised on the State's desire to promote pluralism and diversity in all the State's schools. The Court then stated that these lofty objectives could not be fostered by a program which did not guarantee that State money would only be spent for secular purposes. The New York law provided money to the schools without any assurance that it would not be used for repair of the chapel or to enhance religious instruction classrooms, and this clearly crossed the "wall of separation" between Church and State. The Court also rejected the State's argument that the statute only provided partial reimbursement for maintenance and repair expenses and therefore was a "statistical guarantee of neutrality" because clearly many of the maintenance and repair expenditures incurred by sectarian schools were for secular, and therefore legal, purposes.[4] The Court examined the recently decided *Tilton*[5] case in which it had refused to allow State funding of construction at a sectarian university even though the State statute required that the building be used for a secular purpose for at least twenty years.

> "If tax-raised funds may not be granted to institutions of higher learning where the possibility exists that those funds will be used to construct a facility utilized for sectarian activities 20 years hence, *a fortiori* they may not be distributed to elementary and secondary schools for the maintenance and repair of facilities without any limitations on their use."[6]

The Court held the New York Statute's section on maintenance and repair expenses to be a direct violation of the establishment Clause of the First Amendment of the Constitution.

The Court then turned to the New York State tuition reimbursement program, which gave grants per child to low income parents who chose to send their children to sectarian schools. Once again the Court found the statue to violate the Establishment Clause of the First Amendment of the Constitution. The Court rejected the argument that these grants were given to the parents and not directly to the schools and were, therefore, like scholarships or the G. I. Bill, a permissible use of state monies to support initiatives which were secular in nature and benefited individual taxpayers. Since only individuals with children in sectarian schools were receiving these grants, it was clear to the Court that the statute needed safeguards to prevent the money from being used for sectarian purposes, and the statute provided no such safeguards. The State's argument that these tuition reimbursements were small in amount and could be used to pay for secular services provided by the sectarian schools and, therefore, had "a statistical guarantee of neutrality" was also rejected by the Court.

> "Obviously, if accepted, this argument would provide the foundation for massive, direct subsidization of sectarian elementary and secondary schools. Our cases, however, have long since foreclosed the notion that mere statistical assurances will suffice to sail between the Scylla and Charybdis of 'effect' and 'entanglement.'"[7]

The *Nyquist* Court then turned to the third section of the New York State statute that provided an income modification to New York State taxes for parents of children in sectarian schools. The argument in favor of the statute was based on the *Walz*[8] case, which allowed tax exemptions for Church property because to do otherwise would be a non-neutral, hostile act towards religion by the State. The court found the *Walz* case exemption to be historically supported, while there was no historical record supporting tax credits or income modifications for parents whose children attended sectarian schools. The Court went on to note that:

> "aid programs of any kind tend to become entrenched, to escalate in cost, and to generate their own aggressive constituencies. And the larger the class of recipients the greater the pressure for accelerated increases."[9]

Since the number of parents who might claim this income modification was quite large and, since the State of New York had an incentive to increase this type of aid to avoid having many of the sectarian school children transfer, for economic reasons, to the already overburdened public schools, this tax credit program would provide significant support to sectarian schools for sectarian purposes. It was, therefore, unconstitutional.

Justices Burger, White and Rehnquist dissented in the *Nyquist* case. Justice Burger noted that:

> "the Establishment Clause does not forbid governments, state or federal, to enact a program of general welfare under which benefits

> are distributed to private individuals, even though many of these individuals may elect to use those benefits in ways that 'aid' religious instruction or worship."[10]

This idea will become the rationale used by the majority of the Court in later opinions which allow state aid to sectarian institutions as long as that aid is neutral and indirect in the sense that aid is given to individuals rather than to institutions. Burger argues that the New York statute in *Nyquist* simply is an attempt to equalize costs for all parents and insures access for all parents to all types of education, public and private, sectarian and non-sectarian. Justice Rehnquist notes that the tax credit or income modification approach is no different in his mind than the dependency exemptions given in the tax code and is an example of the benevolent neutrality he believes to be the underpinning of Establishment Clause analysis. Justice White notes that "a State should put no unnecessary obstacles in the way of religious training for the young"[11] and that this mandate is being supported by the New York State law which basically attempts to equalize educational opportunity.

All of the dissenting Justices feel strongly that there is no Establishment Clause violation in the Nyquist case.

THE MUELLER CASE

In 1975 the Supreme Court confronted similar issues in the *Meek v. Pettinger*[12] case. The Court in *Meek* found that a Pennsylvania textbook loan program was constitutional because the textbooks were loaned to the sectarian school students rather than directly to the schools and only textbooks which were suitable for use in public schools could be loaned as part of this program. Justice Brennan dissented because he felt that the Court had failed to consider the "political divisiveness factor" which such massive State aid to sectarian schools would have on the State's political system.[13] The *Meek* Court then invalidated the State program which loaned instructional material and equipment to sectarian schools because this aid was neither indirect nor incidental and therefore violated the Establishment Clause of the First Amendment of the Constitution. In 1977 the Supreme Court in the *Wolman v. Walter*[14] case reaffirmed an Ohio textbook loan program similar to the textbook loan program in *Meek.* The Court also allowed diagnostic services and therapeutic, guidance and remedial services provided off-site. The Court declared unconstitutional the section of the Ohio law which provided instructional material and equipment to students in sectarian schools using Meek as its controlling precedent.

In 1983 the *Mueller v. Allen*[15] case confronted the constitutionality of a Minnesota statute which provided a tax deduction for all parents for educational costs (including tuition, books, equipment, etc.). The majority opinion written by Justice Rehnquist found the statute to be constitutional because the deduction was available to all parents and because the deduction was given to the parents and not directly to the schools. Justice Rehnquist was even so bold as to state:

> "The risk of significant religious or denominational control over our democratic processes – or even of deep political divisions along religious lines – is remote."[16]

This was an attempt to answer issues raised by Justice Brennan in his dissent in *Meek* by demonstrating that political divisiveness wasn't an issue or potential issue in Establishment Clause cases. The dissenting opinion by Justice Marshall notes that the deduction is primarily of use to parents of students attending sectarian schools and covers primarily the costs of tuition. The deduction also seems exactly the same as the income modification law declared unconstitutional in *Nyquist*. So the deduction is anything but neutral, provides a substantial direct benefit to sectarian institutions, and deeply commingles the activities of Church and State. In *Meek* and *Wolman* and *Mueller* the divisiveness of the issue of aid to sectarian schools is seen in stark detail. When laws are upheld, they are upheld because they can be justified as indirect and insubstantial assistance which does not break down the boundary between Church and State.

THE WITTERS AND ZOBREST CASES

The Supreme Court for a moment reached agreement on the proper interpretation of the Establishment Clause of the Constitution in the *Witters*[17] case. *Witters* involved a disabled student who was given aid to attend school under a clearly neutral Washington state statute the goal of which was to open up educational opportunities to handicapped individuals. The Marshall opinion is brief and to the point: no statute should masquerade as a neutral law when it is skewed in any way to provide greater benefits to sectarian schools. Here, the law provides benefits to any and all persons who meet the statute's criteria regarding disabilities. If that individual chooses to invest these funds in a religious school program leading toward certification as a minister, it is the same as if an individual were to donate his or her tax refund to a religious institution. There is no State involvement and no legal fiction attempting to transfer State money to a sectarian school for a religious purpose. The Supreme Court in *Witters* seems to have finally agreed on where to draw the line in the debate on State aid to sectarian schools.

In *Zobrest v. Catalina Foothills School District*[18] dissent and quagmire reappear as the Court confronts the issue of providing a sign-language interpreter for a student enrolled in a sectarian school. In light of both *Mueller* and *Witters*, it would seem clear that this is a permissible undertaking as the interpreter's job is simply to translate for the student. Since the statute involved is the Individual with Disabilities Education Act (IDEA) and since the aid is provided to the parents of the student rather than directly to the school, it seems to clearly fit in with established precedent as a neutral and indirect provision of aid by the government to all of its citizens. A sign-language interpreter is not a teacher or guidance counselor who might add a religious component to the lesson (unless we assume that interpreters are devious enough to place their own messages in the translation). Yet Justices Blackmun and Souter come up with a very vigorous and well-reasoned dissent that challenges the majority decision.

> "Until now, the Court never has authorized a public employee to participate directly in religious indoctrination."[19]

Blackmun and Souter then go on to review the recent history of Establishment Clause jurisprudence:

> "Thus, the Court has approved the use of public school buses to transport children to and from school, *Everson v. Board of Ed. of Ewing*, 330 U.S. 1 (1947), while striking down the employment of publicly funded buses for field trips controlled by parochial school teachers, *Wolman*, 433 U.S. at 254. Similarly, the Court has permitted the provision of secular textbooks whose content is immutable and can be ascertained in advance, *Board of Ed. of Central School Dist No. v. Allen*, 392 U.S. 236 (1968), while prohibiting the provision of any instructional materials or equipment that could be used to convey a religious message, such as slide projectors, tape recorders, record players, and the like, *Wolman*, 433 U.S. ay 249. State-paid speech and hearing therapists have been allowed to administer diagnostic testing on the premises of parochial schools, *id.*, at 241-242, whereas state-paid remedial teachers and counselors have not been authorized to offer their services because of the risk that they may inculcate religious beliefs, *Meek*, 421 U.S. at 371."[20]

The line drawn in the dissenting opinion seems crystal clear: providing a benefit to all is okay, providing a benefit to sectarian schools to enhance the conveyance of their religious messages is unacceptable and must be avoided at all costs. Blackmun and Souter then go on to note that the interpreter is also threatened as there may be dress requirements that threaten the interpreter's individual liberty. The interpreter will also be exposed to religious indoctrination and catechism. I personally agree with the legal reasoning the dissenting opinion uses to draw the line but not with the application they use it for in the *Zobrest* case. To me, *Zobrest*, like *Witters*, involves permissible State conduct that is neutral and does not interfere with or involve itself in religious issues.

THE ROSENBERGER CASE

In 1995, the Supreme Court decided the *Rosenberger v. University of Virginia*[21] case. The University of Virginia provided printing funding for student groups but would not give funding to Wide Awake, a student-published pamphlet with a clearly religious message. The majority decision was based on First Amendment reasoning involving primarily Free Speech grounds and saw that failure to provide State aid in this case might have a significantly chilling effect on freedom of speech. This was viewed as even more unacceptable because freedom of speech is considered one of the linchpins of University life. The Court went on to note that the Establishment Clause was not a problem because the University provided printing funding to all qualified student groups based on neutral criteria that neither hindered nor advanced sectarian viewpoints. In fact, the majority opinion argues quite effectively that forcing the University of Virginia to monitor the message of all student groups to avoid an Establishment Clause problem would clearly be antithetical to freedom of speech.

Souter's dissent is blistering. He notes that this is the first time that the Supreme Court is approving "direct funding of core religious activities by an arm of the State."[22] Students with no religious affiliation are being forced to pay a student activity fee which then is used, in part, to further sectarian organizational purposes. For Souter, this is hardly neutral. The trouble in *Rosenberger* is that there is a clear clash between freedom of speech and the separation of Church and State and the majority opinion seems to do the better job of reconciling the conflict between these two *a priori* "goods." To require government to restrict funding to those student groups with no religious message, forces government to evaluate the content of the messages produced by all student groups and puts a distinct damper on student free speech rights.

THE AGOSTINI CASE

In 1997 the Supreme Court decided the *Agostini v. Felton* case[23] which involved the New York City Title One Program. This case directly overrules *Aguilar v. Felton*[24], a 1985 case which had held that the New York City Title One Program violated the Establishment Clause of the Constitution. The Title One Program allowed State employees to be present in sectarian schools for the purpose of providing remedial education. The *Aguilar* Court had seen this as unconstitutional because the physical presence of the State employee on the grounds of the sectarian school created an actual and a symbolic union between Church and State which clearly violated the Establishment Clause of the First Amendment to the Constitution. The *Aguilar* Court also found that monitoring the instruction provided under the Title One Program to prevent the inclusion of religious doctrine would perforce lead to the excessive entanglement of the State in sectarian affairs. The *Aguilar* case had a companion case, *School District of Grand Rapids v. Ball*,[25] where the Michigan Shared Time Program provided both remedial and enrichment instruction conducted by State teachers on the grounds of the sectarian schools. The *Agostini* Court decides to overrule the *Aguilar* and *Ball* cases because of the changes in jurisprudence that have occurred in the twelve year period from 1985 to 1997.

> "To summarize, New York City's Title I program does not run afoul of any of three primary criteria we currently use to evaluate whether government aid has the effect of advancing religion: it does not result in excessive government indoctrination, define its recipients by reference to religion, or create an excessive entanglement. We therefore hold that a federally funded program providing supplemental, remedial instruction to disadvantaged children on a neutral basis is not invalid under the Establishment Clause when such instruction is given on the premises of sectarian schools by government employees pursuant to a program containing safeguards such as those present here."[26]

These safeguards are that the aid is available to all students, both sectarian and nonsectarian, and that the aid is allocated on the basis of neutral, secular criteria. Justice Souter's dissent notes that the new standards adopted in *Agostini* will lead to government partnership with religion when a cause is worthy.

> "While it would be an obvious sham, say, to channel cash to religious schools to be credited only against the expense of 'secular' instruction, the line between 'supplemental' and general education is likewise impossible to draw. If a State may constitutionally enter the schools to teach in the manner in question, it must in constitutional principle be free to assume, or assume payment for, the entire cost of instruction provided in any ostensibly secular subject in any religious school.[27]

Justice Souter is convinced that *Agostini* allows virtually all types of State funding of sectarian schools and is an impermissible mingling of Church and State. Yet the *Agostini* opinion makes lots of sense when one considers the New York Program as a State imposed mandate on sectarian schools. Shouldn't the State provide financial support to sectarian schools to carry out State mandated programs as long as they are secular in nature?

THE STATE SUPREME COURT CASES

The trouble with the reasoning in the *Agostini* case becomes apparent when one examines two State Supreme Court cases. In 1999 in *Bagley v. Raymond School Department*,[28] the Maine Supreme Judicial Court upheld the validity of a Maine statute which provided State tuition reimbursement to parents in school districts without a high school as long as the parents sent their children to nonsectarian schools. Some parents in the Town of Raymond wished to send their children to Cheverus, a Catholic high school in Portland. The Maine Supreme Judicial Court found that the *Nyquist* case prevented direct aid to sectarian schools. Yet, as Justice Souter noted in *Agostini*, the State purpose under the Maine statute is to provide education for all pupils and that is clearly a secular purpose. Why not provide the Raymond parents with $5350 per child to spend on the education of their children? How does this differ from the New York Title I program? Justice Clifford's dissent in the *Bagley* case follows this line of reasoning and argues that it would be unfair and discriminatory not to provide the Cheverus parents with equal access to educational funding. The majority of the Maine Supreme Judicial Court rejected this reasoning and found that providing State aid to the Cheverus parents would violate the Establishment Clause of the First Amendment to the Constitution.

"The direct, substantial, and unrestricted nature of the financial benefit"[29] made it clear that the Establishment Clause would be violated if it were provided to sectarian school pupils or their parents.

Unfortunately, the Wisconsin Supreme Court in another 1999 decision upholds the constitutionally of a Wisconsin statute which provides vouchers to low income parents in the Milwaukee public school system to use for attendance at other sectarian or nonsectarian schools. The *Jackson v. Benson* case[30] is based on the principles of neutrality and indirection advanced in *Agostini.* The Wisconsin Supreme Court notes that the *Nyquist* case would prevent direct voucher aid to sectarian schools but upholds the Wisconsin statute because its purpose is secular, to provide low income parents in the failing Milwaukee public school system with effective educational opportunities for their children, and because the aid is given indirectly as the voucher check is written out to the parents. The Wisconsin Supreme Court uses *Agostini* and *Zobrest* as the defining precedents for its decision. So now two State Court decisions exist which seem to interpret the Supreme Court precedents differently.

THE SIMMONS-HARRIS CASE

The final plot twist in this complicated legal scenario is provided by the *Simmons-Harris v. Zelman* case[31], a Sixth Circuit Court of Appeals case from Ohio which is presently before the Supreme Court for review. In this case an Ohio statute allowed low-income parents in the Cleveland public school system to obtain vouchers which could ostensibly be used in any public or private, sectarian or nonsectarian school. These vouchers were for up to $2500. Since the per capita expense of educating a student in Ohio public schools was $7097, public school districts outside Cleveland declined to participate in the voucher program. The net result was that 96% of the students using the vouchers were enrolled in sectarian schools. The Sixth Circuit Court found this voucher program, which is substantially similar to the voucher program upheld by the Wisconsin Supreme Court in the *Jackson* case, to clearly violate the Establishment Clause of the First Amendment of the United States Constitution. The Sixth Circuit cited the *Nyquist* case as the controlling precedent. Justice Ryan in a vigorous dissent distinguishes the *Nyquist* case as one in which the clear statutory intent was to confer a direct benefit on financially hard-pressed New York Schools and finds the principles of the *Agostini* case to be determinative.

> "The rule is now settled that a government program that permits financial aid ultimately to reach religious schools does not offend the Establishment Clause if the government's role in the program is neutral. Neutrality exists if the 'governmental aid that goes to a religious institution does so only as a result of the genuinely independent and private choices of individuals.'"[32]

The *Simmons-Harris* case once again leaves the field of Establishment Clause jurisprudence extremely muddled.

CONCLUSION

At present, the standards defining the constitutionality of State voucher statutes seem quite difficult to interpret. This fuzziness is the result of thirty plus years of Supreme Court cases which have attempted to draw fine jurisprudential lines between unconstitutional State support of religion and neutral, indirect support given to sectarian schools to achieve legitimate State purposes. The Supreme Court, based on its past decisions involving Establishment Clause cases, seems poised to allow State voucher programs like the ones in Wisconsin and Ohio as long as they are neutral (don't advance a sectarian purpose) and Indirect (given to the parents rather than the sectarian schools).

This will raise the thorny issue of how to handle the Maine situation involving parents with high school age children in school districts that don't have a public high school. If the purpose of the Maine law is clearly to provide equal educational opportunity for all students in the State (a secular and neutral purpose), why not give the aid as a voucher to the parents (indirect), thereby making the full tuition voucher legal under the *Agostini* case precedent? This full tuition voucher concept seems, to me, to clearly violate the Establishment Clause of the First Amendment of the United States Constitution. I'd advocate the selection of *Nyquist* as the controlling precedent and the invalidation of both the Wisconsin and the Ohio voucher programs.

ENDNOTES

1. *Committee for Public Education v. Nyquist*, 413 U.S. 756 (1973) at 775.

2. *Everson v. Board of Education*, 370 U.S. 1 (1947).

3. *Board of Education v. Allen*, 382 U.S. 236 (1968).

4. *Nyquist*, *Id.* at 774.

5. *Tilton v. Richardson*, 403 U.S. 672 (1971).

6. *Nyquist, Id.* at 777-778.

7. *Id.* at 788.

8. *Walz v. Tax Commission*, 397 U.S. 664 (1970).

9. *Nyquist, Id.* at 996.

10. *Id.* at 800 (Burger dissent).

11. *Id.* at 814 (White dissent).

12. *Meek v. Pettinger*, 421 U.S. 349 (1975).

13. *Id.* at 383.

14. *Wolman v. Walter*, 433 U.S. 229 (1977).

15. *Mueller v. Allen*, 463 U.S. 388 (1983).

16. *Id.* at 400 (quoting *Welman v. Walker*, 433 U.S. at 263 [Powell concurring in part]).

17. *Witters v. Washington Department of Services for the Blind*, 474 U.S. 481 (1986).

18. *Zobrest v. Catalina Foothills District*, 509 U.S. 1 (1993).

19. *Id.* at 18 (Blackmun dissent).

20. *Id.* at 21-22. (Blackmun dissent).

21. *Rosenberger v. University of Virginia*, 515 U.S. 819 (1995).

22. *Id.* at 863 (Souter dissent).

23. *Agostini v. Felton*, 521 U.S. 203 (1997).

24. *Aguilar v. Felton*, 473 U.S. 402 (1985).

25. *School District of Grand Rapids v. Ball*, 473 U.S. 373 (1985).

26. *Agostini, Id*, at 234-5.

27. *Id.* at 240 (Souter dissent).

28. *Bagley v. Raymond School Department*, 728 A2d 127 (1999).

29. *Id.* at 145.

30. *Jackson v. Benson*, 578 N.W.2d 602 (1999).

31. *Simmons-Harris v. Zelman*, 234 F3d 945.

32. *Id.* at 968 (Ryan dissent) quoting *Agostini v. Felton*, 521 U.S. at 528.

Community Investment: The Law Encourages Residences To House the Homeless

by

Richard J. Kraus*

I. INTRODUCTION

J. P. Morgan Chase Manhattan, The Local Initiative Support Corporation, Bankers Trust, the Community Preservation Corporation and other sizeable corporate investors have joined with smaller investors and estates to produce syndicates affiliated with community not-for-profit developers in New York City and throughout the country. The resultant limited partnerships have created affordable housing for the formerly homeless and the poor. (1) The tax credit created by the Tax Reform Act of 1986 and permanently extended by the Omnibus Budget Reconciliation Act of 1993 has provided developers with tax credit upon the investment, extended over years. (2)

Broadway Housing Communities, with executive offices at 10 Fort Washington Avenue, between West 159th and West 160th Streets in New York City, organized itself originally as the Committee for the Heights-Inwood Homeless in 1983 in order to "promote freedom, hope, security and dignity by fulfilling the basic right of all people to housing." (3) This IRC 501 (c) 3 Corporation has utilized the Low-Income Housing Tax Credit to refurbish five buildings in Washington Heights and West Harlem; the corporation presently is completing a sixth renovation. The five completed buildings provide two hundred and eighteen (218) units of mostly single room occupancy housing and studio apartments for formerly homeless and low-income adults; a small number of family units are also available. The sixth building is scheduled to provide seventy (70) apartments devoted largely homeless and low-income families as well as a child care center and community outreach programs.

Broadway Housing Communities, furthermore, has cooperated with the Center for Urban Community Services to provide social service outreach programs, mental health rehabilitation and employment services to all tenants. Persons with AIDS and histories of substance abuse have found homes in the buildings sponsored by Broadway Housing Communities. The tenants in fact have become responsible for the management of the buildings: the Center for Urban

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Community Services has assisted in training tenants to solve problems and resolve conflicts so as to provide a safe and supportive housing for everyone.

The US Internal Revenue Code Section 42 describes the Low-Income Tax Credit which has invaluably assisted Broadway Housing Communities to implement its plans to alleviate a continuing social need. This credit provides a business subsidy of thirty percent (30%) for new construction already federally subsidized and for the acquisition expenditures needed to purchase existing buildings; the tax credit may reach seventy percent (70%) for new construction that is not federally subsidized. The subsidy itself permits a fifteen (15) year credit claimed over a ten (10) year credit, thereby increasing its attractiveness to business investors both small and large. Apartment buildings such as those acquired and renovated by Broadway Housing Communities qualify for the credit as do some single family dwellings. (4)

The Code provides, however, that the tax credit program be administered by the States; in the state of New York, it is also administered through the New York City Department of Housing Preservation and Development. Congress annually limits the number of credits available in each state in accord with a "state housing ceiling" equal to the sum of $1.25 multiplied by the state population and including any unused portions from previous years or unused amounts from national allocations. (5) The parties seeking the tax credit must apply to the proper agency and demonstrate that low-income tenants will have access to affordable housing produced through funds available.

A critical challenge facing the developer and investor is to insure that the low-income building qualifies for the tax credit through meeting a series of eligibility requirements. The qualified low-income building must reserve 1.) fifteen (15%) percent or more of the residential units for tenants whose income is forty (40%) percent or less of the area median gross income, or 2.) twenty (20%) percent or more of the residential units for tenants whose income is fifty (50%) percent or less of the area median gross income, or 3.) forty (40%) percent or more of the residential units for tenants whose income is sixty (60%) percent or less of the area median gross income. (6) The qualified low-income housing projects created by Broadway Housing Communities has no difficulty in meeting any of these three tests. The Heights, located at 530 West 178th Street, New York, NY, contains single room occupancy (SRO) housing devoted solely formerly homeless individuals, including those with mental illness, AIDS, and those with histories of substance abuse. The Stella at 575 West 155th Street, New York, NY, the Benziger/Abraham House at 345 Edgecombe Avenue, New York, NY, and the Delta at 409 West 145th Street, New York, NY continued the Broadway Housing Communities tradition of on-site service to homeless people. The Rio at 10 Fort Washington Avenue, New York, NY, contains two bedroom apartments for families and studio apartments for individuals as well as some SRO units. All occupants of these buildings pay rent through public entitlements including Section 8 subsidies. (7)

All five of the above buildings, however, and the projected Dorothy Day Apartments at 583 Riverside Drive, New York, NY, must take care to comply with the percentage set aside tests in the future. The tax credit will not continue if the 15-40, 20-50, or 40-60 percentages are not maintained. These minimum set aside tests rules must be observed throughout the compliance period, but the unit will remain a low-income unit even if the income of one or more tenants rises above the specified ceiling provided that, if the income of the individuals in the unit rises above one hundred forty (140%) percent of the income limitation, the next available unit be offered to a tenant or tenants who satisfy the required income limitation. (8)

The compliance period mentioned above is defined as fifteen (15) tax years beginning with the first tax year of the credit period; however, the law requires an agreed extension of that period for an additional fifteen (15) years so that the minimum period is thirty (30) rather than fifteen (15) years. (9) During the entire time of this compliance period, the developer must file annual certifications with the State Credit Agency concerning continued compliance with the above mentioned minimum set aside tests, that the owner has received a documented certification of income from each low-income tenant, that each low-income unit was rent restricted in accord with the size of the unit and the income of its occupants, that no forbidden discrimination has occurred in that the building was for use of the public in general, that tenant facilities were equal to all, that vacant units were properly offered to low-income tenants and that the units were not used on a transient basis. (10)

As indicated at the beginning of this article, not-for-profit developers enter partnerships with large and small investors interested in the low-income housing tax credit. Expenditures incurred which are eligible for the tax credit primarily concern the capitalized cost associated with the acquisition and development of the eligible property. Tax shelter organizers, of course, are required to register tax shelters with the Internal Revenue Service on or before the first day the organizers offer the shelters for sale usually to limited partners; the Internal Revenue Service then issues a tax shelter ID number which must be used in all of the business transactions of the investment. (11)

Investors maintain a passive role managing the enterprise in order to protect their limited liability; they permit the not-for-profit developer to manage the housing. The developer guarantees investors that construction will be completed in accord with IRC regulations and that the investors will receive tax credits to which they are entitled in a timely manner.

The structure for the low-income housing project seeks to protect both the investor and the developer through the use of a limited partnership or a limited liability company. The corporate partner or developer is a general partner holding a one (1%) percent interest and may be owned by a not-for-profit agency, such as

Broadway Housing Communities described above; the investor partner or partners are limited partners holding a ninety-nine (99%) percent interest. Investors make capital contributions to an investor partnership which makes corresponding capital contributions to the operating partnership; the general partner, furthermore, usually receives federal grants or other funding, including Section 8 grants which are also contributed as capital to the operating partnership. (12)

Broadway Housing Communities has used the limited partnership structure to manage all five of the presently existing buildings and the sixth planed building, designed for homeless people. Individuals and corporations have contributed capital, and federal and state grants have been attained in order to create a structure attractive to investors.

Footnotes

1. Description supplied by Agency Narrative – Broadway Housing Communities- undated document, pg.1.

2. Steven C. Barranca, "Low-Income Housing Tax Credit – A Primer," 29 Journal of Real Estate Taxation, pg. 28ff.

3. Broadway Housing Communities-Agency Narrative, pg.1.

4. IRC 42 (a) (b).

5. IRC 42 (g). Please note that the federal Housing and Urban Development (HUD) department publishes annual median income figures, based on family size, for each urban area in the country.

6. ibid.

7. Broadway Housing Communities – Agency Narrative, pgs. 1-2.

8. IRC 42 (g).

9. ibid.

10. IRC 42 (h).

11. Barranca, loc. cit.

12. Barranca, loc. cit.; Housing and Community Development Act of 1974, Section 8.

MANDATORY EMPLOYMENT ARBITRATION AGREEMENTS AFTER *CIRCUIT CITY STORES, INC.* AND *WAFFLE HOUSE INC.*

by

J.L. Yranski Nasuti*

In 1925, when Congress enacted the Federal Arbitration Act (FAA),[1] there was a great deal of judicial hostility to the enforcement of arbitration agreements. Since that time, arbitration has become a popular method for resolving a wide variety of controversies. Advocates of arbitration extol its many virtues--the expertise of the decision-maker, the finality of the decision, the privacy of the proceeding, the procedural informality, the low cost, and the speed of resolution.[2] However, critics caution that arbitration may not be the best method for resolving every type of dispute. They are particularly skeptical when an agreement to engage in compulsory arbitration becomes a condition of employment. There are two primary reasons for their concern. The first is the suspicion that most employees do not have any real choice when they are asked to accept arbitration clauses. The second is that the widespread use of arbitration to resolve employment-related disputes has the potential of compromising the long-term effectiveness of the statutory protections relating to employment discrimination.

In recent years, the U.S. Supreme Court has heard two important cases involving the FAA and the use of compulsory arbitration clauses in employment contracts. In *Circuit City Stores, Inc. v. Saint Clair Adams,*[3] the Court upheld the enforceability of compulsory arbitration agreements that were included in employment contracts. Not surprisingly, litigation weary employers were pleased with the decision. However, that pleasure turned to frustration less than a year later when the Court decided *EEOC v. Waffle House, Inc.*[4] *The* majority in the latter case held that the EEOC would not be precluded from filing a lawsuit in its own name as well as on behalf of an employee who had previously agreed to the mandatory arbitration of all employment related disputes. This article will analyze the Court's reasoning in each case and consider the impact of both decisions on the practice of employment law.

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I. *CIRCUIT CITY STORES, INC. V. SAINT CLAIR ADAMS*

The facts in *Circuit City* were not complicated. In 1995, Circuit City, a national retailer of consumer electronics, hired Saint Clair Adams to be a sales counselor. In the course of applying for the job, Adams was required to fill out and sign a standardized application form that included a pre-dispute mandatory arbitration clause.[5] Adams, a homosexual, eventually left Circuit City and filed a lawsuit in the California state court based on state claims of employment discrimination and wrongful discharge.[6] Circuit City petitioned the federal court to enjoin the state-court action and to compel arbitration pursuant to the FAA. The requested order was granted by the U.S. District Court and reversed by the U.S. Court of Appeals.[7] The U.S. Supreme Court granted certiorari in order to give guidance to the lower courts concerning the applicability of the FAA to employment contracts.[8] In its 5-4 decision, the Court reversed the decision of the Ninth Circuit and held that the FAA applied to all employment related arbitration agreements except for those involving seamen and other transportation workers.

a. Majority Decision

The Supreme Court's decision, delivered by Justice Kennedy and joined by Chief Justice Rehnquist, and Justices O'Connor, Scalia, and Thomas, focused on the interpretation of two sections of the FAA--§1 (the exemption clause) and §2 (the basic coverage clause.) Section 1 specifically states that arbitration clauses contained in "contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce" are exempt from the enforcement requirements of the FAA. Section 2, on the other hand, states that:

> [A] written provision in any maritime transaction or *a contract evidencing a transaction involving commerce* to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract (emphasis added.)

Adams' primary argument was that since an employment contract was not a contract evidencing a transaction involving interstate commerce, it could not be subject to the FAA. Relying on the holding in *Craft v. Campbell Soup* Co.,[9] he claimed that a §2 "transaction involving interstate commerce" only referred to a commercial contract and not to an employment contract. Consequently, it was not necessary for the Court to consider the meaning of the exemption clause in order to decide in his favor. Unfortunately for Adams, the Court found his reasoning to be erroneous for two reasons. The first was that it rendered superfluous the §1 exemption for "contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign and interstate commerce."[10] The second was that it was inconsistent with the Court's previous holding in *Gilmer v. Interstate/Johnson Lane Corp.*[11]

For the majority, the correct interpretation of the §2 coverage term, "involving commerce," required a broad implementation of a Congressional intent "to exercise the commerce power to the full"[12] and to include employment contracts within the scope of the Act. The Court was not as generous in its interpretation of the §1 exemption clause. On the contrary, the majority read the statute in such a close way that Justice Stevens' dissenting opinion characterized it as a "parsimonious construction."[13] In order to properly understand the meaning of the §1 phrase, "contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce," the Court applied the *ejusdem generis* rule. Under this canon of construction, "where general words follow specific words in a statutory enumeration, the general words are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words."[14] Following this rule, the majority found that no meaning could be attributed to the residual phrase ("or other class of workers engaged in foreign and interstate commerce") except to the extent that it referred to the enumerated workers ("seamen and railroad workers"). Consequently, the Court concluded that while an employment contract was covered under §2 of the FAA because it was a "transaction involving commerce," it could not be exempted under §1 unless it involved the employment of seamen and railroad workers.

The Court also addressed some of the strong objections that were raised in the dissenting opinions. To bolster its narrow construction of §1, the Court explained, in a much-labored fashion, why it would have reached the same conclusion even if the term "engaged in commerce" had stood by itself in the exemption clause. In enacting statutes, Congress had used different modifiers with the word "commerce." According to the Court, these modifiers indicated a Congressional intent to either "regulate to the outer limits of its authority under the Commerce Clause"[15] or to engage in a more "limited assertion of federal jurisdiction."[16] Since "engaged in commerce" was in the latter category, the Court felt justified in limiting the scope of the exemption. The fact that that phrase had not been a term of art indicating a limited assertion of congressional jurisdiction at the time that the FAA was originally enacted did not bother the Court in the least. On the contrary, the majority was much more concerned that the application of "a variable standard for interpreting common, jurisdictional phrases would contradict earlier cases and bring instability to statutory interpretation."[17] The Court also thought that a requirement "to deconstruct statutory Commerce Clause phrases depending upon the year of a particular statutory enactment" would be too unwieldy for Congress, the courts, and litigants.[18]

Since the majority was satisfied with its own close reading of the text, it did not find it necessary to consider the legislative history of the exemption provision. It did note that the legislative record with regard to §1 was "quite sparse"and that there was no reference in the committee reports of either house to the meaning of the provision. The Court went on to suggest that Adams' reliance on the testimony at a Senate subcommittee (which attributed the inclusion of §1 in the Act to the objections raised by the president of a labor union) was misplaced. At the most, it called for speculation on the "significance of the fact that a certain interest group sponsored or opposed particular legislation."[19]

The Court went on to explain why it did not find it paradoxical for Congress, in 1925, to exempt employment contracts for transportation workers at the same time that it included employment contracts for all other workers.[20] The Court speculated that the exclusion of transportation workers was related to the fact that Congress had already passed specific legislation involving the arbitration of disputes involving seamen and railroad employees.[21] The reason given for the inclusion of non-transportation workers was to ensure that the provisions of the FAA would cover them.[22]

The final section of the majority opinion addressed a concern expressed by many state attorneys general that the Court's decision would frustrate state laws that limited or restricted arbitration agreements in employment contracts. The Court pointed out that it had already decided, in the case of *Southland Corp. v. Keating*,[23] that the FAA could preempt state arbitration laws. It had also done nothing to overrule that holding in the subsequent case of *Allied-Bruce*.[24] In addition, Congress had taken no action to overturn either of those decisions. The Court then restated the benefits derived from the enforcement of arbitration provisions in employment contracts.[25] And, it concluded by stating that the arbitration of statutory claims did not require a party to forgo a substantive statutory right. It only substituted an arbitral forum for the judicial forum.[26]

b. Dissenting Opinions

The two dissenting opinions in *Circuit City* pulled no punches. Justice Souter, joined by Justices Stevens, Ginsburg, and Breyer, began his dissenting opinion with an acknowledgment that when Congress passed the FAA in 1925, it had a much narrower understanding of its own commerce power. That presented the Court with a dilemma when it considered the scope of the FAA. It could apply the narrower view of the commerce power and limit its current application of the FAA to those contracts that were thought to "involve commerce" in 1925 or it could read the statute in a way that adopted Congress' contemporary conception of its commerce jurisdiction. For Souter, the former approach would result in "a statutory ambit frozen in time" that would require Congress to amend statutes such as the FAA every time it wanted to expand enforcement of the acts beyond their original scope.[27] On the other hand, the latter approach would produce "an elastic reach." If the original intention of Congress had been to exercise its power to the fullest extent, then that intention would have to be reflected in the way that the Court adapted its interpretation of that legislation in the future.[28] When the majority had considered the extent of the §2 coverage provision in the *Allied-Bruce* case,[29] it adopted an elastic approach. As a result, it gave effect to a meaning of "involving commerce" that extended coverage to the outer constitutional limits under the commerce clause. However, when the Court, in *Circuit City*, was asked to use an elastic approach to interpret a similarly general phrase in the §1 exemption clause that referred to contracts of "any class of workers engaged in foreign or interstate commerce," it balked. Souter acknowledged that there was a difference in the language of the coverage clause (a contract evidencing a transaction "involving commerce") and language of the exemption clause (a contract of a worker "engaged in commerce"). He also conceded that the placement of the "engaged in . . . commerce" catchall phrase in §1 followed more specific exemptions for employment contracts of seamen and railroad employees. However, he did not see either circumstance to be a bar to the application of an elastic approach to both sections of the FAA.[30]

Souter hypothesized that the language differences in the two clauses were indicative of a congressional intention to cover as many contracts as the commerce clause would allow within each class of contracts addressed. His conclusion was supported, at least with regard to §2, by the Court's holding in *Allied-Bruce* that the phrase, "involving commerce," indicated a plenary intention. The fact that, by the end of the twentieth century, the phrase "affecting commerce" had become the quintessential expression for the intended plenary exercise of the commerce power did not preclude a different phrase, from an earlier date, from having a similar intention.[31]

Souter's understanding of the §1 phrase, "engaged in commerce," came from the temporal context in which it was written. In 1925, the only employment contracts that were subject to congressional regulation were those involving workers who were engaged in interstate commerce.[32] Consequently, when Congress drafted a statute which specifically excluded employment contracts that "engaged in commerce," it was demonstrating an intention to exclude to the limits of its power--just as its inclusion of "involving commerce" in the coverage clause demonstrated its intention to legislate to the full limits of its power.[33] For Souter, it did not make sense for "exemption language to be read as petrified when coverage language is read to grow."[34]

The most significant factor that allowed the majority to reach the conclusion that the §2 exemptions were limited to transportation related employment contracts was its reliance on the interpretative canon of *ejusdem generis.* Souter characterized that doctrine as little more than a fall back that should only be used when an uncertain statutory text could not be explained by contrary legislative history. Souter agreed with Adams that "it [was] imputing something very odd to the working of the congressional brain to say that Congress took care to bar application of the [FAA] to the class of employment contracts it most obviously had authority to legislate about in 1925, contracts of workers employed by carriers and handlers of commerce, while covering only employees "engaged" in less obvious ways, over whose coverage litigation might be anticipated with uncertain results."[35] It was legislative history, and not the doctrine of *ejusdem generis,* that aided Souter in his understanding of the intended scope of the FAA. The record indicated a concern during Senate subcommittee meetings that arbitration of employment disputes might be too expensive or unfavorable for employees who lacked the bargaining power to reject arbitration agreements.[36] In addition, there was testimony by then Secretary of Commerce Herbert Hoover suggesting that the exemption language would respond to any "objection . . . to the inclusion of workers' contracts."[37] According to Souter, the legislative history was sufficient to conclude that Congress had had no intention of limiting the exemption clause to transportation workers.

The dissenting opinion by Justice Stevens, which was joined by Justices Ginsburg and Breyer and in part by Justice Souter, attacked the majority's heavy reliance on the views of the various Courts of Appeals during the past decade at the same time that it inappropriately disregarded three earlier chapters of judicial history which were crucial to an accurate understanding of the FAA. Stevens found the legislative history of the Act to be an invaluable tool for interpreting the exemption and basis coverage clauses. The historical hostility to arbitration agreements that the Act sought to reverse involved the refusal of courts to enforce commercial arbitration agreements commonly used in the maritime context. In fact, the original bill, which was drafted by the American Bar Association's Committee on Commerce, Trade, and Commercial Law, spoke of the "further extension of the principle of *commercial* arbitration."[38] There was no indication either in the original bill that was drafted by the ABA or in the deliberations of Congress that the proponents of the legislation ever intended for it to apply to employment agreements.[39] It was only because of concerns raised by organized labor (that the proposed legislation might authorize the federal courts to enforce arbitration clauses in employment contracts and collective-bargaining agreements) that the exclusionary language of §1 was added.[40] The dissenting opinion found it ironic that the same amendment that had been uncontroversial when it was originally added to the FAA had become the sole justification for the majority's refusal to give the text of §2 a natural reading.[41] It accused the Court of "playing ostrich to the substantial history behind the amendment."[42] According to Stevens, the Court reasoned in a vacuum when it expanded the meaning of §2 by arguing that if all employment contracts were beyond its scope then the separate exemption in §1 would be pointless. A better approach would have been to acknowledge that the only reason that the exemption clause was added was to address the concerns of labor organizations. The irony of the majority's decision was that it "fulfilled the original--and originally unfounded--fears of organized labor by essentially rewriting the text of §1 to exclude the employment contracts *solely* of "seamen, railroad employees, or any other class of *transportation* workers engaged in foreign or interstate commerce.""[43]

Stevens' dissenting opinion expressed a clear frustration with the manner in which the majority chose to disregard the early legislative history of the FAA. It also accused the Court of ignoring the importance of a second chapter in the history of the Act. During the 1950's, a number of U.S. Courts of Appeals delivered conflicting opinions concerning the question of whether collective-bargaining agreements were "contracts of employment" for the purposes of the §1 exclusion. As it would happen, most of the cases did not involve employees engaged in transportation. The matter was finally resolved in 1957, in the case of *Textile Workers v. Lincoln Mills of Alabama,*[44] when the Court heard a request by a union to have the federal court enforce an arbitration clause in a collective-bargaining agreement. The union based its arguments on the authority that was implicitly granted by §301 of the Labor Management Relations Act, 1947 (L.M.R.A.) and authority that was explicitly granted by §2 of the FAA. The Court ultimately held that the authority to compel arbitration was found in §301 (a statutory provision that does not mention arbitration) and not in the FAA (a statute that expressly authorizes the enforcement of arbitration agreements). Stevens viewed that as a strong indication that the Court thought that the FAA did not apply because of the §1 exemption.[45]

Stevens concluded with an observation on just how much the times had changed since the FAA was originally passed. In the nineteenth century, judges had had a strong prejudice against private arbitration. Since then the pendulum had swung to the point that the courts were no longer simply neutral with regard to arbitration but had become strong endorsers of the process. Stevens lamented the fact that recent Court of Appeals opinions had created such a narrow construction of §1 that the scope of the Act was now far beyond the expectations of the Congress that had originally enacted it. Stevens did not conclude that it was always wrong for the Court to put its own imprint on a statute. However, he expressed no reservations when he accused the present Court of misusing its authority in this case by disregarding the legislative history and by engaging in a method of statutory interpretation that was "deliberately uninformed, and hence unconstrained" and that "produce[d] a result that [was] consistent with a court's own views of how things should be, but may [have] also defeat[ed] the very purpose for which a provision was enacted."[46]

II. *E.E.O.C. v. WAFFLE HOUSE, INC.*

The *Waffle House* case also involved an employee who in the course of applying for a job was required to sign an agreement to arbitrate any employment-related dispute.[47] Eric Baker was terminated from his job as a grill operator for Waffle House soon after suffering a seizure while at work. Baker did not initiate arbitration proceedings nor did he pursue a legal action on his own behalf. Instead, he brought a discrimination charge directly to the EEOC alleging that his discharge violated the Americans with Disabilities Act of 1990 (ADA).[48] The EEOC filed a federal enforcement action against Waffle House pursuant to §107(a) of the ADA, 42 U.S.C. §12117(a)(1994 ed.) and §102 of the Civil Rights Act of 1991, as added, 105 Stat. 1072, 42 U.S.C. §1981a (1994 ed.). The complaint, which did not list Baker as a co-plaintiff, requested: 1. Injunctive relief to "eradicate the effects of [respondent's] past and present unlawful employment practices," 2. Specific relief designed to make Baker whole, including backpay, reinstatement, and compensatory damages, and 3. Punitive damages for malicious and reckless conduct.[49] The District Court denied Waffle House's FAA motion to both stay the action and compel arbitration or to dismiss the case on the factual grounds that Baker's employment contract did not include an arbitration provision. On appeal, the Circuit Court held that although there was a binding arbitration agreement between Baker and Waffle House, it did not prevent the EEOC (a non-party to that agreement) from bringing an enforcement action seeking injunctive relief against the employer. However, the existence of the arbitration agreement did preclude the EEOC from seeking any victim-specific relief.[50] In a 6-3 decision, the U.S. Supreme Court reversed the decision of the Court of Appeals and held that mandatory arbitration agreements in employment contracts did not bar the EEOC from pursuing victim-specific judicial relief in enforcement actions based on alleged violations of the ADA.

a. Majority Decision

Justice Stevens, joined by Justices O'Connor, Kennedy, Souter, Gingsberg, and Breyer, delivered a majority opinion that began with a focused interpretation of those sections of Title VII of the Civil Rights Act of 1964 that dealt with the enforcement powers, remedies, and procedures given to the EEOC by Congress.[51] In his dissenting opinion in *Circuit City,* Stevens had criticized the Court for deliberating ignoring the legislative history leading up to the passage of the FAA. In *Waffle House,* he took great care to consider the legislative changes to the relevant statutory provisions.

The Court began its analysis by noting that when Title VII was originally enacted in 1964, it only authorized private actions by individual employees and public actions by the Attorney General in cases involving a "pattern and practice" of discrimination.[52] The EEOC's authority was limited to the investigation and conciliation of charges of discrimination. Under the 1972 amendments to Title VII, the EEOC could to bring its own enforcement actions and courts could enjoin employers from engaging in unlawful employment practices as well as order appropriate affirmative action--including reinstatement, with or without backpay.[53] In 1991, Title VII was amended once again to allow a "complaining party" to recover compensatory damages as well as punitive damages. Under 42 U.S.C. §1981a(d)(1)(A), it was possible for a "complaining party" to be a private party and/or the EEOC. In addition, under §1981a(a)(2), (d)(1)(B), the amendments were made applicable to ADA claims. As a result of these legislative changes, the majority opinion concluded that the EEOC, as a complaining party, had been "unambiguously authorize[d]" to file lawsuits to enjoin employers from engaging in unlawful employment practices and to seek reinstatement, backpay, and compensatory or punitive damages. That being the case, the EEOC had legislative authority to obtain the relief that it sought in the *Waffle House* case.[54]

The Court then reviewed two earlier cases, *Occidental Life Ins. Co. of Cal. v. EEOC,*[55] and *General Electric Co. of Northwest v. EEOC,*[56] in order to clarify the differences between the EEOC's enforcement role and the individual employee's private cause of action. In *Occidental Life*, the Court had held that "under the procedural structure created by the 1972 amendments, the EEOC [did] not function simply as a vehicle for conducting litigation on behalf of private parties."[57] Consequently, the EEOC could not be subject to a state statute of limitations applicable to private party litigants. Similarly, in *General Electric,* the Court had ruled that the EEOC was not required to apply for certification as a class representative under Federal Rule of Civil Procedure 23. Section 706 had provided the EEOC with the necessary authority to bring suit in its own name for the purpose, among others, of securing relief for a group of aggrieved individuals.[58] The Court held that "the EEOC [was] not merely a proxy for the victims of discrimination and that [its] enforcement suits should not be considered representative actions subject to Rule 23."[59] Both *Occidental* and *General Electric* demonstrated that the language of the 1991 amendments had not limited the EEOC's separate enforcement function. On the contrary, the amendments had expanded its power by allowing it to seek the additional remedies of compensatory and punitive damages. As a consequence, the majority in *Waffle House* concluded that "there [was] no language in the statute or in either of these cases suggesting that the existence of an arbitration agreement between private parties materially change[d] the EEOC's statutory function or the remedies that [were] otherwise available."[60]

Before specifically addressing the decision of Court of Appeals, the Supreme Court briefly reviewed certain aspects of the FAA. It noted that when Congress enacted the FAA in 1925 and reenacted it in 1947, it did so to reverse the longstanding judicial hostility to arbitration agreements and to place the agreements on the same footing as other contracts.[61] It also acknowledged the recent decision in *Circuit City* making the FAA applicable to most employment contracts. However, it refused to conclude that the "liberal federal policy favoring arbitration agreements"authorized the courts to create an arbitration obligation where there was no independent agreement between the parties themselves. While the FAA ensured the enforceability of private arbitration agreements, it could not restrict a nonparty's choice of forum.[62]

The majority next considered what it viewed to be the main defect in the Court of Appeals' legal reasoning. That involved basing its decision on the relative merits of the "competing policies" of the ADA and the FAA and not on the texts of either the statutes or the arbitration agreement between Waffle House and Baker.[63] The Court of Appeals had acknowledged that the EEOC had not been a party to the arbitration agreement and that it had "independent statutory authority" to vindicate the public interest. Nonetheless, the lower court limited the remedies available to the EEOC in this particular instance. While the agency was permitted to pursue broad injunctive relief against Waffle House, it was barred from seeking victim-specific remedy on the grounds that Baker had already agreed to arbitrate his claims. For the lower court, the strong public policy favoring arbitration trumped any public interest served by the EEOC seeking "make whole" or victim-specific relief. The Supreme Court illustrated the fallacy of the lower court's reasoning by pointing to the fact that arbitration-like benefits had already been included in the EEOC's statutory duties. (Under 42 U.S.C.§2000e-5(b) (1994 ed.), the EEOC was barred from filing a legal action unless it had first engaged in a conciliation process.)[64] In addition, the majority presented statistics to demonstrate that the EEOC had not a major litigator and that it only brought a small number of the cases that requested victim-specific relief for employees who had previously agreed to, but who had not pursued remedies through, binding arbitration. Consequently, the Court concluded that such actions could have a negligible effect on the federal policy favoring arbitration.[65]

The Supreme Court found the reasoning of the Court of Appeals to be flawed when, in the absence of any textual support, it preempted the EEOC from determining "whether public resources should be committed to the recovery of victim-specific relief."[66] Under 42 U.S.C. §2000e-5(f)(1) (1994 ed.), once a claim had been filed with the EEOC, it was the EEOC, and not the claimant, who was in command of the process. Unless the EEOC granted the employee a right-to-sue letter, the EEOC remained the master of its own case. As such, it had the statutory authority to evaluate the public interest and, if it chose, to pursue a legal action that sought victim-specific relief as well as injunctive relief. Although a court could determine what equitable relief was "appropriate," it could not "announce a categorical rule precluding an expressly authorized form of relief as inappropriate in all cases in which the employee has signed an arbitration agreement."[67] In its attempt to balance the policy goals of the FAA against the clear language of Title VII and the agreement between Baker and Waffle House, the Court of Appeals had lost sight of the fundamental principle that arbitration under the [FAA] is a matter of consent and not the result of coercion."[68] Unless the EEOC, a non-party to the arbitration agreement, voluntarily relinquished its statutory right to bring a legal action on behalf of Baker, it could not be required to do so by the proarbitration policy goals of the FAA.[69]

Another problem for the Supreme Court was the Court of Appeal's rationale for allowing the EEOC to proceed with its lawsuit to the extent that it sought injunctive relief but not to the extent that it sought victim-specific relief. The lower court clearly equated the pursuit of injunctive relief as a legitimate public function of the EEOC that could not be compromised by an arbitration agreement between two private parties. However, it concluded that no public function was served when the EEOC sought victim-specific relief in cases where the employer and employee had already agreed to arbitrate their differences. The Supreme Court found this type of line drawing with regard to victim-specific relief to be both overinclusive and underinclusive. It was overinclusive because it failed to recognize that while punitive damages may benefit an individual employee, they were primarily meant to serve the important public function of deterring future violations. The threat of punitive damage awards are often much more compelling to an employer than the threat of an injunction.[70] The line drawing was also underinclusive because injunctive relief, although not victim-specific, was more closely tied to an employee's injury rather than to a public interest.[71]

The Court of Appeals may have thought that it was acting with the wisdom of Solomon when it severed the EEOC's ability to seek victim-specific relief from its ability to seek injunction relief in cases involving arbitration agreements. The Supreme Court, on the other hand, found that the compromise to be an unjustified transformation of "a forum selection clause into a waiver of a nonparty's statutory remedies."[72] If the lower court truly believed that the policy favoring arbitration justified the negation of the plain language of Title VII, it should have sinned more boldly and barred the EEOC from bringing any action outside of the arbitral forum. "Splitting the difference" did not make sense when the statutes clearly stated that the EEOC had the statutory authority to decide which cases to litigate and which relief to seek in order to vindicate a public interest. The Court of Appeals' actions "undermine[d] the detailed enforcement scheme created by Congress simply to give greater effect to an agreement between private parties that [did] not contemplate the EEOC's statutory function."[73] According to majority opinion, the very purpose of the EEOC could be jeopardized if employees who had been parties to mandatory arbitration agreements knew that the only remedy that the EEOC could seek on their behalf would be injunctive relief. Their incentive to file charges with the EEOC would be greatly reduced. As a result, the EEOC would have a smaller, distorted pool of claims from which to litigate cases in the public interest.[74]

The majority opinion concluded with an acknowledgement that it might have arrived at a conclusion if Baker had actually gone to arbitration or had accepted a monetary settlement. However, the issue of the impact of a settlement or arbitration judgment on the remedies available to the EEOC remained one that the Court chose not to consider. Instead, it limited its ruling to the general effect that mandatory arbitration agreements had on the statutory remedies. In the end, the Court found no justification for balancing the competing policies of the ADA and the FAA or for second-guessing the judgment of the EEOC when it decided which authorized remedies to pursue in any given particular case.[75]

b. Dissenting Opinion

The dissenting opinion, written by Justice Thomas and joined by the Chief Justice and Justice Scalia, criticized the majority for ignoring the purpose of the FAA and for allowing the EEOC to do for an employee that which the employee had agreed not to do for himself.[76] Baker gave up his right to sue his employer when he agreed to a mandatory arbitration clause. Yet, the EEOC specifically brought an action against Waffle House in order to obtain the same victim-specific relief that Baker could not seek on his own behalf in court.

For Thomas, a crucial fallacy with the majority opinion was the Court's belief that the E.E.O.C. had the statutory right to *bring* a lawsuit and a statutory entitlement to *obtain* a particular remedy.[77] His reading of §2000e-5(g)(1) suggested that it was the court's role to decide whether "to enjoin the respondent . . ., and order such affirmative action *as may be appropriate,* which may include, but is not limited to, reinstatement or hiring of employees, with or without back pay . . . or any other equitable relief *as the court deems appropriate*."[78] Consequently, there should have been no problem with the court's determination that the victim-specific remedies sought by the EEOC were inappropriate in cases where the employer and employee had entered into a mandatory arbitration agreement. If Congress had wanted to give the EEOC the authority to adjudicate complaints and to determine remedies, it could have granted the EEOC powers similar to those given to the National Labor Relations Board. However, Congress considered, and rejected, such an option when it passed the Equal Employment Opportunity Act of 1972.[79]

The dissenting opinion presented three reasons why it was appropriate for the court to deny an EEOC petition for victim-specific relief in cases where the ultimate recipient of the relief had signed an arbitration agreement. The first was because the EEOC's ability to obtain a specific type of relief was limited by the actions of the employee on whose behalf it wanted to commence the lawsuit. Such actions would include the employee having signed an agreement to waive or settle discrimination charges against the employer, having failed to mitigate damages, or having unilaterally chosen to pursue an independent discrimination claim.[80] According to Thomas, when an employee waived the right to seek remedies in a civil action, he or she also forfeited the right to be the beneficiary of victim-specific remedies in a civil action brought by the EEOC.[81]

The second reason why the dissent considered it appropriate for the court to deny victim-specific remedies was because to do otherwise would be to contravene the "liberal federal policy favoring arbitration agreements" that is embodied in the FAA. The real issue was not whether the EEOC was bound by an employee's agreement to arbitrate, but whether the EEOC should be allowed to reduce that arbitration agreement to all but a nullity.[82] According to the minority, the FAA compelled the judiciary to give effect to the agreement. For the court to act otherwise would place the employer who was being sued by the EEOC in the unenviable position of having to defend in two different forums against two different parties who were seeking the same relief. The possibility of two different results in two different forums also raised the question of how to adjust damage awards to avoid double recovery. According to the Thomas, the blasphemy of the majority's opinion was that it gave the employee two bites of the apple--one in arbitration and one in a lawsuit initiated by the EEOC. As a consequence, the employee was able to benefit from the more favorable of the two resulting rulings.[83]

The final reason why the minority thought that the court should have had the right to establish a blanket prohibition on victim-specific remedies in EEOC cases involving arbitration agreements was because the minority foresaw the creation of a slippery slope. Thomas feared that the EEOC, as master of its own case, would not only be able to pursue its own victim-specific claims for employees who had entered into arbitration agreements but also for employees who had already settled their claims.[84] The dissent concluded that the EEOC's statutory authority to enforce the ADA could have been reconciled with the FAA if the Court had taken more seriously the clear Congressional directive to resolve ADA disputes by alternative means such as arbitration.[85]

III. IMPACT OF THE DECISIONS ON THE PRACTICE OF EMPLOYMENT LAW

When the decision in *Circuit City* was first announced, it was heralded as a major victory by companies that preferred arbitration to litigation in employment related disputes. Employment lawyers confidently advised their clients to require all job applicants to sign compulsory arbitration agreements. Employers were assured that arbitration would result in more efficiency and lower costs in resolving employment disputes. For employees, who had very little bargaining power with regard to compulsory arbitration agreements, the decision was distressing. Some feared that pre-dispute arbitration contracts would become a new form of yellow-dog contracts. Others predicted that all job applicants would now be required to sign away a constitutional right to a trial by jury in exchange for securing a job. In addition, there was a concern that an employer might have an advantage over a nonunion employee in the arbitration forum because of the employer's status as a repeat user of the process.

Most critics of the *Circuit City* decision do not object to the arbitration process *per se*. Yet, they remain skeptical of the process when it is mandated for employment disputes. Arbitration may work well in resolving controversies arising out of traditional commercial transactions. However, the employment relationship is fundamentally different from the commercial relationship. Most employees do not have the ability to negotiate the exclusion of a mandatory arbitration clause in an employment contract. This is because the playing field between the employer and the future employee is usually anything but even.[86] In addition, the consequences of turning down a job offer because of a compulsory arbitration clause are far more serious than deciding not to buy a commodity because of a similar provision. In an economy where unemployment levels are high, job applicants are more worried about securing a position in the present than they are about giving up the right to bring an employment related claim to court in the future.

Proponents of arbitration note that when employees participate in the process they do not forfeit either substantive or procedural protections. The government and professional arbitration organizations have worked hard to establish standards for workplace arbitration hearings.[87] Employees also retain the ability to file legal actions challenging compulsory arbitration agreements under traditional theories of contract law.[88] These theories may include claims of fraud, duress, and unconscionability. An example of a successful contractual challenge to an arbitration agreement occurred when Court of Appeals reconsidered the *Circuit City* case on remand. The Court ultimately decided that the arbitration provision that had been prepared by the employer and agreed to by the employee was unenforceable because it was both procedurally and substantively unconscionable.[89]

Unfortunately, the fact that the arbitration process is fair or that arbitration agreements can be avoided under certain circumstances does not eliminate the most serious consequence of the Supreme Court's decision in *Circuit City*. The real danger is that as more cases have to be submitted to arbitration, fewer cases will be heard in court. This will be a real loss since many of the legal protections currently available to employees are the direct result of the court's interpretation of state and federal statutes. Case law has been particularly important in the area of employment discrimination. Sexual harassment in the workplace is illegal, not because it is specifically mentioned in a federal statute, but because of the Court's interpretation of the meaning of sex discrimination. It is possible that if an arbitration panel had heard the claim that was submitted to the court in *Meritor Savings Bank, FSB v. Vinson,*[90] it might have concluded that the actions of the bank manager constituted sex discrimination. However, it is more likely that the panel would have been reluctant to recognize sexual harassment as a form of discrimination without some legal precedent to guide it. Even if it had arrived at the same conclusion, its finding would not have generated the same collective protection for employees that is the result of case law.

The decision in *Waffle House* represents a small victory for employees and a major annoyance for employers. It does not reverse the harm of the *Circuit City* decision. Nonetheless, it affirms the ability of the EEOC to pursue federal discrimination claims against employers who have entered into mandatory arbitration agreements with their employees. The EEOC can bring cases on behalf of, and seek specific relief for, employees who cannot do so themselves. Employers who have engaged in egregious violations of statutory rights can no longer be assured that the claims against them will be buried in arbitration hearings. The EEOC can be as aggressive as it wants in litigating claims. It can seek remedies, including monetary relief for employees, which are most likely to deter the employer from engaging in similar behavior in the future. This means that employees, who are precluded from suing their employers directly, have an incentive for filing claims with the EEOC. The *Waffle House* decision also guarantees that employment law claims based on statutory rights can still make their way into court. The number of cases brought to court by private litigants will certainly decrease as the use of mandatory arbitration agreements increases.

As a result, the EEOC will assume a more important role in determining which employment issues go before the court. The resulting case law can then be used to guide the decisions of arbitration panels.

The combined effect of the *Circuit City* and *Waffle House* decisions is probably a net gain for litigation phobic employers. Employment lawyers will learn to draft compulsory arbitration agreements that can survive traditional contract challenges. Most complaints against employers will go to arbitration. Nevertheless, even the most proficient attorney will not be able to draft an arbitration provision that will guarantee that statutory employment claims will not be litigated against the employer. The likelihood that the EEOC will actually file suit against a particular employer remains quite slim. However, the possibility exists and it must be taken into account as the employer makes human resource decisions.

ENDNOTES

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[1] 9 U.S.C. 1-16.

[2] S. Goldberg, F. Sander, & N. Rogers, *Dispute Resolution: Negotiation, Mediation, and Other Processes* 200 (2d ed. 1992).

[3] 532 U.S. 105, 149 L.Ed.2d 234, 121 S.Ct. 1302 (2001).

[4] 534 U.S. 279, 151 L.Ed.2d 755, 122 S.Ct. 754 (2002).

[5] The provision stated: "I agree that I will settle any and all previously unasserted claims, disputes or controversies arising out of or relating to my application or candidacy for employment, employment and/or cessation of employment with Circuit City, exclusively by final and binding arbitration before a neutral Arbitrator. By way of example only, such claims include claims under federal, state, and local statutory or common law, such as the Age Discrimination in Employment Act, Title VII of the Civil Rights Act of 1964, as amended, including the amendments of the Civil Rights Act of 1991, the American with Disabilities Act, the law of contract and the law of tort." *Supra* note 3, at 109-110.

[6] The California Fair Employment and Housing Act, Cal. Govt. Code Ann. § 12900 *et seq.* (West 1992 and Supp. 1997) and other claims based on general tort theories under California law.

[7] 194 F.3d 1070 (CA9 1999).

[8] Of the nine Circuit Courts to address the question of applicability of the FAA to employment contracts, only the Ninth Circuit had held that employment contracts were excluded.

[9] 177 F.3d 1083 (CA9 1999).

[10] *Supra* note 3, at 113.

[11] 500 U.S. 20, 114 L.Ed.2d 26, 111 S.Ct. 1647 (1991). In *Gilmer*, the Court held that §2 required the arbitration of an age discrimination claim based on an arbitration agreement in a securities registration application even though the dispute had not arisen from a "commercial deal or merchant's sale."

[12] *Supra* note 3, at 112, citing *Allied-Bruce Terminix Co. v. Dobson*, 513 U.S. 265, 277, 130 L.Ed. 2d 753, 115 S.Ct. 834 (1995).

[13] *Id.* at 124.

[14] *Id.* at 114-115, citing 2A N. Singer, Sutherland on Statutes and Statutory Construction §47.17 (1991).

[15] These would include phrases such as "affecting commerce" and "involving commerce." *Id.* at 115.

[16] These would include the more general words "in commerce" or the specific phrase "engaged in commerce. *Id.* at 115.

[17] *Id.* at 117.

[18] *Id.* at 118.

[19] *Id.* at 120.

[20] It should be noted that in 1925, Congress had apparent power over transportation workers under the commerce clause. However, there was a less direct and less certain connection between other workers and interstate commerce.

[21] The Shipping Commissioners Act of 1872, 17 Stat. 262, the Transportation Act of 1920, §§300-316, 41 Stat. 456, and the Railroad Labor Act of 1926, 44 Stat. 577, 46 U.S.C. §651 (repealed.)

[22] *Supra* note 3, at 122.

[23] 465 U.S. 1, 79 L.Ed. 2d 1, 104 S.Ct. 852 (1984.) In that case, the Court held that Congress had intended the FAA to apply in state courts and to pre-empt state antiarbitration laws.

[24] *Supra* note 3, at 122.

[25] It allowed parties to avoid the cost of litigation; it reduced the difficult choice-of-law questions that arise in employment matters; and it eliminated the necessity of bifurcation of proceedings where state law precluded arbitration of some, but not all, types of employment claims. *Id.* at 123.

[26] *Id.* at 123, citing *Gilmer*, *supra* note 11, at 26.

[27] *Id.* at 134.

[28] *Id.* at 134.

[29] S*upra* note 12.

[30] *Supra* note 3, at 135.

[31] *Id.* at 135-136.

[32] See *The Employers' Liability Cases*, 207 U.S. 463, 496, 498, 52 L.Ed. 297, 28 S.Ct. 141 (1908) and *Hammer v. Dagenhart*, 247 U.S. 251, 271-276, 62 L.Ed. 1101, 38 S.Ct. 529 (1918).

[33] *Supra* note 3, at 136.

[34] *Id.* at 137.

[35] *Id.* at 138.

[36] *Id.* at 139.

[37] *Id.* at 139.

[38] *Id.* at 125, citing the Report of the Forty-third Annual Meeting of the ABA, 45 A.B.A. Rep. 75 (1920).

[39] *Id.* at 125-126.

[40] *Id.* at 126-127.

[41] *Id.* at 128.

[42] *Id.* at 128.

[43] *Id.* at 129.

[44] 353 U.S. 448, 1 L.Ed.2d 972, 77 S.Ct. 912 (1957).

[45] *Supra* note 3, at 130-131.

[46] *Id.* at 133.

[47] The arbitration provision in this case read as follows: "The parties agree that any dispute or claim concerning Applicant's employment with Waffle House, Inc., or any subsidiary or Franchisee of Waffle House, Inc., or the terms, conditions or benefits of such employment, including whether such dispute or claim is arbitrable, will be settled by binding arbitration. The arbitration proceedings shall be conducted under the Commercial Arbitration Rules of the American Arbitration Association in effect at the time a demand for arbitration is made. A decision and award of the arbitrator made under the said rules shall be exclusive, final and binding on both parties, their heirs, executors, administrators, successors and assigns. The costs and expenses of the arbitration shall be borne evenly by the parties." *Supra* note 4, at 282 n.1.

[48] 42 U.S.C. § 12101 *et seq.*

[49] *Supra* note 4, at 283-284.

[50] *Id.* at 284, 193 F.3d 805, 812 (CA4 1999).

[51] 42 U.S.C. §§2000e-4, 2000e-5, 2000e-6, 2000e-8, and 2000e-9.

[52] 42 U.S.C. §2000e-6(a) (1994 ed.)

[53] *Supra* note 4, at 286.

[54] *Id.* at 287.

[55] 432 U.S. 355, 53 L.Ed.2d 402, 97 S.Ct. 2447 (1977).

[56] 446 U.S. 318, 64 L.Ed.2d 319, 100 S.Ct. 1698 (1980).

[57] *Supra* note 4, at 287-288, citing *Occidental*, *supra* note 55, at 368.

[58] *Id.* at 288, citing *General Electric*, *supra* note 56, at 324.

[59] *Id.* at 288, citing *General Electric, id.* at 326.

[60] *Id.* at 288.

[61] *Id.* at 289, citing *Gilmer, supra* note 11, at 24.

[62] *Id.* at 289.

[63] *Id.* at 290.

[64] *Id.* at 290 n.7.

[65] In the fiscal year 2000, 79,896 charges of employment discrimination were filed with the EEOC. Although the agency found 8,248 of the claims to be reasonable, it only filed 291 lawsuits and intervened in 111 other cases. The fact that 21,032 employment discrimination lawsuits were filed by individuals during that same period would suggest that the EEOC filed a small percentage of all antidiscrimination claims in federal court. *Id.* at 290-291 n.7.

[66] *Id.* at 291-292.

[67] *Id.* at 292-293.

[68] *Id.* at 294, citing *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University,* 489 U.S. 468, 479, 103 L.Ed.2d 488, 109 S.Ct. 1248 (1989).

[69] *Id.* at 294.

[70] *Id.* at 294-295.

[71] *Id.* at 295; See *supra* note 55, at 383 (Rehnquist, J., dissenting.)

[72] *Id.* at 295.

[73] *Id.* at 296.

[74] *Id.* at 296 n.11.

[75] *Id.* at 297.

[76] *Id.* at 300.

[77] *Id.* at 301.

[78] *Id.* at 301.

[79] *Id.* at 302-303.

[80] *Id.* at 304-305.

[81] Justice Thomas attempted to show why the Court's use of the *Gilmer, General Telephone, and Occidental Life* cases failed to prove that the EEOC's claims were not "merely derivative" of those of the employees. In the *Gilmer* case, Thomas noted that the Court had never claimed that the EEOC could obtain victim-specific relief on behalf of an employee who had signed an arbitration agreement. In the *General Telephone* case, Thomas acknowledged that the EEOC had a dual function when it acted as a representative of a specific employee and when it acted to vindicate the public interest in preventing employment discrimination. However, he failed to see how that dual function could allow the EEOC to seek victim-specific relief on behalf of an individual who could not personally obtain the same relief in court. Finally, with regard to *Occidental Life,* Thomas suggested that although the EEOC could ignore a state's statute of limitations when discharging its administrative duties, it could not ignore a private arbitration agreement on the grounds that it impeded the agency from discharging its administrative duties.

[82] *Supra* note 4, at 308-309.

[83] *Id.* at 310.

[84] *Id.* at 311.

[85] *Id.* at 313.

[86] Some might view *Circuit City* as a twenty-first century version of *Lochner v. New York*, 198 U.S. 45 (1905). In *Lochner,* the Court found a New York State law limiting work hours in bakeries to be unconstitutional because it interfered with the fourteenth amendment rights of the employee to negotiate a contract with his employer. Criticism of that case focused on the fact that the negotiation playing field was quite uneven. Subsequent decisions upholding wage and hours statutes found the liberty and property arguments of *Lochner* to be far less compelling.

[87] The Court in *Gilmer*, *supra* note 11, at 26, held that the arbitration of a statutory claim does not mean that a party has to forgo substantive rights under the statute. In addition, the government has established procedural guidelines to ensure fairness in the arbitration process. In the area of employment arbitration, the Dunlop Commission proposed a set of quality standards for workplace arbitration hearings. It include the use of a "neutral arbitrator who knows the law . . . and understands the concerns of the parties; a fair and simple method by which the employee can secure the necessary information to present a claim; a method of cost sharing between the employer and employee to ensure affordable access to the system for all employees; the right to independent representation if the employee wants it; a range of remedies equal to those available through litigation; a written opinion by the arbitrator explaining the rationale for the result; and sufficient judicial review to ensure that the result is consistent with the governing laws," Dunlop

Commission, U.S. Dep'ts of Commerce and Labor, *Report on the Future of Worker-Management Relations,* 56-57 (1994).

Other organizations, including the American Bar Association and the American Arbitration Association, have established protocols and rules to relating to the private resolution of statutory disputes. See ABA Sec. on Labor and Employment, *Due Process Protocol for Mediation and Arbitration of Statutory Disputes Arising Out of Employment Relationships* (1995); American Arbitration Association, *National Rules for the Resolution of Employment Disputes (Including Mediation and Arbitration Rules*), as amended Nov. 1, 2002.

[88] The FAA provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds that exist at law or in equity for the revocation of any contract." (9 U.S.C. 2). See also, *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687, 116 S.Ct. 1652, 134 L.Ed.2d 902 (1996).

[89] 279 F.3d 889 (CA9 2002), *cert.* denied 122 S.Ct. 2329, 1533 L.Ed.2d 160 (2002). The agreement was found to be procedurally unconscionable because it was an adhesion contract. The employer, who possessed considerably more bargaining power than the employees or applicants, drafted it; it was a prerequisite for employment; and the job applicants could not modify it. *Id.* at 893. The agreement was also substantively unconscionable because of its one-sidedness. Among its deficiencies were the fact that employees could only take disputes to arbitration while the employer had the option to bring disputes to arbitration or to court; it limited the remedies that would otherwise have been available to the employee under state law; it required the employee to split the arbitrator's fees with the employer; and it imposed a one year statute of limitations that deprived the employees of the benefit of the continuing violation doctrine available under state law. *Id.* at 893-894.

[90] 477 U.S. 57, 106 S.Ct. 2399, 91 L.Ed.2d 49 (1986).

CLICK-WRAP, SHRINK-WRAP, AND BROWSE-WRAP AGREEMENTS: JUDICIAL COLLISION WITH CONSUMER EXPECTATIONS

by

Roy J. Girasa*

Introduction

Everyone with a modicum of knowledge is aware that Article 2 of the Uniform Commercial Code ("UCC") provides extensive protections for the consumer. For example, Sections 2-312-315 list an extensive collection of expressed and implied warranties binding the seller of goods.[1] The Code, in particular, extends the concept of unconscionability that prior to the enactment of the code permitted trial judges to refuse enforcement in whole or in part in contract cases only under the most extreme circumstances. The enactment of the UCC, Section 2-302, permits a court relatively broad discretion to declare that a contract or any clause therein to be unconscionable.[2]

Unconscionability may be procedural or substantive. Procedural unconscionability may be illustrated by a contract's provision of unreasonable limitation of remedies or exclusion of damages, especially when there is a substantial inequality of parties' bargaining positions. Substantive unconscionability is illustrated where there is proof that a party who is damaged by the other party's breach of contract is unreasonably deprived of protection against the said breach. Although consumers have received substantial protection by judicial fiat in courts' interpretation of the UCC, a very different result has taken place with respect to click-wrap and shrink-wrap agreements. In this paper, we will initially describe and define these agreements and, thereafter, review the judicial interpretations governing such agreements.

Shrink-Wrap Licenses and Click-Wrap Agreements

Shrink-Wrap Licenses

We are all familiar with the packages ensconced in clear plastic containing the familiar notice:

> Before you open this package: Carefully read the following
> legal agreement regarding your use of the enclosed product.
> By the act of opening the sealed package, using the

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> software or permitting its use, you will indicate your full consent to the terms and conditions of this agreement. If you don't agree with what it says, you may return the software package within 7 days of your receipt for a full refund.

Thereafter, a highly extensive, small print restrictive notice follows the warning. Such notice constitutes what is euphemistically is called a "shrink-wrap" license or agreement.[3] It is on most software packages. The difficulty is that most consumers purchase the product often unaware of the restrictions being imposed upon them. How legal is it to compel purchasers and users of goods containing such notices to comply with the post-purchase restrictions?

Online shrink-wrap agreements are utilized in a variety of situations. The most common usage is when a purchaser of goods, that includes the uploading of software from a diskette, inserts the diskette into the computer to access it and places it on the computer hard drive for permanent storage. Other uses include the limitation or exclusion of liability under the warranty provisions of the UCC and under contract law, and the requirement that all disputes be litigated before a non-judicial tribunal.

At first blush, such notices may be superfluous inasmuch as copyright laws that restrict users from unlawful copying and/or distribution of the programs protect software programs. The leading cases discussing the issue that arrived at different conclusions are: *ProCD, Inc. v. Zeidenberg*[4] and *Step-Saver Data Systems, Inc. v. Wyse Technology and the Software Link, Inc.*[5] In ProCD, the plaintiff, ProCD, compiled a computer database containing some 3,000 telephone directories. The database is sold under the trademark label "SelectPhone" to users on CD-ROM discs. The license agreement is seen as soon as the packaging is unwrapped. A copyrighted application program permits the user to search the database for the telephone number of the person named by the user. The plaintiff spent some $10 million to compile and keep current the database. The database costs about $150 to purchasers thereof. The resale or other dissemination of the product was thus restricted by the licensing agreement when the package was opened, as well as set forth on initial application of the software.

The defendant, Zeidenberg, bought the software and decided to ignore the restrictive notice by reselling the information under his corporation, Silken Mountain Web Services, Inc. The price charged by Silken was less than that charged by the plaintiff. When the plaintiff sued for an injunction and other relief, the trial court decided that the license was not enforceable because the terms were not displayed on the outside of the package. The issues that the court addressed were: (1) Are buyers of computer software subject to the terms of the shrink-wrap license stated within the packaging;? and (2) Does the Copyright Act prevent enforcement of shrink-wrap licenses?

The Court of Appeals decided in favor of the plaintiff, reversing the decision of the trial court and holding: (1) buyers are subject to the license terms and (2) the

Copyright Act did not prevent enforcement thereof. The court stated that shrink-wrap licenses are enforceable unless the terms therein contain clauses that are objectionable on grounds normally applicable to contracts in general. Examples of non-enforceability include fraud, mutual mistake of fact, or if they are they are unconscionable. The claim made by Zeidenberg was that the placing the package of software on the shelf is an "offer," which a customer may accept by paying the price and taking possession of the goods. The court noted, however, that one of the terms to which Zeidenberg agreed by purchasing the software is that the transaction was subject to a license. The option available to sellers of goods who wish to place the entire terms of a contract is do so on the outside of a box by using microscopic type at the cost of removing other information that buyers might desire.

The court was persuaded by the fact that there are many transactions in which the buyer pays money before reading the detailed terms of the agreement. For example, purchasers of an insurance policy rarely see the terms of the policy at the time of purchase. A buyer ordinarily goes to an insurance agent, states the type of insurance needed and receives an explanation concerning the essential elements of the insurance agreement that is being sold. The agent receives and transmits the initial premium payment to the home office, which sends back a policy containing numerous previously unread terms. Similarly, with respect to the purchase of an airline ticket, the prospective traveler initiates the call to the carrier or agent, receives a price quote, orders the ticket, and ultimately is sent the ticket or confirmed reservation. The ticket contains numerous terms, which the purchaser may reject by canceling the reservation.

There are also other types of tickets and agreements wherein the terms are unknown until after the purchase, such as tickets to a play or, concert, or other such event. When one purchases a radio, television, refrigerator, or numerous other consumer goods, the critical instructions, warranties, environmental information, and other data are also contained in the packaging that may be read after a purchase. Drugs that are purchased contain a curtailed list of ingredients on the outside of the packaging and a much more detailed information insert on the inside including drug interactions and other vital information.[6]

With respect to the purchase of computer software industry, most sales take place at a computer sales outlet where the prospective purchaser peruses the large variety of items available for sale. Whether the customer makes the purchase in a store, by phone from items in a catalog, by mail, over the Internet, the purchasers generally never see the terms of the licensing agreement until the software is received. The court then reviewed the provisions of the UCC. It began with the recitation of Section 2-204(1) that states: "A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." The vendor offeror sets forth the terms of the offer, invites acceptance by the proposed vendee and may set forth limitations on what form of conduct by the vendee constitutes acceptance. The buyer may accept the offer by complying with the terms of the offer. Thus, in the within case, ProCD proposed a contract that enabled a buyer to accept the offer after having had the opportunity to read the license at the defendant's leisure.

Zeidenberg could not avoid the terms of the license agreement because the software had placed the license on the screen that would not permit the purchaser to proceed further without indicating acceptance.

The court recited UCC Section 2-606, which defines what constitutes "acceptance of goods."[7] A buyer accepts goods under Section 2-606(1)(b) when, after an opportunity to inspect, (s)he fails to make an effective rejection under sec. 2-602(1). ProCD extended an opportunity to reject if a buyer should find the license terms unsatisfactory; Zeidenberg inspected the package, tried out the software, learned of the license, and did not reject the goods. With respect to the claim that the Copyright Act provided an exclusive remedy for copyright infringements, the court stated that the defendant was precluded by contract if not by copyright law to duplicate the information contained the CD Rom.[8]

In a State of Washington case, *A. Mortenson Co., Inc. v. Timberline Software Corp.*,[9] citing the *ProCD* decision, an appeals court upheld a license agreement that was enclosed in a sealed envelope and on the inside cover of the manual accompanying the program. Whenever a user opened the program, reference to the agreement appeared on the screen. The agreement also limited the damages for which the company could be held liable. The user was advised that if the user did not agree with the contents of the license, the program could be returned for a full refund. The license agreement was held to be a permissible "accept-or-return" license.

In the *Step-Saver* action, which preceded the *ProCD* action, the Court of Appeals for the Third Circuit came to a different conclusion with respect to shrink-wrap licenses. In 1981, Step-Saver developed a program combining hardware and software to satisfy word processing and other purposes for use by physicians and attorneys based on the IBM personal computer system. It selected a program created by the defendant, TSL, as the operating system and terminals manufactured by Wyse to accomplish its purposes. After having done so, the plaintiff received many complaints from customers and sued Wyse and TSL seeking indemnity with respect to lawsuits instituted against it by customers. The plaintiff, Step-Saver, alleged breach of warranties by Wyse and TSL. The trial court dismissed the complaint as against TSL holding that the box-top license disclaimed all express and implied warranties. The Court of Appeals reversed the decision, holding in favor of Step-Saver.

The Court noted that the box-top licenses states that the customer did not purchase the software but only a personal, non-transferable license to use the program; that all expressed and implied warranties were disclaimed; that the sole remedy was to return the defective disk for replacement and that all damages were disclaimed; that the license was the final and complete expression of the parties' agreement and that opening the package indicated an acceptance of the above terms and conditions. If the user did not agree, the purchase could be returned within fifteen days of purchase and all moneys would be returned.

With respect to the effect of the box-top license, the plaintiff alleged that it did not become a part of the contract because it was a material term and that the license was not intended to be a final and complete expression of the terms of the agreement. The Court stated that UCC Section 2-207 was applicable. The section provides:

Additional Terms in Acceptance or Confirmation.

(1) A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it contains terms additional or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
(2) The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
    (a) the offer expressly limits acceptance to the terms of the offer,
    (b) they materially alter it, or
    (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.
(3) Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such a case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provision of the Act.

The Court stated that Section 2-207 attempts to distinguish between standard terms in a form confirmation that a party wishes the Court to incorporate in the event of a dispute and the actual terms understood by the parties as governing the agreement. The burden is upon the party asking the court to enforce its form to determine that a particular clause was part of the contract. In applying this test, the Court said that the consent by opening provision did not make Step-Saver's acceptance conditional. When a person has gone through the effort of making a purchase, "the purchaser has made a decision to buy a particular product and has actually obtained the product, the purchaser may use it despite the refund offer, regardless of the additional terms specified after the contract formed [at p. 34]." There was no evidence to show that TSL would have refused to sell if Step-Saver had not consented to the restrictive terms. The Court thus held that the box-top license did not contain the complete and final expression of the terms of the parties' agreement.[10]

The difference in the two decisions may lie in the refusal of both courts to become parties to actions by defendant to evade responsibility for errant actions. In the *ProCD* case, the defendant converted the effort of the plaintiff in amassing data requiring the expenditure of millions of dollars and significant time to integrate telephone listing from many hundreds of sources. In the *Step-Saver* case, the defendant sought to prevent liability accruing to it for defective performances as to leave the plaintiff in the position of being responsible for the defendant's unsatisfactory performance.

The Gateway 2000 Cases. The above cases concerned transactions among commercial parties. Does the reasoning apply to consumer transactions? In *Hill v. Gateway 2000*,[11] the action concerns a typical consumer who purchases a computer by telephone and uses a credit card for the purchase. S/he then receives the box containing the purchase some time thereafter with terms stating that they will govern the transaction unless the box is returned within thirty days. The customer almost never reads the terms. One such term is an arbitration clause that was not prominently set forth but was one of many paragraphs in the terms of agreement. The problem is that arbitration was to take place in the State of Illinois before the International Chamber of Commerce. The parties had to pay their respective arbitration fees, which were not inconsiderable. Consider a purchaser of a present day Gateway that may sell for substantially less than $1,000. In the event of a dispute, s/he would have to institute arbitration proceedings, pay the arbitrator, legal fees if any, the cost of travel to the location and for the hotel room, none of which is reimbursed in the event of a victory. Obviously, the cost may substantially exceed the award if an award were in the consumer's favor.

The Court in *Hill* referred to Section 2 of the Federal Arbitration Act, that makes no provision that an arbitration term had to be prominently set forth in an agreement. The Court said that "an agreement to arbitrate must be enforced 'save upon such grounds as exist at law or in equity for the revocation of any contract.'...A contract need not be read to be effective; people who accept take the risk that the unread terms may in retrospect prove unwelcome...Terms in the Gateway's box stand or fall together. If they constitute the parties' contract because the Hills had an opportunity to return the computer after reading them, then all must be enforced." The Court refused to modify the holding in the *ProCD* case, repeating the statements that such terms are common in many agreements such as air transportation and the like. The Court further indicated that the result in *ProCD* was not limited to merchants but also applied to consumers. It was not relevant that the terms and conditions in the Gateway box did not make reference on the outside box of such terms. The Court also determined that claims under the Racketeering Influenced Corrupt Organization Act (RICO) may be determined by arbitration.

In *Brower v. Gateway 2000*,[12] a New York appeals court was also called upon to determine the validity of the "Standard Terms and Conditions Agreement" contained in the Gateway 2000 computer box purchased by the plaintiffs. In slightly larger print than the remaining terms, one of the terms entitled "dispute resolution" stated:

> Any dispute or controversy arising out of or relating to this Agreement or its interpretation shall be settled exclusively and finally by arbitration. The arbitration shall be conducted in accordance with the Rules of Conciliation and Arbitration of the International Chamber of Commerce. The arbitration shall be conducted in Chicago, Illinois, U.S.A. before a sole arbitrator. Any award rendered in any such arbitration proceeding shall be

final and binding on each of the parties, and judgment may be entered thereon in a court of competent jurisdiction.

Brower sued alleging deceptive sales, breach of warranty, breach of contract, fraud, and unfair trade practices. The basis for the claim is Gateway's promise of around-the-clock free technical support, free software, and other related promises. Plaintiffs claimed that it was almost impossible to connect to such technician as allegedly promised. Gateway moved to dismiss the case and to enforce the arbitration clause. Plaintiffs claimed that the contract was one of adhesion[13] and that the said clause was unconscionable under UCC 2-302 for the reason that it was almost impossible to contact the arbitration tribunal; that the cost of such arbitration was prohibitive requiring application fees of $4,000 of which $2,000 was not refundable even if the plaintiff prevailed; that the travel costs were high relative to the amount at issue, to wit, about $1,000; that the loser would have to bear the legal expenses of the victorious party; and all correspondence had to be sent to the ICC headquarters in France.

The New York Appellate Division, citing the *Hill v. Gateway 2000*, and *ProCD* cases, though stating they did not constitute precedents, agreed with the rationale of the decisions. "[T]here is no agreement or contract upon the placement of the order or even upon the receipt of the goods. By the terms of the Agreement at issue, it is only after the consumer has affirmatively retained the merchandise for more than 30 days—within which the consumer has presumably examined and even used the product(s) and read the agreement—that the contract has been effectuated." The Court rejected the claim of contract unenforceability as a contract of adhesion, which means that the consumer had no choice or negotiation but was in a "take-it-or-leave-it" position with unequal bargaining power. The Court said that the customer had the right to return the merchandise within thirty days and purchase similar merchandise from a competitor of which there were many.

The Court indicated that the clause was not unconscionable inasmuch as it was not stated in fine print or hidden and tucked away; the purchasers were not subject to high pressure sales; and the purchasers had thirty days to read and decide whether or not to accept the merchandise. Nevertheless, the Court did agree that the cost of arbitration was excessive under the circumstances and ordered that the parties have leave to seek appointment under 9 U.S.C. Section 9 (the Federal Arbitration Act) and have arbitration conducted in a more suitable forum. The Court cited yet another Gateway 2000 action, *Filias v. Gateway,*[14] wherein the Federal District Court appointed the American Arbitration Association ("AAA") to conduct the arbitration. Due to the nonrefundable cost to the AAA of $500, the New York Court said it would designate an arbitrator upon application of either party if one is not otherwise designated.

The Delaware state court concurred with the reasoning in *Hill* in *Westerdorf v. Gateway 2000,*[15] wherein the plaintiff recipient of a gift of a Gateway computer failed to return it within the stated 30-day period after purchase or else be subject to the arbitration clause contained in the shrinkwrap packaging. She had initially purchased a Gateway as a gift to a third person who in turn gave a comparable Gateway gift to the plaintiff. The complaint herein was that the advertised service of Gateway.net given to all purchasers of Gateway computers was inadequate. As a result she instituted a class action lawsuit against the defendant. Citing *Hill*, the court dismissed the litigation stating that the parties had to arbitrate their dispute as per the shrink-wrap clause requiring Illinois International Chamber of Commerce arbitration resolution. The clause also bound third party beneficiaries as in the within case. The court said that a person who accepts the benefits of the consideration underlying the purchase provided by other parties become bound by the restrictions in the underlying agreement. Furthermore, even though the Service Agreement in the shrink-wrap packaging did not have a separate arbitration clause, it was not necessary for Gateway to insert such a clause in each of the several agreements provided in the package.[16]

Not all courts have ignored the pro-consumer stance rendered by the UCC. In the following case, the U.S. District Court in Kansas had the benefit of not only the prior cited cases for reference but also the commentaries of legal scholars. In *Klocek v. Gateway 2000*,[17] Klocek sued Gateway and Hewlett-Packard concerning the purchase of a H-P scanner. Gateway was sued for allegedly inducing him and other consumers to purchase computers and support packages by making false promises of technical support, as well as for breach of contract and warranties. As in the other cited cases, Gateway claims that the plaintiff must arbitrate his claims under Gateway's Standard Terms and Conditions Agreement located in the box containing the computer power cables and instruction manuals. At the top of the first page, the Standard Terms includes the following notice:

> NOTE TO THE CUSTOMER:
>
> This document contains Gateway 2000's Standard Terms and Conditions. By keeping your Gateway 2000 computer system beyond five (5) days[18] after the date of delivery, you accept these Terms and Conditions.

The notice was inside the printed box, in larger print than the other printed materials and was set apart from other provisions of the document. The Standard Terms are four pages in length, paragraph 10 of which contained the following arbitration clause:

> DISPUTE RESOLUTION. Any dispute or controversy arising out of or relating to this Agreement or its interpretation shall be settled exclusively and finally by arbitration. The arbitration shall be conducted in accordance with the Rules of Conciliation and Arbitration of the International Chamber of Commerce. The arbitration shall be conducted in Chicago, Illinois, U.S.A. before a sole arbitrator. Any award rendered in any such arbitration proceeding shall be final and binding on each of the parties, and judgment may be entered thereon in a court of competent jurisdiction.

Gateway alleges that after the sale of the computer, it mailed to all customers in the U.S. a copy of its quarterly magazine with a notice of change permitting customers the option of choosing either the International Chamber of Commerce, the American Arbitration

Association, or the National Arbitration Forum in Chicago, Illinois for the site of arbitration [presumably due to the *Hill* decision above]. Gateway requested the Court to dismiss the case under the Federal Arbitration Act, 9 U.S.C. Section 1 that provides

> If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

The question before the court was whether the contract of sale between Gateway and the plaintiff included the Standard Terms as part of the agreement. The Court denied Gateway's motion to dismiss the action holding that the Standard Terms were not part of the agreement. The court indicated that the UCC governed the within transaction. After noting that Section 2-102[19] of the UCC applies to "transactions in goods," it recited Comment 1 to the statute: "'Goods' means all things...which are movable at the time of identification to the contract of sale....Regardless whether plaintiff purchased the computer in person or placed an order and received shipment of the computer, the parties agree that plaintiff paid for and received a computer from Gateway. This conduct clearly demonstrates a contract for the sale of a computer...."

The federal court indicated that state courts in Kansas and Missouri had not decided whether terms received with a product become part of the parties' agreement. Furthermore, authority from other courts based on the *Step-Saver, ProCD, Hill,* and other cases was split. The court refused Gateway's request that it follow the *Hill* decision above. Agreeing that the *Hill* case was similar to the case at bar, nevertheless, the court disagreed that the *ProCD* decision should be followed. In its footnote, the Court noted that commentators have criticized the reasoning of the Seventh Circuit in this regard. It indicated that the outcome in Gateway was questionable on federal statutory, common law and constitutional grounds as a matter of contract law. The court felt that the *ProCD* was unwise as a matter of policy because consumers were unreasonably held to the standard of ascertaining the existence of the arbitration clause and the implications thereof.

The Court said that it was unlikely that the Kansas or Missouri courts would follow the Seventh Circuit reasoning in *Hill* and *ProCD*. In each of the said cases, the Seventh Circuit had concluded without any precedents that UCC Section 2-207 was irrelevant. Apparently, it was believed that the battle of the forms[20] did not apply when there was only one form utilized between the parties. Kansas or Missouri law did not support such a conclusion. Nothing in the language of Section 2-207 precluded the application of the resolution of the battle of forms in cases that involved only one form. It applies only to an acceptance or written confirmation and says nothing that requires another form for the provision to become effective. "The official comment to the section specifically provides that Sections 207(1) and (2) apply "where an agreement has been reached orally…and is followed by one or both of the parties sending formal memoranda embodying the terms so far agreed and adding terms not discussed…Thus, the Court concludes that Kansas and Missouri courts would apply section 2-207 to the facts in this case…."

In addition, the court noted that the Seventh Circuit provided no explanation for its conclusion that "the vendor is the master of the offer." Ordinarily, in most transactions, it is the purchaser rather than the vendor who the offeror. In the absence of evidence to the contrary, the court assumed in the within case that the plaintiff consumer was the offeror rather than Gateway. Thus, it was Gateway who accepted the offer by the purchaser by either selling the goods at the store location or over the Internet. Under Section 2-207, the Standard Terms thus would constitute a counter-offer only if Gateway expressly made its acceptance conditional on plaintiff's assent to the additional or different terms The condition had to be clearly stated if the offeror is to be given sufficient notice that the offeree would not proceed unless the additional or different terms in the contracts was accepted. Gateway did not provide any evidence the sale was conditioned on plaintiff's acceptance of the Standard Terms. Moreover, the shipment to the computer by Gateway did not serve to communicate to the plaintiff that the sale was conditioned upon the plaintiff's agreement to the Standard Terms.

Moreover, inasmuch as the plaintiff is not a merchant, the additional or different terms contained in the Standard Terms of the purported contract did not become part of their agreement unless plaintiff expressly agreed to them. The court rejected Gateway's argument that the keeping of the computer beyond the five-day period for rejection of the sale constituted an acceptance of the terms of the shrink-wrap agreement. Therefore, Gateway had not provided sufficient evidence for the court to dismiss the plaintiff's lawsuit for referral to arbitration under Kansas or Missouri law.

UCITA does not apply to the facts of the within case because it is a sale of goods rather than a computer information transaction, which is defined as an agreement "to create, modify, transfer, or license computer information or informational rights in computer information [Sections 102(11) and 103)]." The reasoning in *Klocek* appears to be persuasive. The UCC, Article 2, has as fundamental premises, "good faith" dealing, which is defined as "honesty in fact in the conduct or transaction concerned" [UCC 2-201(19)]. Gateway's position that a consumer purchasing its computer may institute dispute resolution only in Illinois before the International Arbitration Association (and, later, as a result of judicial decisions, the American Arbitration Association), for a purchase that may be under $1,000, without recovery of legal expenses, appears to be manifestly lacking in the good faith requirement. The consumer, who at least had 30 days to read and return a computer if s/he did not agree with the terms, now has only five days. Many consumers, especially in holiday purchases or purchases for students about to travel to campuses in other states, often do not open the box containing the computer until after the five-day period. Gateway has offices throughout the country and can resolve disputes in the state where purchases are made. It is in a far better position to absorb such legal and other expenses as a result of its transactions than consumers in distant states.

Click-Wrap Agreements

Click-wrap agreements are similar to shrink-wrap licenses. The user generally opens a new program being installed on a computer or where the program was initially installed on a new computer and is faced with an agreement to which the user is given the choice of agreeing or not agreeing with the contents. The program will not open unless consent by clicking on the box containing the words "I agree" or similar wording to the terms on the agreement is given. The question again is whether such agreements are valid and enforceable against the user.

Although the agreements are similar in nature, they differ because shrink-wrap agreements invariably concern the purchase of goods within which the agreements are placed in sealed packaging. Click-wrap agreements are online agreements that ordinarily concern use of software but may also concern the purchase of goods. The distinction is important because the purchase of goods *ipso facto* brings into play the UCC, while online click-wrap agreements generally concern licensing and other non-sale of goods wherein the common law of contracts applies.[21]

In *Crispi v. The Microsoft Network, L.L.C.*,[22] the New Jersey Appellate Court upheld the trial court's determination that such consent by a user becomes a binding contract. The Court also upheld the forum selection clause contained in the agreement that compels all lawsuits arising out of the contract to take place in Kings County, in the State of Washington. Thus, the result of the case is that a person purchasing and using Microsoft programs may have to travel to the State of Washington to sue or defend a lawsuit for an alleged breach of the agreement consented to which agreement becomes known only after one opens the program.

A similar result took place in *Geoff v. America Online, Inc.*,[23] wherein the court upheld an agreement wherein a subscriber to America Online's Internet service had to consent to the posted agreement before the service could be accessed. The Court said that a person who signs an agreement by clicking onto the "I agree" button cannot later complain that the agreement was not read or understood. Also, like the *Microsoft* case, the Court upheld the validity of the forum selection clause requiring all litigation take place in Virginia.

In a Massachusetts case, *Williams v. America OnLine, Inc.*,[24] the court denied America Online's motion to dismiss the case and compel arbitration in Virginia. Plaintiffs had commenced a class action against AOL alleging that their computers were damaged as a result of the installation of software furnished by AOL. They claimed that AOL's version 5 caused unauthorized changes to the configuration on their computers that disabled access to non-AOL Internet service providers and other programs. AOL moved to dismiss the litigation alleging that the terms of service agreement (TOS) on the program to which users of the program clickwrapped their assent compelled arbitration of all disputes in Virginia.

The court decided in favor of the plaintiffs thereby compelling a trial on the merits in Massachusetts. It distinguished this action from other clickwrap agreements based on the affidavit of a computer expert who stated that the alleged harm to the computers took place *before* the user clicks assent to the TOS. The clicking of agreement occurred after the computer program had been altered in the complex installation process. When the user sought to cancel the installation by not accepting the TOS, the changes to the program were not reversed. AOL argued that the user of version 5 had previously installed an earlier version of the program and had assented to the prior TOS. The court said that the contractual agreement of version 5 controlled rather than the earlier TOS. Moreover, inasmuch as this was a class action, some of the parties had not assented to the earlier TOS. A third factor that the court considered was AOL's assent to transfer numerous other prior cases to a federal court in Florida, which constituted a waiver on its part to the TOS.

The enforceability of click-wrap agreements between two corporate entities was discussed at length in *I.LAN Systems, Inc. v. Netscout Service Level Corp.*,[25] In the said case the plaintiff, iLAN Systems, Inc., is in the business of assisting companies to monitor their computer networks. The defendant, formerly known as NextPoint Networks, Inc. ("NextPoint"), sells sophisticated software that monitors networks. In 1998, for the alleged sum of $85,231.42, plaintiff entered into an agreement with the defendant whereby it is claimed that it was given the unlimited right to use NextPoint's software together with perpetual upgrades and support that it could rent the software to its customers. When plaintiff installed the software unto its computers, the program contained a click-wrap license agreement that in bold print stated that in the event of a dispute, the defendant's liability was "limited to the license fees paid for the licensed product." Litigation arose concerning conflicting interpretations of a 1999 purchase order entered into between the parties. The plaintiff sued for specific performance of the contract, to wit, for perpetual upgrades of the defendant's software and unlimited support. A motion for summary judgment was made by the plaintiff and the defendant countered with its own motion that alleges that the said click-wrap agreement between the parties limited defendant's exposure to the sum paid on contract ($85,231.42) and that the plaintiff could not contractually ask for any additional remedies.

The issue in the said case is whether the click-wrap agreement limited the enforceability of the 1998 and 1999 agreements? The court agreed with defendant's contention that the click-wrap agreement was applicable thereby limiting defendant's possible liability to the sum of $85,231.41. Initially, the court discussed the typical scenario of persons clicking on "install" when inserting computer software. They ordinarily ignore the license agreement that would take some time to read and which contains legalese blocking the usage of the program unless one clicked "I Agree."

The court in discussing the application of common law contracts versus the UCC said that although the purchaser of software may appear to be entering into an ordinary contractual relationship, the reality is that the purchaser is receiving only a license to use the software that is being sold. Thus, there is never a sale under the UCC Section 2-106(1) definition of a "sale", to wit, a "passing of title from the seller to the buyer for a price." Massachusetts's courts have assumed that Article 2 determined agreements concerning software licenses. The court then examined the clickwrap license agreement as though it was governed by the UCC inasmuch as it appeared that the code best fulfilled the parties' reasonable expectations and such agreements were "in a legislative void." The Uniform Computer Information Transactions Act ("UCITA") would have applied had it been enacted in Massachusetts, but almost all states have not so enacted the proposed statute nor its predecessor Article 2B that governed licensing agreements.

Section 4 of the clickwrap license agreement stated:

> NEXTPOINT'S LIABILITY FOR DAMAGES TO LICENSEE FOR ANY CAUSE WHATSOEVER REGARDLESS OF THE FORM OF ANY CLAIM OR ACTION, SHALL BE LIMITED TO THE LICENSE FEES PAID FOR THE LICENSED PRODUCT.

The clause clearly indicated a limitation of liability provision, i.e., that i.LAN's only remedy is money damages. Without the clause, such damages could be astronomical. The parties were entitled to limit the nature and scope of the damages so as to avoid such possibility. The UCC allows the parties to waiver the warranties and limit their liability.[26] NextPoint did try to use the UCC provisions to limit liability by placing a 30-day limited warranty, by disclaiming all warranties, and by limiting its liability to the fees it received for the license. The question for the court then was whether such limitation was enforceable. The court recited that typical clicking clause whereby the licensee assents to the terms of the agreement by clicking "I Agree" button. The limitation of warranty was also set forth in full. It indicated that the click-wrap license agreement could be analyzed under the provision of UCC Section 2-204 (Formation in General) or (ii) under UCC Section 2-207 (Additional Terms in Acceptance or Confirmation) that concerns the "battle of the forms" difficulties. Under Section 2-204,[27] i.LAN expressed consent to the clickwrap license agreement when it clicked on the box stating that it agreed to the terms thereof. Thus, under this section of the UCC, the agreement is enforceable.

If the clause is analyzed under UCC section 2-207, the question initially becomes whether or not the click-wrap license agreement is a counteroffer, that is whether the acceptance of the i.LAN's purchase order was "expressly made conditional on assent to the additional or different terms." UCC Section 2-207(1) concerning additional terms limits NextPoint's potential liability. Was i.LAN acceptance of the additional terms either explicit, implicit, or by default. By clicking on "I agree," it appears that there was explicit acceptance. The statute states that as between merchants, additional terms to a proposed agreement become part of the agreement unless (a) the offer expressly limits acceptance to the terms of the offer; (b) they materially alter it; or (3) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

The click-wrap license agreement could be viewed as a counteroffer, inasmuch as its language appears to follow UCC Section 2-207(1): "NEXTPOINT IS WILLING TO

LICENSE THE LICENSED PRODUCT TO LICENSEE ONLY ON THE CONDITION THAT LICENSEE ACCCEPTS THE TERMS AND CONDITIONS CONTAINED IN THIS AGREEMENT."…. Did the purchase order reflect a disagreement concerning the additional terms? The i.LAN's purchase order was initially silent on the issue of liability. It appears that iLAN accepted the click-wrap license agreement when it did so explicitly by clicking on "I agree," or implicitly, as provided in UCC section 2-207(2).

The court then reviewed the *Step-Saver* case. It said that Step-Saver once was the leading case on shrink-wrap agreements. Today, most courts favor the *ProCD* reasoning. The difference between the two cases "is whether "money now, terms later" forms a contract (i) at the time of the purchase order or (ii) when the purchaser receives the box of software, sees the license agreement, and does not return the software…." citing *Klocek* and *Mortenson*. Thus, if the purchase order is deemed to be the contract, then UCC Section 2-207 applies, which provides that material terms cannot be added to the contract without the other party's consent. If the contract is viewed as not having been formed until after the purchaser views the shrink-wrap license agreement, then UCC Section 2-204 applies and the act of retaining the software implicitly shows assent.

The court then stated that it would enforce the NextPoint's click-wrap license agreement for two reasons, namely: (1) its acceptance of the ProCD reasoning that the UCC "shall be liberally construed and applied to promote its underlying purposes and policies," which include the continued expansion of commercial practices through custom, usage and agreement of the parties." UCC Section 1-102…. "If ProCD was correct to enforce a shrinkwrap license agreement, where any assent is implicit, then it must also be correct to enforce a clickwrap license agreement, where the assent is explicit." Secondly, even if UCC section 2-207 governs, iLAN implicitly accepted the click-wrap license agreement because the additional terms were not material under UCC Section 2-207(2)(b). There was no showing of unreasonable surprise or hardship to i.LAN.

Browse-Wrap Agreements

In addition to shrink-wrap and click-wrap agreements, there are now "browse-wrap" agreements. In *Specht v. Netscape Communications Corp.*,[28] , the district court decided three cases concerning the enforceability of "browse-wrap licenses." Such licenses differ from click-wrap agreements- click-wrap agreements require users to assent affirmatively to the terms of a license agreement before being able to view licensed software. When a viewer wishes to use a site subject to the "browse-wrap" licensing agreement, the user is informed of the agreement but does not have to click assent or even view it before accessing the site. The notice of the agreement is often shown as a small text on the initial downloading in a different color. The issue is whether the user, who did not affirmatively agree to be bound by the terms of the license, is subject to the license's restrictions.

In *Specht*, the court refused to enforce the agreement that provided for mandatory arbitration of disputes arising under between parties in Santa Clara County, California.

The text of the license agreement read similarly to clauses in other click-wrap agreements that stated that the user by accepting, installing, or using Netscape agreed to be so bound. The court reviewed the major cases cited in the text, including *ProCD Hill* and *Klocek* and concluded that the citations fundamentally differed from the instant case in that the licensing agreements required affirmative assent before the users could access or use the hardware or software products or services. The court, which previously found California law to be applicable, said that California courts have refused to honor agreements containing "inconspicuous contractual provisions of which he was unaware, contained in a document whose contractual nature is not obvious…." The mere act of downloading is not an unambiguous expression of assent unlike the other cited cases that required the user to click or other clearly indicate assent.

In the within case, the user is not made aware of the fact that the user was entering into a contract. No agreement is displayed before the user downloads the software. The only indication of an agreement was the placement of a small box referring to the license agreement that appeared below the screen used for downloading. The agreement said, "Please review and agree…" rather than making the downloading subject to the agreement. Accordingly, the defendant, Netscape" could not require arbitration under the circumstances of the within case. The court appeared to be amenable to enforcing a click-wrap or shrink-wrap agreement but not the type of agreement shown in the within case.

UCITA's Application to "Wrap" Agreements

Inasmuch as the cases cited above almost always concern the licensing of protected computer data and programs, it is clear that the Uniform Computer Information Transactions Act ("UCITA") would be applicable. The difficulty is that few states have enacted the statute that was a successor to the ill fated Article 2B of the UCC.

Scope of UCITA. UCITA applies to a contract relating to a *computer information transaction*. It is not a sale of goods; rather, it is in the nature of a licensing of computer information. A "computer information transaction" is defined as:

> an agreement or the performance of it to create, modify, transfer, or license computer information or informational rights in computer information. The term includes a support contract under Section 612.[29] The term does not include a transaction merely because the parties' agreement provides that their communications about the transaction will be in the form of computer information.

Computer information refers to information rendered in electronic form obtained from or from the use of a computer or is in a form that is capable of being processed through a computer. It includes a copy of the information as well as any documentation or packaging that comes with the copy.[30]

Exclusions. UCITA does not apply to:

(1) Financial services transactions;
(2) Agreements concerning audio or visual programming by broadcast, satellite, or cable;
(3) Motion pictures, sound recordings, musical works, or phonorecords
(4) A compulsory license;
(5) Contract of employment of an individual unless such person is an independent contractor furnishing computer information; or
(6) Matters coming within the scope of Articles 3-8 of the Uniform Commercial Code.[31]

Opting Out of the Act. If the agreement contains a material part of the covered subject matter, the parties have the choice of having the Act apply in whole or in part or they may opt out of the Act's provisions. If they decide affirmatively to exclude the Act's provisions, nevertheless, consumer protection statutes will still be applicable. Furthermore, in a mass-market transaction (a consumer transaction or license contract directed to the general public as a whole wherein the licensee acquires information or in a retail transaction), the licensor will continue to be subject to consumer protection statutes and to the doctrines of unconscionability and good faith.[32]

Formation of Contract

UCITA's Statute of Frauds is found in Section 201. A contract calling for the payment of $5,000 or more is not enforceable unless:

(1) the party against which enforcement is sought authenticated a record sufficient to indicate that a contract has been formed and which reasonably identifies the copy or subject matter to which the contract refers; or
(2) the agreement is a license for an agreed duration of one year or less or which may be terminated at will by the party against which the contract is asserted.

The record will suffice even if a term is missing but is enforceable only up to the number of copies or subject matter stated in the record.

The agreement will nevertheless be enforceable in the absence of the prescribed record if the performance was tendered or the information was made available and accepted by the party to be charged. Also, the agreement will be enforced to the extent that the said party admits under oath in court, in the pleadings of the case, or by testimony that such a contract was formed. As between merchants, a record sent in confirmation of the contract within a reasonable time will make the agreement enforceable unless objection is made by the receiver within ten days of receipt.

Offer and Acceptance. A contract may be formed in any manner that signifies that the parties have entered into an agreement. As in Article 2 of the UCC, a contract may be formed even if one or more terms have been left open or a party reserves the right to modify the agreement provided the parties so intended. The open terms will not cause a contract to be unenforceable provided it is reasonable for a court to provide a remedy. A major disagreement regarding a material term will ordinarily nullify the existence of a contract.

Warranties

UCITA's provisions on warranties are similar to those pro-consumer warranties found in the UCC"s Article 2 warranties. They include warranties against infringement, express warranties, and a number of implied warranties.

Warranty Regarding Infringement. A merchant licensor warrants that the information delivered under an agreement subject to the statute will be delivered free from a rightful claim of infringement or misappropriation. The exception is where the licensee furnishes to the licensor detailed specifications and the method for complying with them. The warranty includes non-interference with the licensee's rightful enjoyment of the information, that any licensed patent rights conveyed under the agreement are valid and exclusive. There are exclusions for conspicuous disclaimer of such warranty and rights subject to privileged use, collective administration, or compulsory licensing. The warranty covers only informational rights arising under U.S. law unless specified otherwise.[33]

Express Warranties. An express warranty is created by (1) an affirmation of fact or promise by the licensor to the licensee, including advertising, that is part of the basis of the bargain between the parties; (2) a description of the information in the bargaining process; and (3) reasonable conformity to any sample, model, or demonstration of a final product. Exclusions to liability of the licensor for predictions of the value of the subject matter, a display or description for aesthetic, or similar purpose, or a statement of opinion.[34]

Implied Warranties. There are three implied warranties under the Act: (1) merchantability of computer program; (2) informational content; and (3) licensee's purpose.

Implied Warranty of Merchantability. The warranty is very similar to the UCC Article 2 warranty of merchantability. Unless disclaimed or modified, the merchant licensor warrants to the end user that the computer program is fit for the ordinary use of such program; to the distributor that the program is adequately packaged and labeled as per agreement and, if there are multiple copies, that they are of even kind, quality, and quantity except for minor variations; that the program conforms to promises or affirmations of fact stated therein; and any other implied warranties arising from course of dealing or usage of trade.[35]

Implied Warranty of Informational Content. A merchant, using reasonable care, warrants to a licensee that informational content compiled, collected, processed, or transmitted is accurate. Exceptions to responsibility are given to published informational content and where the person conveying the information is merely acting as a conduit, providing no more than editorial services in the compilations and transmission of the information.[36]

Implied Warranty of Licensee's Purpose. Where the licensor is made aware of the licensee's particular purpose for the requested computer information and that the licensee is relying upon the licensor's skill to select, develop, or furnish the information, then an implied warranty arises that the information given is fit for such purpose. If the licensor is paid for the time or effort regardless of the fitness of the information to be conveyed, then the warranty is that the information will not fail to meet such purpose by reason of the licensor's lack of reasonable effort. Exceptions to liability are for aesthetics, suitability to taste, subjective quality of informational content, or published informational content unless the selection was negligently made on behalf of the licensee.[37]

Disclaimers. Express warranties may not be unreasonably disclaimed or modified. In order to disclaim the implied warranty of merchantability, the language used must be conspicuous and must specifically mention the word "merchantability," "quality," or similar words. To disclaim the warranty of informational content, the language in a record must mention "accuracy" or similar wording. To disclaim the implied warranty of licensee's purpose, the language must be conspicuous and state to the effect that there is no warranty that the information, the licensor's efforts, or the system will fulfill the particular purposes of the licensee. Except for the warranty of infringement, language such as "as is", "with all faults," and similar language will suffice to disclaim implied warranties. A licensee who has examined a model or sample before entering into a contract receives no implied warranty as to any deficiencies apparent upon inspection. An implied warranty can be disclaimed by a course of dealing, course of performance, or usage of trade. Remedies can be expressly limited concerning liquidation or limitation of damages.[38]

Warranties are cumulative unless such construction is unreasonable. A licensee who modifies a computer program will forfeit the warranties as to the portion of the program that has undergone modification. The warranties also extend to the licensee's immediate family and to foreseeable users.[39]

Breach of Contract

UCITA provides a number of remedies for a breach of contract. The Act provides them in the absence of an agreement setting forth in what manner damages will be assessed. A material breach is one that the contract so states, or where there is substantial failure to perform or there is substantial likelihood of injury or deprivation of what was reasonably expected under the contract.[40] The aggrieved party may waive the breach and accept the performance as rendered. There is no waiver if the acceptance of the performance was made on the presumption that the breach would be cured and/or notice is given to the party at fault. If a party refuses a performance, notice should be given of the specific defect if readily ascertainable and the defect could have been seasonably cured. As between merchants, failure to comply with a request concerning the nature of then defect may operate as a waiver.[41]

The party who breaches the agreement may cure the defect if time for performance remains and there is seasonable notification to the other party. A person receiving a defective tender of performance may reject the tender, accept it, or accept the portion that is not defective and reject the remaining performance. Refusal of tender must be done before acceptance, or within a reasonable time after tender or completion of time to cure, and there is notification of refusal to the tendering party. The contract may be canceled only if there is a material breach of the contract. In a mass-market transaction calling for only a single tender of a copy, a licensee may refuse a defective tender if there is a lack of conformity to the contract.[42]

A *mass market transaction* is treated differently by UCITA. It is defined as:

(A) a consumer contract; or
(B) any other transaction with an end-user licensee if:
- (i) the transaction is for information or informational rights directed to the general public as a whole, including consumers, under substantially the same terms for the same information;
- (ii) the licensee acquires the information or informational rights in a retail transaction under terms and in a quantity consistent with an ordinary transaction in a retail market; and
- (iii) the transaction is not
  - (I) a contract for redistribution or for public performance or public display of a copyrighted work;
  - (II) a transaction in which the information is customized or otherwise specially prepared by the licensor for the licensee, other than minor customization using a capability of the information intended for that purpose;
  - (III) a site license;
  - (IV) or an access contract.[43]

A party receiving a nonconforming tender of a copy may revoke acceptance for a material breach only if the other party is notified; there was acceptance on the reasonable assumption that the defect would be cured; or the acceptance was induced by the other party's assurances. Revocation will be precluded if there was a substantial alteration of the information by the accepting party, or there was a failure to notify seasonably. If a party reasonably believes that performance will not be made by the other party, a demand for adequate assurance of due performance may be sought. Until such adequacy of performance is accomplished, the party making the demand may suspend its performance.[44]

Remedies

Remedies are cumulative so that it is possible for an aggrieved party to have several forms of relief. They are (1) *cancellation* of the contract for material breach upon notification to the other party; (2) remedies as provided for in the agreement between the parties if such remedies are not unconscionable; (3) *liquidated damages* (wherein the parties agree at the outset what money will be due and owing in the event of a breach); (4) *compensatory* damages as determined by a court based on market value as of date of breach of contract but a party may not recover *consequential damages* for losses of published informational content unless otherwise provided for in the contract, nor are speculative damages recoverable. Consequential damages will be allowed for disclosure or misuse of trade secrets.[45]

A licensor may recover no more than the contract fee and the market value of other consideration required under the contract. Damages include the accrued and unpaid contract fees, the market value of other consideration earned but not received for performance accomplished or for a reasonably hypothetical substituted performance, plus consequential and incidental damages. A licensee may recover damages no more than the market value of the performance, plus restitution of amounts paid for performance not received, plus incidental and consequential damages, less fees paid for performance that has been accepted by the licensee.[46] In addition, the aggrieved party may deduct the sum from money due and owing to the other party for the deficient performance and may request specific performance if the aggrieved party is not seeking money but rather the unique agreed upon performance.[47]

Application to "Wrap" Agreements. It appears that the above-stated UCITA provisions could greatly benefit consumers in the shrink-wrap, click-wrap and browse-wrap scenarios. Section 105 provides for public policy exclusions that are similar to the UCC Article 2 provisions. Both statutes negate contracts that conflict with consumer protection laws and UCITA specifically denies enforcement that violates public policy.[48] Both statutes provide broad express and implied warranty provisions.[49] Given the exceedingly liberal interpretation of the warranty provisions by courts in consumer cases under the UCC, it would appear that the enactment of UCITA would lead to a greater liberality of holdings in the above stated cases.[50] On the other hand, Section 208 of UCITA could be used by courts to uphold the licensing restrictions. It provides in part:

> (2) the terms of a record may be adopted...after beginning performance or use if the parties had reason to know that their agreement would be represented in whole or part by a later record to be agreed upon and there would not be an opportunity to review the record or a copy of it before performance or use begins...(3) If a party adopts the terms of a record, the terms become part of the contract without regard to the party's knowledge or understanding of individual terms in the record.

It would appear that UCITA would not necessarily change the results of the above decisions if the courts were not so inclined to decide otherwise. It would not take priority over a conflicting federal statute.[51] Another possibility for consumer protection against unjust "wrap" provisions is the interference of the Federal Trade Commission on behalf of consumers.[52] It possesses the power to regulate "unfair or deceptive practices." It would appear that the Gateway and other corporate provisions might fall under the FTC jurisdiction.[53]

Conclusion

It appears at this juncture that, in the absence of congressional and state legislation, consumers have to wary of all shrink-wrap and click-wrap agreements. By failing to read the legalese set forth by vendors, purchasers have few judicial venues that will protect their rights. The multitude of UCC decisions, which render unfair agreements as unconscionable, appear not to be made applicable to agreements that almost no one reads and almost no one understands or to which s/he knowingly consents. The *ProCD* court, that concluded a person had to go to Illinois at his or her cost to litigate a case that a victory would provide little or no relief, appears to dispute previously adjudicated consumer-oriented decisions. Its reasoning is questionable. Gateway stores are now located in almost all states. Certainly, it is in a far better position to adjudicate disputes in the various state courts within the domain of the vendee than for the vendee to travel to Gateway's unilaterally determined place of adjudication.

Previously, corporate entities and sophisticated purchasers have been made subject to all portions of an agreement entered into but consumers were given much latitude. Courts appear no longer to be protective of unknowing consumers. Whether one agrees or disagrees with such reasoning, it appears that one is bound even where the degree of unconscionabilty is extreme. Another possibility, with concerted effort by a number of consumers, is to make the purchases and then return the products making known that they refuse to abide by the terms of the shrink-wrap agreement. The vendors would then weigh the loss of purchasers against the remote possibility that litigation will take place.[54]

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[1] Section 2-312 is entitled "Warranty of Title and Against Infringement; Buyer's Obligation Against Infringement." It states that in a contract for sale, the seller warrants: the title being transferred is good and rightful; that the goods are being transferred free from any security lien or encumbrance of which the buyer is aware; and that a *merchant* seller warrants that the goods are delivered free from any rightful claim of a third person of infringement except where the buyer furnishes specifications.

Section 2-313, entitled "Express Warranties by Affirmation, Promise, Description, Sample" compels a seller to be bound by any affirmation of fact, promise, description of goods, or sample or model that relates to the goods and is a part of the basis of the bargain, notwithstanding that the seller did not use words or warranty or guarantee.

Section 2-314 entitled "Implied Warranty: Merchantability; Usage of Trade" provides that a *merchant* seller is bound by the implied warranty that the goods are in general conformity with the contract description; that they are fit for the ordinary purpose for which they are ordinarily used; that they are adequately packaged, contained, and labeled as per the agreement; and that they conform to promises of fact or affirmations made with respect to the said goods.

Section 2-315, entitled "Implied Warranty: Fitness for Particular Purpose" impliedly binds the seller to furnish the buyer with the appropriate goods wherein the seller, who is made known of the particular purpose that the buyer requires, makes the selection.

[2] Section 2-302. "Unconscionable Contract or Clause" states:

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

(2) When it is claimed or appears to the court that the contract or any clause thereof may be unreasonable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

[3] For a more detailed discussion of this issue, see David A. Einhorn, *Shrink-Wrap Licenses: The Debate Continues*, IDEA: The Journal of Law and Technology, 38 IDEA 383 (1998).

[4] 86 F.2d 219 (7th Cir. 1996).

[5] 939 F.2d 91 (3d Cir. 1991).

[6] A possible distinction that can be made is that the Warsaw Convention concerned rights and obligations that are set forth by agreement of member states. Presumably, before entering into the convention, a country takes into consideration whether the convention is in the best interests of the citizens of the country. Similarly, the use of insurance policy analogy is questionable because insurance contracts are created in consultation with the particular state insurance department and, again, presumably, the rights of policyholders are protected by the state. The same reasoning arises with respect to drug purchases, which come within the jurisdiction of federal governmental agencies. Moreover, consumer purchases under the UCC are rarely subject to small print or unreasonable disclaimers made by the vendors or manufacturers.

[7] Section 2-606 provides: "What Constitutes Acceptance of Goods."

(1) Acceptance of goods occurs when the buyer

  (a) after a reasonable opportunity to inspect the goods signifies to the seller that the goods are conforming or that he will take them in spite of their nonconformity; or

  (b) fails to make an effective rejection (subsection (1) of Section 2-602), but such acceptance does not occur until the buyer has had a reasonable opportunity to inspect them; or

  (c) does any act inconsistent with the seller's ownership; but if such act is wrongful as against the seller it is an acceptance only if ratified by him.

(2) Acceptance of a part of any commercial unit is acceptance of that entire unit.

[8] Einhorn [see endnote no. 3 above] discussed the theories of contract law that may be applicable to shrink-wrap cases. He indicated (at 387) that three possible interpretations could be found by a court: (1) the imposition of conditions subsequent to the sale by the vendor or licensor; (2) terms of a reverse unilateral contract between the parties; and (3) the imposition of conditions subsequent to a sale. With respect to the first theory, courts will not determine that such conditions cause forfeitures of otherwise enforceable contract rights. The second theory that calls for agreement to restricted use of the program as a condition of usage is normally not available. The third theory will not help the purchaser provided that the conditions are made known prior to usage and the purchaser may return the product for a full refund in the event s/he decides to return the product due to the disagreement with the condition.

[9] 970 P.2d 803 (1999).

[10] The federal district court in Arizona in *Arizona Retail Sys., Inc., v. Software Link, Inc.*, 831 F. Supp. 759 (D.Ariz. 1993), concurred with the reasoning in *Step-Saver* finding that once the seller of the goods shipped them to the purchaser, such shipment would not include the license agreement concerning which the

purchaser was previously unaware. The attached shrink-wrap license agreement was merely a proposal to modify the agreement that would not become effective in the absence of express consent of the purchaser.

[11] 105 F.3d 1147 (7th Cir. 1997).

[12] 676 N.Y.S. 2d 569 (1998).

[13] For an excellent discussion of adhesion contracts and their application to the "wrap" agreements, see Dawn Davidson, *Click and Commit: What Terms are Users Bound to When They Enter Web Sites?*, 26 Wm. Mitchell L. Rev. 1171 (2000). As stated by the author (at p.1194), "Contracts of adhesion arise when a standardized form of agreement, usually drafted by the party having superior bargaining power, is presented to a party, whose choice is either to accept or reject the contract without the opportunity to negotiate its terms."

[14] 2000 (No. 97C 2523, ND Ill, Jan. 15, 1998).

[15] 2000 Del. Ch. LEXIS 54 (Del. Chancery Court, March 16, 2000).

[16] For a discussion of the case, see Martin Samson, <INTERNETLIBRARY@PhillipsNizer.com>.

[17] 104 F. Supp.2d 1332 (D.Kan. 2000).

[18] Note that Gateway reduced the time frame within which to return the computer from thirty to five days.

[19] Section 2-102 states:

> Scope; Certain Security and Other Transactions Excluded From This Article.
> Unless the context otherwise requires, this Article applies to transactions in goods; it does not apply to any transaction which although in the form of an unconditional contract to sell or present sale is intended to operate only as a security transaction nor does this Article impair or repeal any statute regulating sales to consumers, farmers or other specified classes of buyers.

[20] The "battle of the forms" refers to the often-found situation wherein the offeror in a sale of goods transaction send a form offer to the offeree. The offeree then also utilizes a form to accept the offer, generally not realizing that the purported acceptance had a minor deviation which, under common law, would have constituted a counteroffer rather than an acceptance. Thus, the UCC attempted to salvage the purported contract by its enactment of Section 2-207 (see above recitation).

[21] For a discussion, see Dawn Davidson, *Click and Commit: What Terms are Users Bound to When They Enter Web Sites?*, 26 Wm. Mitchell L. Rev. 1171 (2000).

[22] 323 N.J. Super. 118 (N.J. App. Div., 1999).

[23] No. C.A. No. PC 97-0331, 1998 (R.I. Superior Ct., 1998).

[24] No. 00-0962, 2001 Mass. Super. LEXIS 11 (Sup. Mass., Feb. 8, 2001).

[25] No. 00-11489-WGY, 2002 U.S. Dist. LEXIS 209 (D.Mass., Jan. 2, 2002).

[26] See UCC Section 2-316 "Exclusion or modification of warranties." Subdivision (1) and (2) provide:

(1) words or conduct relevant to the creation of an express warranty and words or conduct tending to negate or limit warranty shall be construed wherever reasonable as consistent with each other, but subject to the provisions of this article on parol or extrinsic evidence (Section 2-202) negation or limitation is inoperative to the extent that such construction is unreasonable.

(2) Subject to subsection (3) [allowing use of "as is" and other like language to exclude warranties], to exclude or modify the implied warranty of merchantability or any part of it the language must mention merchantability and in case of a writing must be conspicuous, and to exclude or modify any implied warranty of fitness the exclusion must be by a writing and conspicuous. Language to exclude all implied warranties of fitness is sufficient if it states, for example, that "There are no warranties which extend beyond the description on the face hereof."

[27] Section 2-204, Formation in General provides:

(1) A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.
(2) An agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined.
(3) Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.

[28] No. 00 Civ. 4871 (AKH), 00 Civ. 6219 (AKH), and 00 Civ. 6249 (AKH) (S.D.N.Y., July 5, 2001).

[29] A "support contract" is an agreement to correct performance problems in computer information other than an agreement to cure a defect amounting to a breach of contract.

[30] The definitions are found in Section 102 of the Act.

[31] Section 103 of the Act.

[32] Section 104 of the Act.

[33] Section 401 of the Act.

[34] Section 402 of the Act.

[35] Section 403 of the Act.

[36] Section 404 of the Act.

[37] Section 405 of the Act.

[38] Section 406 of the Act.

[39] Sections 407 and 409 of the Act.

[40] Section 701 of the Act.

[41] Section 702 of the Act.

[42] Sections 703-704 of the Act.

[43] Section 102(44) of the Act.

[44] Sections 707-708 of the Act.

[45] Section 808 of the Act.

[46] Section 809 of the Act.

[47] Sections 811-812 of the Act.

[48] Compare UCITA Section 105 with UCC Section 2-102.

[49] Compare UCITA Sections 401-409 with UCC Sections 2-312-318.

[50] For a discussion of UCITA to the topic, see Garry L. Founds, *Shrinkwrap and Clickwrap Agreements: 2B or Not 2B?,* 52 Fed. Comm. L.J. 99 (Dec. 1999).

[51] Section 105 of UCITA states that provisions of the Act that are preempted by federal law would be unenforceable.

[52] For an excellent discussion of this aspect of protection, see Roger E. Schechter, *The Unfairness of Click-On Software Licenses,* 46 Wayne L. Rev. 1735 (Winter, 2000).

[53] It is unlikely that decisive action would be undertaken with the present conservative mindset of the executive branch.

[54] For a background review of the many cases and interpretations of the subject matter, see Roy J. Girasa, *Cyberlaw: National and International Perspectives* (Prentice Hall: 2002), ch. 3.

A Reality Check: United States v. Emerson

Todd Barnet *

In 1999 the United States District Court for the Northern District of Texas decided U.S. v. Emerson. [1] The district court dismissed the indictment of Joe Emerson, on Fifth and Second Amendment grounds. The decision is certain to cause quite a stir because it represents the first significant decision to unambiguously hold that firearms ownership granted by the Second Amendment is an individual, not a collective right. [2] The longstanding legal fiction of collective rights in this regard is seriously questioned in the Fifth Circuit Court of Appeals, and the court also held that the right to keep and bear arms is an individual right. Ultimately, however, we see that the Circuit Court's findings are flawed and the court reversed and remanded to the trial court for further proceedings. The district court's dismissal of the indictment on Fifth and Second Amendment grounds is reversed by the Fifth Circuit-the same holding that stresses the individual right to keep and bear arms. The Second Amendment issues are examined in this case note in the context of Fourteenth Amendment notice and due process. These notice issues are intertwined with Second Amendment questions, because Emerson involves ownership of a handgun, subsequent to issuance of an order of protection.

In part two the legal fiction denying individual rights of gun ownership in general and in the context of U.S. v. Emerson is examined. We see that the Fifth Circuit Court of Appeals in U.S. Emerson rejects the fiction but then adopts its own, more minor legal fiction while rejecting the obvious and substantial notice concerns in regard to the federal criminal statute, which Joe Emerson was prosecuted under. There follows an analysis and evaluation of the precedents the appellate court cites for its decision ordering the district court to recommence criminal proceedings against defendant Joe Emerson.

In part three, the powerful dissent in a related case decided at almost the same time as Emerson is analyzed, i.e. U.S v. Wilson. The dissent in Wilson, and the radically new direction the Fifth Circuit has ventured forth on in Emerson, are evaluated as possible indicators of a long term sea change that appears to be taking place in our federal courts, in particular. In conclusion, new ground has been broken by the decision in the Fifth Circuit Court of Appeals in U.S. v. Emerson in regard to Second Amendment rights. At the same time, the court has left an opening. It is fascinating that the fictional quality of the court's citations as to Fourteenth Amendment issues of due process may prove to be the future "Achilles' heel" available to academics and legal practitioners alike to further cement future precedent in regard to the existence of an individual right to " right to keep and bear arms."

Introduction

The Emerson case involves a troubled husband whose wife was involved in an affair with another man. Mr. Emerson was going through the painful experience of witnessing the disintegration of his marriage and his family. According to the Texas District Court he had threatened his wife's boyfriend's life indirectly during a telephone call to his wife. There had soon after been a request by his wife for an order of protection in the Texas Family Court and one was issued following a cursory hearing. In the hearing in family court it was alleged by his wife that he had threatened solely her boyfriend. In the Fifth Circuit Court of Appeals, Judge Parker in a special concurring opinion also stated that evidence in the district court revealed that Mr. Emerson had cocked a handgun in a threatening manner apparently while in close proximity to his wife. This evidence was not mentioned in the published decision in the court below.

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The statute in issue, 18 USC 922(g)(8) states it is a federal felony to possess a firearm following issuance and service upon an individual of any family court order of protection. The District Court for the State of Texas held that defendant's Tenth Amendment rights had not been violated, nor had his rights under the Commerce Clause but that his Second Amendment and Fifth Amendment rights had been violated and that on the facts the Family Court order of protection was unconstitutional. The District Court dismissed the indictment. [3] The court reasoned that defendant's Second Amendment rights were too substantial to be taken from him by virtue of a state family court, form order of protection. The court also ruled that inadequate notice had been given to Emerson of elimination of his right to possess firearms as per the prohibitions contained in 18 USC 922(g)(8).

There is no disagreement alleged by the District Court or the Court of Appeals as to certain facts. The family court order of protection was a form order, and it alleged no specific acts or threats of physical injury to Mrs. Emerson, or to the couple's daughter. Mrs. Emerson did not state that her husband had ever threatened her or their daughter in the application for the family court order of protection, or in the brief hearing prior to the granting of the order. Rather, she did allege threats made to her against her boyfriend. In the hearing prior to the granting of the order, Mrs. Emerson specifically states that at no time did her husband threaten her. [4] The order is silent as to any statement that Mr. Emerson was not permitted to possess firearms as per the order of protection. This seems vague enough to raise certain due process issues of a lack of notice but in addition the family court judge also never told Mr. Emerson of the federal statute That prohibited such ownership and possession!. As Mr. Emerson appeared pro se at the hearing, he also had no attorney to inform him of the statute. [5] The Court of Appeals for the Fifth Circuit however reversed the District Court and sent the case back down for a retrial. This was ostensibly based mainly on statements on a form defendant had signed when he purchased the gun a year before the order of protection was issued. The dissent however in another very similar case recognizes the failure of the U.S. Department of Justice to inform the state courts of the existence of 18 USC 922(g)(8). This same failure apparently contributed substantially to the lack of notice to Joe Emerson.[6]

The Radical But Flawed Second Amendment Analysis Of The Fifth Circuit

An important Second Amendment issue is whether or not from a perspective of stare decisis the 80 plus pages devoted to the elucidation of Second Amendment rights in the Fifth Circuit decision is mere dicta, as Judge Robert M. Parker specially concurring states. [7] It is reasonable to assume it is not dicta, as the due process and Second Amendment issues are so intertwined in this case as to be effectively inseparable. This is also because notice requirements tend to be more stringent as the right the defendant is faced with losing becomes more substantial. For example, it may be assumed that a person with a felony conviction is effectively on notice that he may not possess a firearm, even absent coincidental, actual notice of the statute.[8] Therefore, it may be posited, the district court was obliged to rule on exactly how substantial a right the Second Amendment right in the specific case was, to" keep and bear arms." Judge Parker in a separate but concurring opinion in Emerson rules that " reasonable regulation " is what is at issue, not whether or not gun ownership in the United States is a collective or an individual right .The inadequacy of the argument (and the logic of his ruling in concurrence) is that it minimizes the question of the adequacy of the notice as per the Fourteenth Amendment in the Texas Family Court. The Fifth Amendment due process issues may be viewed as a central focal point in the context of the defendant's Second Amendment guarantees. Due to the arguably inalienable and fundamental nature of these rights, which clearly pre-date both the Constitution and the Second Amendment, the court below acted not only legally but also wisely and even circumspectly in dismissing the indictment. [9] The decision dealt a body blow to a vast judicial legal fiction that has jeopardized logic and the rule of law in the United States since 1894 in Miller v. Texas.[10] This is the legal fiction that an American's Second Amendment rights are not individual rights allowing one to protect oneself and the state, by virtue of a "well regulated militia". but instead are merely collective rights which have no existence, absent state or federal government. [11] A judicially created legal fiction, in short.[12] Emerson may mark the demise of this fiction or at least a significant turning point. This would have the advantage of lending a greater clarity, logic, accuracy and transparency to the law. A precise, " civilian" definition of a legal fiction is:

An assumption of fact deliberately, lawfully and irrebutably made contrary to the facts proven or probable in a given case, with the object of bringing a particular legal rule into operation or explaining a legal rule, the assumption being permitted by law or employed in legal science.[13]

An example of this would be the settled fiction in maritime law that a ship can have a guilty mental state, despite it's inanimate nature. The ship itself may then be put on trial, found "guilty" and deemed forfeit by the government.[14] This case is still the law in the United States!

The Second Amendment may always be modified, if the people so wish, by passage of an amendment by a three-fourths majority of the legislatures of the States or three fourths of conventions of the States. This is the proper and constitutional method to create modification and not a court created legal fiction. [15] Please note that the possible change is accomplished by the legislative branch and therefore does not impose a violation of the Constitutional plan of separation of powers .If Mr. Emerson were put on real and actual notice of the law, he could simply rid himself of his weapons, or face legitimate felony prosecution under the federal statute. There is no allegation in either the district or appeals court that his guns are not all properly registered with the proper authorities. This should make any government seizure of the weapons simple for the Bureau of Alcohol, Tobacco and Firearms.[16] Mr. Emerson, on both Second and Fifth Amendment grounds, richly deserves a new trial on the issues of notice and the coincident due process issues. This is fair and logical, and was the position of the dissent in U.S. v Wilson, a Seventh Circuit case on almost identical facts.

Legal Fictions Weaken the Second Amendment

An academic debate has stormed for decades in the United States as to whether or not the right to keep and bear arms is an individual and therefore a substantial right, or one that is far more minor, a mere collective right that may be more severely monitored and controlled by the state. Our state and federal courts have ruled almost without exception that the right, such as it exists, is collective and not substantial. This position also conveniently permits far greater " gun control " by the states, while at the same time depriving the people of their natural right of self-defense.[17] The vast bulk of the scholarly and academic articles have for well over twenty years produced a flood of literature investigating and exposing with great precision and logic just how and why it is that the Second Amendment right is historically and constitutionally an individual right to keep and bear arms. These scholars have eschewed the politically correct position taken by our courts and others, and have instead through careful and thorough analysis of the Second Amendment and its historical basis concluded it is an individual right. [18] The academic literature forms a substantial part of the Fifth Circuit Court of Appeals citations in U.S. v Emerson.[19]

The District Court, as we know by now, held that defendant's due process rights had been violated, as had his constitutional right to keep and bear arms and dismissed the indictment. The Circuit Court, however, while exploring at length in a superb exposition the importance of defendant's Second Amendment rights, nevertheless concludes that adequate notice was given, and that additionally, "ignorance of the law is not a defense." The District Court was correct in measuring the scope of defendant's Second Amendment rights as necessary to analyze the extent of due process required to take away those rights via the Fourteenth Amendment. This is a matter of rudimentary logic. What is at first perplexing about the Circuit Court decision is not that it finally reveals the legal fiction of the long-standing, collective rights fiction. This had to be spelled out by the court to precisely analyze the due process issue and the Second Amendment issue because the Fourteenth Amendment notice issue involved possession of a weapon. [20]This state of facts reveals the flaw in Judge Parker's special concurrence. It is disappointing however that the majority opinion cites a whole host of cases attempting to establish that a case called U.S. v. Lambert has been overruled. Lambert held as U.S. v. Emerson did, in the court below, that proper notice had not been given. The cases cited as overruling Lambert all hold sufficient notice had been given. What is odd is that in one breath the Circuit Court finally eviscerates the long standing judicial legal fiction of (Second Amendment) collective rights, and in the next breath cites a group of cases that supposedly prove that Emerson is not similar to Lambert, but that Emerson is instead like U.S .v. Staples, Giles, Bryan and others! These latter cases are not analogous to Emerson or Lambert The court's reasoning is quite incredible. Emerson is clearly far more similar to Lambert, and totally different from the cases the court compares Emerson to, namely Giles, Staples, Bryan and others. The paradox is why the court chooses to reveal the central, judicially created legal fiction of collective rights, and then proceeds to espouse its own far more minor legal fiction in regard to what it cites as relevant case law for the proposition that Emerson received proper notice and possessed the requisite mens rea. These cases also do not demonstrate that Lambert has been overruled. One would hesitate to believe that this is some peculiar judicial perversity. It may simply be that the court believed the indictment should not have been dismissed and felt compelled while dismissing the central legal fiction to then reverse and remand as to the dismissal of the indictment by creating another, lesser legal fiction, with a line of controlling case " precedent" that upon examination is not relevant precedent.[21] The process becomes a bad habit exercised once again by the court in place of a logical and more genuine approach. Instead, the court, it may be respectfully suggested, could have explained the law as to mens rea and notice and then said there really was no appropriate Second Amendment precedent. This would have been more philosophically direct, as well as relatively easy to justify, especially in light of the court's findings that the numerous other precedents were all based on the judicially created legal fiction of a mere collectivist right to gun ownership.[22] Greater clarity, transparency and respect for the court's findings would have been gained by this process. The court would thereby reveal that it was breaking new ground and was unashamed to do so. Instead, the Fifth Circuit Court's holding appears to be based on a sort of " guilt by association theory." It proceeds as follows: 1. Emerson threatened his wife's adulterous lover indirectly with death over the telephone in an emotional, depressed outburst to his wife. She alleges no threats to the wife in the hearing prior to issuance of the order of protection, although Judge Parker in the court of appeals says such threats occurred. 2. There exists 18 USC 922 (g)(8), an obscure federal criminal statute that prohibits gun ownership by one who is subject to a family court of protection. 3. Emerson was such a person; therefore he must have been on notice of the statute, even though common sense tells us he probably was not. This is the confused and vague reasoning put forth by the Circuit Court of Appeals for the Fifth Circuit.

An Examination of The Fictional Precedents Cited By The Fifth Circuit Court of Appeals

The following examination of the precedents cited by the United States Court of Appeals for the Fifth Circuit in United States v. Emerson will commence to reveal the unconvincing character of the court's dubious reasoning. U.S. v. Lambert, which the Court in Emerson claims was overruled, dealt with defendant's failure to register with the Los Angeles County Police Department as a convicted felon who had resided in Los Angeles for seven years. During the period of her residence, she had been convicted of forgery, a felony in California, and when arrested for another crime, had still not registered her current address as required of felons who live in Los Angeles in excess of five days under the Los Angeles Municipal Code. At trial she protested that she had no knowledge of the statute, but she was found guilty. The Appellate Division, Superior Court, affirmed. On appeal, the United States Supreme Court held that her due process rights had been violated. In a five to four decision the court held that Ms. Lambert did not know she had to register and that there " was no proof that she probably had such knowledge. " If we compare U.S. v. Emerson we observe that therein the Fifth Circuit ruled that since Mr. Emerson had signed a form in the gun store a little over a year before, at the time of purchase, he was supposedly aware of and surely recalled wording about one year later on the reverse of that form barring weapons possession or purchase or transport thereof if an order of protection was in existence at time of purchase! One wonders if this is reality or fiction? As for precedents in regard to proper notice, the court held in Lambert that for a registration law, the state legislature was not free to exclude elements of knowledge as part of the offense. And please note that Ms. Lambert was clearly aware that she had not registered with the Los Angeles Police Department and that she was indeed a convicted felon.[23] The Fifth Circuit states Lambert is to be differentiated from Emerson. Emerson, in the court's wisdom, is deemed to be similar to Giles. U.S. v. Giles however deals with a convicted felon who shortly after being released from state prison goes out and buys two handguns at licensed gun stores and at purchase signs BATF paperwork in which he swears he has no felony convictions on pain of felony prosecution! [24] Emerson, on the other hand, was not informed of the federal criminal statute when the order of protection was served on him (unless one accepts as notice the BATF form he read and signed a year prior), and, as already mentioned, the order itself made no mention of the prohibition. . Emerson had appeared pro se at the pre-issuance hearing and had no lawyer at his side to warn him of the law. Assuming that is, that his lawyer, had he existed, would have known about it. No one from the federal legislative branch apparently had bothered to inform anyone at the state judiciary level of the law. Well, we have mentioned all of this already. The court's reasoning is simply not convincing.

U.S. v. Bryan, another case the court uses in it's vain attempt to distinguish Emerson from Lambert, deals with an individual literally selling handguns on a street corner, from which Mr. Bryan had previously filed off the serial numbers! [25] He was charged with violation of 18 USC sec. 922(a)(1)(A), by willfully engaging in the business of dealing in firearms, a different section of 18 USC from Emerson's prosecution. Basically, Bryan's defense was that he was unaware of the specific law that he was charged with violating. This is unlike Emerson as to notice, mens rea and the obvious and blatant illegality of the conduct contained in the Bryan fact pattern. Another case the Fifth Circuit Court of Appeals cites, as being similar to Emerson and distinguishable from Lambert is Staples. U.S. v. Staples deals with possession of a semi-automatic rifle converted to fully automatic fire. The weapon had not been licensed or registered as a machinegun. The United States Supreme Court ruled that the prosecution should have proven beyond a reasonable doubt that Staples knew the unregistered machinegun he possessed had the characteristics of a machinegun and therefore was capable of full automatic fire .It was remanded to the District Court for that purpose. Additionally, the Court as per Justice Clarence Thomas found that some mens rea was required for the alleged violation of the statute.[26] The court in the instant matter seems to undermine it's own position by citing Staples. Justice Thomas in Staples ruled that the court must construe the criminal statute in terms of the background of common law for which some mens rea is required for a crime, particularly as it is not in Staples a statute merely for the common welfare, or a " mere regulatory statute." Thus, the statute as applied to Emerson did not pass constitutional muster as per the precedent of Staples. Mr. Emerson had no knowledge of the criminal statute and because it is generally lawful for non – felons, such as Emerson, to possess a licensed firearm, actual notice is necessary. [27] Staples lists the severity of potential incarceration of ten years and the general legality of gun ownership in the U.S. as requiring mens rea as to the specifics that make the conduct prohibited a crime.[28] This was what the District Court ruled .in Emerson. The District Court was correct and for all the Fifth Circuit Court's obeisance to high sounding phrases and the importance from a constitutional perspective of the Second Amendment holding, its ruling was ultimately seriously flawed. The central legal fiction was rejected, but the appeals court still remanded the charges for further proceedings pursuant to its judgement. While of little apparent benefit to Mr. Emerson, we are nevertheless indebted to the Fifth Circuit for its wise though nevertheless halting demonstration of bravery "under fire." This was accomplished by a less substantial legal fiction, as mentioned earlier, involving analogies to cases that are in no way even remotely analogous. This is the central flaw in the Fifth Circuit's finding in Emerson and in the Seventh Circuit's finding in Wilson. Both judgements are based on a fictional analysis of current case law. A brief analysis of U.S .v Wilson follows.

The Circuit Court in Wilson [29] held that defendant was guilty of a felony on facts involving a family court order and subsequent, prohibited gun ownership by Wilson and a consequential violation of 18 USC section 922(g)(8) This is the identical section and sub section of 18 USC by which Emerson was prosecuted. A powerful dissent by Chief Judge Posner however is a harbinger quite possibly of things to come in this area of the law. Well-reasoned and passionate dissents are sometimes signposts of future law!

The Dissent In Wilson

Chief Judge Posner argues his dissent with a light touch that is all the more powerful because of its subtlety. He clearly states that a constitutional analysis is not required as the case is clear without such analysis. This is an approach utilizing what is commonly called " judicial economy" and as such is well recognized and respected in the law. Wilson, Judge Posner believes, is " entitled to a new trial at which the government would have to prove that he knew that continued possession of guns after the restraining order was entered was a crime." [30] Wilson's conduct was malum prohibitum, not malum in se.[31] Posner also believes that the lack of a firearms prohibition statement in the family court order may have led Wilson to believe guns were still permitted. This logic also applies to Emerson. The United States Attorney General's Office it is noted in Wilson did nothing about informing the state court judges of the federal criminal statute until after the Seventh Circuit decision in Wilson. This would also place such initial attempts at notice by the federal government at a time after Emerson was decided in the Fifth Circuit Court of Appeals. [32] Wilson, by the way, received 41 months incarceration for his violation of 18 USC 922(g)(1), and Emerson faces the prospect of a substantial sentence. The counter argument on which the court relies is the principle that " ignorance of the law is not a defense." This is not an absolute, however, and Posner believes notice was insufficient in Wilson, and also, as aforementioned, that it was not even a close enough call to warrant " bringing out the heavy cannons of constitutional law." He compares Wilson to Lambert and sees a strong analogy. Posner argues that all sorts of criminal violations are hidden in the federal code, and that in Wilson's case, the law acted" as a trap." 18 USC sec. 708, for example, he notes, prohibits using the coat of arms of Switzerland in advertising. Or see 18 USC sec. 714, which forbids using " Johnny Horizon " as a trade name without the authorization of the Department of the Interior.[33] Did you the reader know of these two federal criminal statutes? One wonders how many other " traps" lurk for any one of us in the United States Code?

Conclusions

The Fifth and Seventh Circuit Court's of Appeal are basically in agreement as to the issue of the notice requirements to apply 922(g)(8) – due process is ruled to exist on the basis of purely fictional analogies to citations that upon examination are not relevant.

As to U.S. v Emerson in particular, Joe Emerson was trapped by the federal statute and was doomed from the start because of his lack of knowledge and lack of notice. The lack of any realistically sufficient notice of the statute has been finessed by our federal appeals courts in shocking disrespect for the Fourteenth Amendment rights of the defendant. He was never informed of the existence of the law in either the order itself, or by the judge who issued the order. And he had no attorney to explain the obscure rule to him. We await the decision in the Texas District Court in Emerson on remand, but the Court of Appeals fictional interpretation of Fifth Amendment notice and due process rights presents a formidable obstacle to the defendant's freedom. For Joe Emerson, the only avenue may be appeal to the United States Supreme Court on certiorari.

In a broader perspective, however, the forceful stand taken by the Fifth Circuit Court of Appeals in U.S. v. Emerson is sure to rekindle the Second Amendment debates. . The individual rights position adopted by the majority in the Fifth Circuit will surely lend renewed vigor to academics and legal practitioners alike throughout the nation. It is also possible that the decision brings us a substantial step closer to decisive action in this sensitive area by the United States Supreme Court. The groundwork has been laid. First by the academic community in its voluminous and pointed articles and now by the important holding in the Fifth Circuit. The legal fiction of collective rights has been exposed to the bright light of day. In hindsight it may be that with U.S. v. Emerson we have " crossed – over" in an important sense, and that it will be very difficult for the federal courts to go back to " fiction as usual." By trampling on the due process rights to real, as opposed to fictional, notice of the criminal statute, the Fifth and Seventh Circuit Court's of Appeal have left a significant and obvious opening to pursue defendant's rights in similar fact patterns.

[1] United States Of America v. Timothy Joe Emerson, United States District Court For The Northern District of Texas, San Angelo Division, 46 F. Supp. 2d 598 (1999).

[2] . In the last 100 years our highest Court has decided just five relevant cases. These are U.S. v Cruikshank, 92 U.S. 542 (1875) for the concept that the right to bear arms pre-dates the Constitution; Presser v. Illinois, 116 U.S. 252 (1886), the Supreme Court upheld the conviction of a member of an unorganized and armed militia on parade; Miller v. Texas, 153 U.S. 535 (1894), the Court without much discussion simply dismissed an appeal on procedural grounds and stated the Second Amendment only protects firearms used by militiamen in " civilized warfare;" United States v. Miller, 307 U.S. 174 (1939), sustained a conviction of two individuals who were carrying an unregistered shotgun in interstate commerce; and finally in dicta in United States v. Verdugo-Urquidez, 494 U.S. 259(1990), the Court interpreted the term " the people" in the Preamble and the First, Second , Fourth, Ninth, and Tenth Amendments as a term of art giving the same connotation in the Preamble and in all five Amendments of " the People" as referring to an individual right

[3] The issue of the equities in this case has been totally ignored by the courts. It seems now to be settled law in the United States that if a wife commits adultery and abandons her husband, then she is entitled to alimony, support and a fault free divorce. The law apparently contradicts a strong public policy in favor of marriage and, when a form order of protection is granted to hold the displeased husband at bay, negatively impacts Second Amendment rights. See also U.S. v. Wilson 159 F.3d 280 (7th Cir. 1998). In a quite similar case in the Seventh Circuit a strong dissent noted it acted not as a deterrent but rather as a trap for the vast majority of persons subject to state domestic relations orders of protection. These persons were never informed of 18 USC 922(g)(8) and the U.S. Attorney General" slipped up" and never informed the state court judges. Therefore, nothing in the orders or their issuance alerted the defendants Wilson and/or Emerson to the prohibition on weapons possession, and the family court judges were also unaware of the law. The orders were in fact silent on this point. The notification process began after Emerson was remanded for trial and after Wilson's indictment under the federal statute.

[4] See United States v. Emerson, Fifth Circuit Court of Appeals, Circuit Judge Parker, specially concurring, apparently contradicts Mrs. Emerson's statements at the hearing in this regard.

[5] See U.S. v. Wilson 159 F.3rd 280 (7th Cir. 1998). Chief Justice Posner , in a scathing dissent in U.S. v. Wilson , a case on it's facts virtually identical to Emerson , opined that " if none of the conditions that make it reasonable to dispense with proof of knowledge is present, then to intone " ignorance of the law is no defense" is to condone a violation of fundamental principles for the sake of a modest economy in the administration of criminal justice." The legislative intent was to get guns out of the hands of those who would threaten a spouse with a firearm in " the usual case" and this is not served by " keeping the law a secret." Note also as a collateral issue that in Emerson the only threat his wife complained of was allegedly directed at her boyfriend, not at her, or the child of the marriage. The Texas domestic relations statute does not mention threats to third parties as requiring orders of protection.

[6] Id.

[7] See U.S. v. Emerson 159 F.3rd 280 (7th Cir. 1998). Circuit Judge Parker specially concurring rejects the court's findings that the Second Amendment bestows an individual as opposed to a mere collective right of gun ownership. He states the court's finding in this regard are dicta. The judge states that " the fact that the 84 pages of dicta contained in Section V. are interesting, scholarly and well written does not change the fact that they are dicta and at best an advisory treatise on this long- running debate." The entangled nature of the issues of notice of firearms restriction and requisite mens rea of the defendant however casts serious doubt on the efficacy of Judge Parker's findings in this regard.

[8] See Harold E. Staples, III, Petitioner v. United States 128 l. Ed. 2d 608 (1993-94); which held that it is sufficient if defendant knows he possesses a device which is a machine gun, and he need not know of the precise statute which prohibits possession of an unlicensed machinegun.
[9] A natural rights theory.
[10] See Miller v. Texas, 153 U.S. 535 (1894), which states the Second Amendment only prohibits firearms used by militiamen in " civilized warfare."
[11] The Second Amendment reads as follows: " A well regulated militia being necessary to the security of a free state, the right of the People to keep and bear arms shall not be infringed." See generally STEPHEN P. HALBROOK, That Every Man Be Armed 7 (2d ed. 1994). The Supreme Court has failed to express a clear opinion as to whether or not the Second Amendment grants an individual right but the most recent case, decided in 1990, may represent a weak beginning towards the recognition of the individual rights in Emerson on Second Amendment grounds. In dicta in United States v. Verdugo-Urquidez, 494 U.S. 259(1990), the Court interpreted the term " the people" in the Preamble and the First, Second, Fourth, Ninth, and Tenth Amendments as a term of art referring to the same connotation of an individual right in all the amendments cited.
[12] For a complete analysis of legal fiction from an historical perspective see generally PIERRE J.J. OLIVIER, LEGAL FICTIONS IN PRACTICE AND LEGAL SCIENCE (1975); (1930/31).
[13] Id. at 81.
[14] The Palmyra, 25 U.S. (12 Wheat.) 1, 14-15(1827).
[15] The Constitution has been amended 27 times since its adoption. . Article V states the procedure to follow to amend it. This basically requires two thirds of both Houses or two thirds of the State legislatures to initiate the proposal of an amendment. A convention is thereby called to formally propose the amendment, to be ratified by three fourths of the State legislatures or by conventions in three fourths of the States…
[16] See U.S. v. Wilson, 159 F.3rd 280 (7th Cir. 1998) in which on almost identical facts, Chief Judge Posner in an impassioned dissent writes that Wilson should be granted a new trial in which the People must prove that Wilson beyond a reasonable doubt had actual notice of the prohibition on guns contained in 18USC 922 (g) (8).
[17] See Miller v. Texas, 153 U.S. 535 (1894).
[18] See Tribe, American Constitutional Law, and Vol.1, n.221 at 902, for a practical perspective on the meaning of the Second Amendment. Quoting from U.S. v. Emerson, Fifth Circuit Court of Appeals, at 63. " Perhaps the most accurate conclusion one can reach with confidence is that the core meaning of the Second Amendment is a populist/republican/federalist one. Its Central objective is to arm " we The People " so that ordinary citizens can participate in the collective defense of their community and their state. But it does so not through directly protecting a right on the part of states or other collectivities, applicable by them against the federal government, to arm the populace as they see fit. Rather, the amendment achieves its central purpose by assuming the federal government may not disarm individual citizens without some unusually strong justification consistent with the authority of the states to organize their own militias. That assurance in turn is provided in turn through recognizing a right (admittedly of uncertain scope) on the part of individuals to possess and use firearms in the defense of themselves and their homes…a right that directly limits action by Congress or the Executive Branch."
[19] See n9 of the decision United States of America v. Timothy Joe Emerson, United States Court of Appeals For The Fifth Circuit, 270 F.3rd 203 (2001); Michael A. Bellesiles, The Second Amendment in Action, 76 CHI.-Kent L. REV. 61 (2000); Carl T. Bogus, The Hidden History of The Second Amendment, 32 U.C. Davis L. Rev. 309 (1998); Keith A. Herman and Denis A. Henigan, The Second Amendment in the Twentieth Century, Have You Seen Your Militia Lately? 15 U. Dayton L.Rev. 5 (1989); Paul Finkelman, A Well Regulated Militia: The Second Amendment in Historical Perspective 76 Chi.-Kent L.Rev. 195 (2000); Steven J. Heyman, Natural Rights and The Second Amendment 76 Chi.-Kent L. Rev. 237 (2000); H. Richard Uviller and William J. Merkel, The Second Amendment in Context, The Case of The Vanishing Predicate 76 Chi.-Kent L. Rev. 403 (2000).
[20] Fifth Amendment rights of due process apply to a defendant in state court through the Fourteenth Amendment. The Court has not incorporated the Second Amendment into the Fourteenth Amendment to apply against the states. See Todd Barnet, Gun" Control" Laws Violate the Second Amendment and May Lead to Higher Crime Rates, Missouri Law Review, Volume 63, Number 1, (Winter 1998) at p. 164, citing United States v. Cruikshank, 92 U.S. 542, 554-55 (1875).

[21] A process of backwards reasoning by a court, in which the court first determines the result it wishes to achieve and then locates and states the " reasoning" needed for the conclusion, is not unusual.
[22] The reason the court did not choose a forthright approach may have to do with the fact the court never admitted there ever had been any legal fiction in regard to the " collective rights" theory and long standing lack of precedent as to individual rights theory, except perhaps indirectly in Miller v. Texas 153 U.S. 535 (1894).
[23] The dissent in Wilson mentions convicted felons as being in that class of persons who are aware they may not own firearms in any situation.
[24] See United States of America v. Alphonse Giles, United States Court of Appeals 640 F. 2d 621 (5th Cir. 1981). Giles had previously pleaded guilty to a felony of grand theft in Louisiana, and had served almost two years in prison for that offense. On June 8, 1979, he bought a .32 caliber semi-automatic pistol from a local sporting goods store. In November of 1979 he also bought a shotgun from another licensed firearms dealer. He filled out Bureau of Alcohol, Tobacco, and Firearms forms prior to both purchases. Form 4473, which included a question as to whether purchaser had ever been convicted of a crime carrying over a one-year sentence. Giles answered in the negative on both forms. This sort of outright lying on a firearms purchase form is a very serious matter and there is nothing like it in Emerson. Giles was indicted on two counts of unlawful receipt of a firearm and of false statements in connection with purchase of a firearm.
[25] See Sillasse Bryan, Petitioner v. United States 524 U.S. 184 (1998). This case clearly has nothing to do with Emerson!
[26] See Harold E. Staples, III, Petitioner v. United States 128 1. Ed. 2d 608, (1993-1994).
[27] Id. The United States Supreme Court reversed and remanded in this case involving alleged illegal possession of an unregistered machinegun. The court held that some mens rea must be shown to convict of possession of the machinegun. Staples also notes relevantly that as a result of the Second Amendment, the possessing of firearms is generally legal and therefore some mens rea must be shown by the People in the case of possession of an unregistered machinegun.
[28] Id. Staples distinguishes private, lawful gun ownership and the mental state required from things such as sale of dangerous drugs, see United States v. Balint, 258 U.S. 250 (1922) and United States v. Freed, 401 U.S. 601 (1971), possession of hand grenades. " In such cases, the Court has reasoned that as long as a defendant knows that he is dealing with a dangerous device of a character that places him in responsible relation to a public danger, he should be alerted to the probability of strict regulation, and is placed on notice that he must determine at his peril whether his conduct comes within the statutes inhibition." Staples clearly holds that this is not so in regard to lawful ownership of weapons not capable of full automatic fire. This precedent is therefore relevant to U.S. v. Emerson. The "machinegun" in Staples possession was a semi-automatic rifle that apparently had been converted to permit full automatic fire. Staples alleged it had never fired full automatic and that he was unaware it had this capability.
[29] See U.S. v. Wilson 159 F.3d 280, 293 (7th Cir. 1998). This case has a remarkably similar fact pattern to U.S. v. Emerson. The year of the arrests, 1998, is also the same. Therefore, all of Judge Posner's observations about a lack of notice of the federal law apply equally to Emerson. Apparently the family court in Emerson was similarly totally unaware of USC 922(g)(8).
[30] The Chief Judge states: " It is wrong to convict a person of a crime if he had no reason to believe that the act for which he was convicted was a crime, or even that it was wrongful. This is one of the bedrock principles of American Law. It lies at the heart of every civilizes system of law." He cites Bouie v. City of Columbia for the proposition that a valid criminal statute must give notice, i.e. " fair warning."
[31] The alternate position, which the Fifth Circuit adopts in it's judgement, finds that Emerson need only have awareness that he possesses a firearm...not that such possession is illegal. This position is however rejected by the precedent in Staples. Staples is a case not involving a " mere regulatory statute " as Justice Clarence Thomas points out. Emerson also involves more than a regulatory statute because of the substantial possible penalties involved and the fact the gun is of a common usual type. It is not a machinegun, or a hand-grenade as was the case in U.S. v Freed. Therefore, The Appeals court in Emerson is ignoring clear precedent when it concludes there was adequate notice of the statute.

[32] The Family Court Order of Protection was granted in Emerson on September 14, 1998, and Emerson was convicted of possession of a firearm in violation of the statute. The unlawful possession occurred on November 16, 1998. The family court in Texas apparently knew nothing of the statute.

[33] Posner feels 18 USC 922(g)(8) of all of the federal criminal statutes, is " one of the most obscure." A gun owner knows or should know that conviction of a felony will mean he will have to relinquish his firearms, but that is basically common knowledge, unlike the present statute.

THE WALRUS AND GRANDPA'S MUSTACHE: USING SCHEMATA TO TEACH BUSINESS LAW CONCEPTS

by

Robert Wiener*

I. Introduction

Business law teachers often teach survey courses in which they introduce students to nearly every area of law other than taxation. Some may feel that such courses are superficial, but the broad range of topics they contain provides an opportunity to use themes that run across different fields of law.[1] Professors who highlight these common principles can deepen the understanding of students as to how the law works and facilitate their comprehension of new areas of law. In fact, students may learn best in business law survey courses when they are taught to connect legal concepts with their prior knowledge.

Learning is more effective when we use prior knowledge to acquire new knowledge. The field of education refers to this way of knowing and understanding as schema, or, in the plural, schemata.[2]

When my daughter Galit first encountered a walrus at the age of two, she exclaimed, "It has grandpa's mustache." She was using her prior knowledge of her grandpa's handlebar mustache to understand this new phenomenon, a walrus.

This paper explores legal schemata, that is, the different conceptual approaches used in the law. It considers how schemata that appear in several sections of the law can be used to both facilitate and deepen the learning of business law rules in survey courses.

II. Prior Knowledge

Students enter classrooms with prior knowledge. It would be profitable to consider the knowledge students bring into a business law class. Conceptions students have about the law may provide topics for discussion at the first class session. Students may be aware of phrases related to the law such as the following:
"Ignorance of the law is no excuse."
"Possession is nine tenths of the law."
"Don't make a federal case out of it."
"You're innocent until proven guilty."
"An agreement must be in writing or it's worthless."
"You can't yell fire in a theater."[3]

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Some student prior knowledge is based on misconceptions, but some of it is helpful. In either case, teachers who are aware of what students know, or think they know, can make use of it. Teachers can use correct prior knowledge to assure students that the law is not totally new to them and connect new legal information with ideas students already have. This use will facilitate learning by creating self-confidence in a student's ability to learn and building upon knowledge already acquired.

Furthermore, when teachers confront rather than ignore student misconceptions, students learn that sometimes a little knowledge is indeed a dangerous thing[4] (and that they should develop skepticism of simple sayings[5]).

Business law professors should be wary of the inappropriate transfer of prior knowledge. Students often believe that terms used in both ordinary and legal vocabulary have the same meaning in both. Therefore, teachers need to take special care in teaching such legal terms as "consideration" in contract law, "false imprisonment" in tort law, and "entrapment" in criminal law.[6]

This paper focuses not on student knowledge before entering our classrooms, rather on how business law faculty can teach business law so prior knowledge can be exploited and knowledge learned in one area of law can be more easily exported to other areas of law.

III. Schemata

Knowledge of a legal concept organized as a schema can be more easily imported and used in other areas of law. Sometimes several areas of law are related and all must be understood for any to be satisfactorily understood.[7] This seamless web nature of the law can frustrate students.[8] And it is often the best students who are most frustrated, especially when learning by the case study method, if they expect to understand all of the ramifications of the first cases they read. But the law is by its nature interrelated. And teachers can use that fact to help them teach rather than seeing it as a barrier to learning.

For example, the tort concept of deceit[9] is related to fraud in the inducement in both contract law[10] and commercial paper law,[11] and securities fraud.[12] Once one understands the priorities of secured transactions in personal property, it is easier to understand bankruptcy law. And the concept of different levels of scrutiny in judicial review comes up in both the "arbitrary and capricious" standard in administrative law[13] and the different standards in constitutional law First Amendment freedom of speech cases.[14]

The teacher of business law must decide how to teach complicated legal concepts to students -- whether to prepare students for further analytical legal reasoning by introducing the new concept with some of its complexities or to introduce the concept simply, even simplistically, in order to provide limited understanding in a limited amount of time rather than causing confusion and resulting frustration. For example, should a teacher teach simply that certain contracts must be in writing or, instead, that the statute of frauds may be satisfied in a number of ways, of which a memorandum is but one? The first approach will give students a basic concept imprecisely, but perhaps give them useful knowledge. The second approach will prepare students to learn in sales law about satisfying the statute of frauds with written confirmations[15] and in specially manufactured goods cases.[16]

Should one go into the intricacies of consideration analysis when teaching contract law or wait until suretyship to teach why the contract between the surety and creditor is supported by consideration even though the surety gains no direct benefit? And should the timing issues of consideration be taught when teaching contracts or only when consideration is distinguished from value while discussing bona fide purchaser rules for a sales law buyer in ordinary course of business[17] or a commercial paper holder in due course?[18]

If we are thinking of legal concepts as schemata, prior knowledge upon which we will rely to develop future knowledge, we may be more likely to create clear, organizing legal principles that will be applicable in other areas of law.

For the remainder of this paper I will discuss what legal principles may be applied in more than one area of law and, therefore, can serve as schemata for our students. The list is far from exhaustive, but I hope that it will provide teachers with a framework for thinking about schemata and the incentive to further develop their own lists.

IV. Types of Rules

In Anglo-American common law different types of legal rules are used to judge different kinds of cases.[19] Here are examples of the categories:

A. All or Nothing at All Rules

Occasionally the law is rigid, allowing for no variation from a precise test. On such occasions, an all or nothing at all approach is used. In effect, each item on a checklist must be checked off for a certain legal outcome. This approach, with no discretion for the judge, is perhaps the simplest for a student to understand.

A checklist is applied to determine the governing law in commercial paper cases. An instrument is negotiable and governed by the Uniform Commercial Code Article 3 only if each of the elements of negotiability is satisfied.[20] If one of the elements is missing, contract common law governs.

Another application of the all or nothing at all principle is situations when the law requires that one's actions be precise. Examples are the contract law mirror image rule[21] and the sales law perfect tender rule.[22]

B. Pretty Much Rules

At other times the law is not so strict. The question is not whether perfection is achieved rather whether what was achieved was pretty much what was expected. The burden of proof for criminal cases is the beyond a reasonable doubt test. This rule is probably best classified as a pretty much test. Although anything short of perfect performance constitutes a breach, in a contract law case if performance is substantial,[23] the breach is minor and not material. Therefore the non-breaching party is not entitled to contractual discharge as a remedy.

C. Balancing Tests

More commonly legal issues are decided using balancing tests. In fact, a common symbol that students may be familiar with for the law is the scales of justice.[24]

An example of the balancing test is the evidentiary test for the burden of proof in civil cases, the preponderance of the evidence rule.[25] Burdens of proof may be taught while teaching legal process or in comparison with the burden of proof in criminal cases.[26] Another example is the predominant factor test used to determine the governing law for hybrid sales and service contracts.[27]

Sometimes factors must be balanced against each other to arrive at a legal conclusion. For example, in agency law tort liability cases a list of factors is used to determine whether one is a servant or an independent contractor.[28]

On other occasions competing legal values must be balanced against each other such as freedom of speech vs. a right to privacy. Another example is the determination of whether a non-compete clause in a contract is valid when its effect is to restrain trade in order to protect property rights.[29]

It is valuable to acknowledge that the law is not always clear but often requires judgment calls. This requires more sophistication on the part of students, but is necessary for them to understand how the law works.[30]

D. One Drop Rules

Less frequently there are one drop rules in the law. Here a legal litmus test is used and if there's just a little bit of something in a case, the law treats it as though it is completely in that category.

If broad authority is given to govern an area of law, the courts are likely to interpret the governing law quite expansively. The commerce clause of the United States Constitution is one such example.[31] Case interpretation of this clause suggests that if there is just a little bit of interstate commerce in a transaction, federal law preempts state law under the supremacy clause.[32] A similar situation is the broad interpretation of the application of the Federal Arbitration Act.[33]

Note that even with one drop rules, there is usually a companion *de minimus rule;* that is, if the drop is small enough, it is not treated in that category. For example, state miscegenation laws established that if one's parentage was a certain fraction black, a person was treated as black for the purpose of marriage.[34] However, below that fraction they were treated as white.

V. Legal Problem Solving Strategies

A. The Legal Fiction

The law sometimes solves problems by imagining the existence of something that does not exist in real life. This creation is called a legal fiction. Examples of this conceptual approach are the reasonable person and quasi-contract.

1. The Reasonable Person

The politically correct version of the reasonable man, this legal fiction is used in tort law to hold people responsible for negligence only if their actions fall short of the care that would be exercised by an imaginary reasonable person.[35] The trier of fact, for example the jury in a jury trial, must discover the precise qualities of this fictional legal character to determine liability for negligence.

This concept of reasonableness has been extended to many areas of common law. Sales law has codified the principle in many areas and the Uniform Commercial Code is sprinkled with the term.[36]

2. Quasi-Contract

Quasi-contract is another legal fiction or, perhaps more accurately, an equitable fiction. Here the court behaves as though there is a contract while acknowledging that there is none. That is, there is no valid and enforceable contract due to some common law inadequacy.[37] Yet the plaintiff is deemed entitled to a remedy.

An interesting example of quasi-contract is in the disaffirmance by parties lacking capacity of voidable contracts concerning necessaries. In order to achieve the goal of protecting parties who lack contractual capacity, the court of equity acknowledged an equitable right against these parties for such bargains.[38]

B. The Two Good Guys Problem

Periodically the problems arises that one bad guy injures two good guys financially. How should the law respond? The law could have the two good guys share the cost of the injury and have a joint suit against the bad guy. However, the typical Anglo-American common law approach is that one of the good guys will get the money or the goods and the other will get the cause of action against the bad guy.[39] This approach is seen in action in the impostor rule,[40] the fictitious payee rule,[41] and entrustment cases with buyers in ordinary course of business.[42]

VI. Common Legal Principles

When teaching business law survey courses, we all probably notice repeated legal principles in different areas of law. These repeated themes can serve as schemata for our students, particularly when they reappear and can provide a shortcut to additional knowledge. Here are several common legal principles.

A. Objective vs. Subjective

The common law prefers objective standards to subjective standards. It is far more common to see objective tests such as reasonableness[43] or objective intent tests.[44] However, subjective tests are sometimes used such as the general good faith test of "honesty-in-fact" in the Uniform Commercial Code.[45]

B. Timing Matters

In the determination of legal rights, timing often matters. For example, the filing of a complaint under a statute of limitations,[46] when loss occurs in risk of loss cases,[47] and whether consideration is past, present, or future in contract cases.[48]

C. *Bona Fide or Good Faith Purchaser*

When teaching the principle of the *bona fide* or good faith purchaser, the professor has the opportunity to prepare the student for later discussions of the related buyer in ordinary course of business in sales law[49] and the holder in due course in commercial paper.[50]

D. Double Standards

The law sometimes establishes double standards. Examples are elevated standards for experts in negligence cases[51] merchants in sales contracts,[52]

E. History

1. Common Law and Equity

The historical relationship between common law and equity may seem irrelevant to the teaching of a survey course, yet it may serve as a schema to facilitate learning in a number of tricky legal situations. Despite the fact that the law and equity courts have been merged with the same judge serving both functions, equity still steps in only when the common law is deemed inadequate to produce a just result.[53]

This principle arises several times in contract law. If a contract is either invalid or unenforceable, a quasi-contract may still be found. Also, if legal remedies are inadequate, equitable remedies, such as specific performance, may be available.[54] Even promissory estoppel, although not derived from the equity courts, is perhaps best understood as an equitable substitute for legal consideration.[55]

2. Land

The history of feudalism and English common law will help explain the special treatment of land in the law. Examples are the protection of property in the United States Constitution's due process clause,[56] the fact that a sale of real property is within the statute of frauds,[57] and the availability of specific performance as a remedy in the case of a breach of a contract for the sale of land.[58]

VI. Comparing and Contrasting

Survey courses give us the opportunity to compare and contrast different business organizations,[59] consideration and value,[60] benefits and detriments consideration analysis[61] with rights and duties third party rights analysis,[62] and strict liability in tort law,[63] products liability,[64] and *respondeat superior*.[65] Sometimes these topics are in separate chapters or even in separate courses, yet the comparing and contrasting helps students both in their comprehension and their retention of the material.

VII. Conclusion

Some see a student as a tabula rasa with the teacher engaged in the divine activity of creation *ex nihilo*.[66] I believe that such a model fails to acknowledge that even in the depiction of the creation of the world in the Hebrew Scriptures it was not out of nothing, but *tohu vavohu*,[67] a primordial soup. Indeed, I see this as the existing and the ideal teaching situation.

Regardless of one's conception of the nature of creation, students come to our classes with prior knowledge related to business law. If we are aware of that knowledge we can use it by correcting it when it is wrong and building upon it when it is correct.

Moreover, once we have begun to teach our students legal principles the slate is certainly no longer blank. We can take advantage of schema theory to teach concepts of the law in such a way that our students can anticipate related applications to come and recall related applications learned before. These connections within the law make the learning and teaching of survey courses of business law easier and richer.

ENDNOTES

[1] References in this article to these areas of business law will be made to RICHARD A. MANN & BARRY S. ROBERTS, SMITH AND ROBERSON'S BUSINESS LAW (12th ed. 2003) (http://smithandroberson.westbuslaw.com).

2 Readers rely on their prior knowledge and world experience when trying to comprehend a text. It is this organized knowledge that is accessed during reading that is referred to as schema (plural schemata). Readers make use of their schema when they can relate what they already know about a topic to the facts and ideas appearing in a text. The richer the schema is for a given topic the better a reader will understand the topic.

> Schema theorists have advanced our understanding of reading comprehension by describing how prior knowledge can enhance a reader's interaction with the text. Accordingly, comprehension occurs when a reader is able to use prior knowledge and experience to interpret an author's message (Bransford, 1985; Norris & Phillips, 1987). Educators and researchers have suggested numerous instructional strategies to help students activate and use prior knowledge to aid comprehension....

Marino C. Alvarez & Victoria J. Risko, *Schema Activation, Construction, and Application*, ERIC (Educational Resources Information Center) Digest ED312611 (1989).

[3] Cf. "The most stringent protection of free speech would not protect a man in falsely shouting fire in a theatre and causing a panic." Schenck v. U.S., 249 U.S. 47 (1919), Justice Oliver Wendell Holmes, Jr.

[4] Indeed, the word "sophomore," related to the word "sophomoric," is "probably influenced by Greek *sophos*, wise, and *moros*, dull," meaning one who thinks that they are wise but are, in fact, dull. THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (3d ed. 1992).

[5] Such as this one. "If a little knowledge is dangerous, where is the man who has so much as to be out of danger?" THOMAS HENRY HUXLEY, ON ELEMENTAL INSTRUCTION IN PHYSIOLOGY (1877).

[6] Other examples are terms such as "damages," "remedy," "acceptance" as performance in sales law (contrasted with "Will you accept this package?").

[7] To understand the relationship of the Federal Arbitration Act to state laws on the availability of litigation as a method of dispute resolution, it is necessary to understand the workings of the supremacy clause.

[8] Apparently the concept of the law as a seamless web is an adaptation of the following quotation, "Such is the unity of all history that anyone who endeavours to tell a piece of it must feel that his first sentence tears a seamless web." Frederic William Maitland, *Prologue to a History of English Law*, 14 Law Quarterly Review 13 (1898).

[9] Deceit is "the tort of fraudulent representation." STEVEN H. GIFIS, LAW DICTIONARY (2d ed. 1984).

[10] MANN & ROBERTS, *supra* note 1, at 177-79.

[11] *Id.* at 497.

[12] Securities fraud. *Id.* at 864-65.

[13] Administrative law "arbitrary and capricious" standard. *Id.* at 76.

[14] First amendment scrutiny. MANN & ROBERTS, *supra* note 1, at 55-57.

[15]. U.C.C. § 2- 201(2) (1977).

[16] U.C.C. § 2-201(3)(a) (1977).

[17] Buyer in ordinary course of business. U.C.C. § 2-403(2) (1977).

[18] Holder in due course. U.C.C. § 3-302(1)(a).

[19] It would be fascinating to consider elsewhere paper why different rules are used in different situations. For example, it seems to me that the "Beyond a reasonable doubt" burden of proof rule is used in criminal law to acknowledge the significance of the societal censure represented by a guilty verdict.

[20] U.C.C. § 3-104; MANN & ROBERTS, *supra* note 1, at 461-66.

[21] Mirror image rule. MANN & ROBERTS, *supra* note 1, at 164.

[22] U.C.C. § 2-503 (1977).

[23] A party got pretty much what it bargained for. MANN & ROBERTS, *supra* note 1, at 274.

[24] I refer here to the image of Justice personified as a woman, blindfolded and holding up equally balanced scales.

[25] Preponderance of the evidence test. MANN & ROBERTS, *supra* note 1, at 5.

[26] Criminal Law. *Id.* at 93.

[27] Predominant purpose. *Id.* at 352.

[28] Independent contractors and agents. *Id.* at 307.

[29] A covenant not to compete. *Id.* at 211.

[30] In fact, I believe that it is a good life lesson.

[31] The commerce clause is in the U.S. CONST. Art. I, §8.

[32] The commerce clause has been interpreted quite broadly to include any transaction that affects commerce. MANN & ROBERTS, *supra* note 1, at 52-53.

[33] The Federal Arbitration Act has similarly been understood by the U.S. Supreme Court to be of broad application. Circuit City Stores, Inc. v. Saint Clair Adams, 532 U.S. 105, 121 S.Ct. 1302, 149 L.Ed. 2d 234 (2001).

[34] Somewhat atypical was the Virginia Preservation of Racial Integrity Act (1924) which defined as "white" a person with "no trace whatsoever of any blood other Caucasian," however, even there, those with "one-sixteenth American Indian blood" were still classified as white. African American Review.
http://www.findarticles.com/cf_o/m2838/n2_v32/21059953/print.jhtml

[35] Reasonable person standard. MANN & ROBERTS, *supra* note 1, at 120-122.

[36] The term "reasonable" or "reasonably" appears five times in U.C.C. § 2-503 (1977).

[37] Quasi contract. MANN & ROBERTS, *supra* note 1, at 149-50.

[38] Contractual capacity – liability for necessaries. *Id.* at 224-25. Apparently the theory is that a person dealing with a party lacking contractual capacity would not deny them necessaries knowing that you could recover the *quantum meruit* for their goods or services.

[39] Note that the law could take the advice of King Solomon and mandate that they share. This is one of several opportunities for a teacher, if so inclined, to invite students to consider a variety of ways in which a legal problem could be solved. In fact, the law solves problems in a variety of ways, but the professor may be reluctant to consider all the possibilities and risk student confusion of the actual law in a particular situation.

[40] The impostor rule. MANN & ROBERTS, *supra* note 1, at 474-75.

[41] The fictitious payee rule. *Id.* at 475.

[42] Entrusting of goods to a merchant; buyer in ordinary course of business. U.C.C. § 2-403 (1977); *Id.* at 475.

[43] See comments on the reasonable person test in above at VA1.

[44] Essentials of an offer – intent. MANN & ROBERTS, *supra* note 1, at 159.

[45] Definition of good faith. U.C.C. § 1- 201(19)(1977).

[46] Statutes of limitations in contract and sales law. MANN & ROBERTS, *supra* note 1, at 276 and 445. The professor may point out the importance of timeliness in the law here and use it as a real world rational for timely homework and test taking.

[47] Risk of loss in absence of breach. U.C.C. § 2-509 (1977); MANN & ROBERTS, Id. at 396.

[48] Past consideration. MANN & ROBERTS, *supra* note 1, at 197.

[49] Buyer in ordinary course of business. U.C.C. § 2-403(2) (1977).

[50] Holder in due course. U.C.C. § 3-302.

[51] For example, medical malpractice. MANN & ROBERTS, *supra* note 1 at 121.

[52] Consider the higher good faith standard, U.C.C. § 2-103(1)(b) (1977), and the possibility of being held to a firm offer, unlike non-merchants, U.C.C. § 2-205(1977).

[53] Justice is more the concern of equity with such words as "justice" and "justifiable" appearing in equity cases, while the word "reasonable" as in reasonable person, reasonable time, and reasonable amount is a cue that we are dealing with the common law.

[54] Specific performance. MANN & ROBERTS, *supra* note 1, at 200.

[55] Promissory estoppel. *Id.* at 198-99.

[56] Due process clause. *Id.* at 57; U.S. CONST. 5th and 14th Amendments.

[57] Contracts within the statute of frauds – land contract provision. MANN & ROBERTS, *supra* note 1, at 239.

[58] Apparently due to the inherent uniqueness of land.

[59] Such as the sole proprietorship, general, partnership, limited partnership, limited liability companies. MANN & ROBERTS, *supra* note 1, at 549.

[60] For example, regarding their timing relative to contract formation. *Id.* at 491.

[61] *Id.* at 193.

[62] *Id.* at *255-59.*

[63] *Id.* at 127-129.

[64] *Id.* at 415-21.

[65] *Id.*

[66] Creation *ex nihilo* ("out of nothing"). THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (3d ed. 1992).

[67] *Tohu vavohu* is translated as "unformed and void" in THE TORAH: THE FIVE BOOKS OF MOSES (Jewish Publication Society of America 2d ed. 1967) at Genesis 1:1.

THE INTERACTION OF THE PASSIVE ACTIVITY LOSS RULES AND C CORP. TO S CORP. CONVERSIONS: DOES NO + NO = YES?

By

Vincent R. Barrella*

In *St. Charles Investment Co. v. Commissioner*,[1] the Court of Appeals for the Tenth Circuit (hereafter "10th Circuit") ripped a hole in the statutory fabric of the Subchapter S rules.[2] In the process, the Court added additional complexity to the passive activity loss rules.[3] Describing the issue before it as one of "first impression," the 10th Circuit held that the shareholders of St. Charles Investment Co. (hereafter "SCI") could deduct in 1991, passive activity losses incurred by the corporation in 1988 through 1990. The 10th Circuit adopted the position advanced by SCI that section 469(b) rendered section 1371(b) powerless to prevent its deduction of the passive activity losses at issue.[4] In so holding, it reversed the United States Tax Court (hereafter "Tax Court").[5] The Tax Court had held that section 469(b) and section 1371 could be harmonized so as to give effect to both provisions of the statute.

I. BACKGROUND

The facts of *St. Charles* can be summarized as follows. Prior to 1991, SCI was a C Corporation that fit the definition of a closely held C corporation.[6] During the years 1988 through 1990 SCI operated rental real estate that gave rise to the passive activity loss (hereafter "PAL") in question. SCI elected S corporation status effective January 1, 1991. At the time of its election of S corporation status SCI had suspended PALs from its real estate activities. During 1991, SCI disposed of certain of the rental real estate properties that had produced the suspended PALs. SCI reported the sales of the properties and deducted the suspended PALs related to those properties on its 1991 S corporation tax return. Six of the seven properties sold produced losses that in the aggregate exceeded $9 million. The seventh property produced a gain of slightly in excess of $6,000. SCI then sought to pass these losses through to its shareholders. SCI elected to terminate its S corporation status on March 30, 1995, a little over four years after it elected to be taxed as an S corporation.[7] By sanctioning the pass through of these losses, the Court effectively permitted the shareholders of SCI to make a retroactive subchapter S election.[8] The 10th Circuit's opinion is even more remarkable in that the mechanism employed by it to shred the Subchapter S anti-abuse rules were the PAL rules, provisions which themselves were enacted by Congress to minimize the incidence of tax avoidance. Section 469 was added to the Internal Revenue Code as part of the Tax Reform Act of 1986.[9] Its enactment was precipitated by a concern on the part of Congress that the proliferation of taxpayers engaging in activities that generated losses that were then used to shelter income from other activities was undermining confidence in our system of taxation.[10]

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Generally, section 469(a) disallows a PAL for a particular tax year in the case of specifically enumerated types of taxpayers. Taxpayers subject to the provisions of section 469 are any individual, estate or trust, any closely held C corporation, and any personal service corporation.[11] A PAL is the amount by which the aggregate losses from all passive activities for the year exceed the aggregate income from all passive activities for such year.[12] A passive activity is generally one in which an enumerated taxpayer does not "materially participate."[13] In addition, rental activities are considered to be *per se* passive activities.[14] PALs that are disallowed pursuant to section 469(a) are not lost. Rather, section 469(b) provides that, "Except as otherwise provided in this section, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a deduction or credit allocable to such activity in the next taxable year." These rules have the effect of allowing a taxpayer to deduct PALs against passive activity income in subsequent years.

Section 469(g)(1) provides generally, that any disallowed PAL's relating to a particular passive activity may be deducted against both passive and non-passive income in the year in which that particular activity is disposed of.[15] Where an activity ceases to be a passive activity (*e.g.*, where the taxpayer satisfies the requirements of material participation), section 469(f)(1) provides that the previously disallowed PALs relating to that activity retain their status as PALs. Finally, section 469(f)(2) provides that if a closely held C corporation or personal service corporation experiences a change of status, such that they no longer fit within an enumerated class of taxpayer, section 469 will continue to apply to PALs from their passive activities as though they had not undergone a change in status.[16]

In 1982, Congress enacted the Subchapter S Revision Act of 1982.[17] Its intent in doing so was to provide a statutory means for shareholders of corporations that were not widely held to obtain essentially the same tax treatment as was available under the partnership provisions, without having to subject themselves to the personal liability typically associated with the partnership form.[18] An election to be treated as an S corporation can be made either by a new corporation, or one that has a prior history as a C corporation. When a C corporation elects S corporation status, a new taxpayer is not created, and there is no shift of assets or liabilities to a new entity. Rather, the corporation is viewed as having subjected itself and its income and expenses to a new taxing regime.[19]

Two of the provisions added in 1982 were section 1362 and section 1371. Section 1362, which provides the rules for electing S corporation status generally does not permit retroactive elections. Section 1371(b) operates as an "anti-abuse" provision by precluding former C corporations from passing onto to their shareholders, as a result of their new S status, losses sustained while in C corporation status.[20]

II. COMPARISON OF THE 10th CIRCUIT AND TAX COURT OPINIONS: THE FUNDAMENTAL DIFFERENCE IN APPROACH

The linchpin of the 10th Circuit's opinion was its holding that the "except as otherwise provided" language of section 469(b) precludes any non-enumerated exception from interfering with the operation of section 469.[21] In framing the question before it, the 10th Circuit assumed that there was an irreconcilable conflict between the relevant provisions.[22] The 10th Circuit answered this question without examining the legislative history of, or the circumstances surrounding the enactment of, the two provisions it deemed to be in conflict. Rather, the 10th Circuit relied upon what it referred to as "our accepted rules of statutory construction" in confining its analysis to the statutory language alone.[23]

By way of contrast, the Tax Court relied heavily on the legislative history of both section 1371 and section 469 in reaching its determination.[24] The Tax Court acknowledged that a basic principle of statutory construction is "that a specific statute controls over a general provision."[25] However, in reaching its conclusion, the Tax Court also gave effect to the principle that "when two statutes are capable of coexistence, 'it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective.'"[26]

A. THE 10th CIRCUIT ERRED BY REFUSING TO LOOK BEYOND THE STATUTORY LANGUAGE IN ORDER TO ASCERTAIN CONGRESSIONAL INTENT

There can be little doubt that the 10th Circuit's opinion in *St. Charles* produces absurd results.[27] The court acknowledged that Congress enacted section 1371(b) "in order to prevent corporate losses incurred prior to its electing S status from inuring to the benefit of the corporation's shareholders after an S status election."[28] The court also acknowledged that in enacting section 469 Congress was concerned "that taxpayers were 'front loading' deductions arising from activities in which the taxpayers did not participate."[29] While C corporations generally do not fall within the scope of Congressional concern, one class of C corporations, closely held C corporations do.[30]

The effect of the 10th Circuit's opinion is to put the shareholders of a closely held C corporation in a significantly better position than the shareholders of C corporations in general. If a C corporation that was not subject to the PAL rules had incurred losses of the type incurred by SCI those losses would have created a net operating loss carryfoward. Upon electing S corporation status, section 1371(b) would preclude the corporate shareholders from garnering any benefit from those losses. However, by virtue of the 10th circuit's opinion, if that same C corporation were a closely held C corporation, its shareholders would reap the benefit of those deductions. Thus, the effect of the court's opinion is to place the shareholders of a Congressionally defined "suspect" C corporation[31] in a significantly better position than the shareholders of a C corporation which Congress chose not to include in the suspect class. The absurdity of this result is patently obvious.

The 10th Circuit was on solid ground when it began its analysis with the language of the statute.[32] It went astray when, as a result of its unquestioning reliance on the "plain meaning rule," it confined its analysis to that language.[33] The Supreme Court has held that there is no rule of law that precludes the examination of legislative history no matter how clear the words of the statute may appear to be.[34] Before concluding that the plain language of the statute required its holding, the 10th Circuit should have examined the legislative history of section 469 and 1371.[35] Its failure to do so constitutes a significant flaw in its opinion. What makes this error even more egregious is that *St. Charles* did not involve a situation where the 10th Circuit was simply interpreting a single statute. Rather, it involved a determination (at least as framed by the 10th Circuit) as to which of two competing (again in the view of the 10th Circuit) provisions was going to prevail over the other. Given these circumstances, the 10th Circuit was compelled to fully search out Congressional intent before making that decision.[36]

Moreover, the 10th Circuit acknowledged that the shareholders of SCI were receiving a "windfall" as a result of its holding. It justified the grant of this windfall because in its view "the language of §469 is sufficiently unequivocal to require this result."[37] The 10th Circuit simply begged the question. Once it concluded that it was granting the shareholders of SCI a windfall, it had an obligation to examine whether that was what Congress intended.[38] Assuming that it was initially justified in not examining the legislative history of the relevant statutory provisions, the 10th Circuit was compelled to revisit its absolute reliance on the plain meaning rule upon its acknowledgement that its initial analysis created a windfall.[39]

The court pointed to section 469(f)(2) as additional evidence that Congress intended the result it reached. While the 10th Circuit was correct that the literal language of section 469(f)(2) does not excludes its application in the case of a C corporation to S corporation conversion,[40] the it once again relied upon the language of the statute in a vacuum. For section 469(f)(2) to evince Congressional intent consistent with the result reach by the 10th Circuit it is necessary to conclude that Congress intended a section designed to preclude tax avoidance, to be the instrument by which a provision with a similar purpose and intent, section 1371(b), is circumvented.[41]

B. THE TAX COURT PROPERLY SOUGHT TO HARMONIZE SECTION 469 AND SECTION 1371

Like the 10th Circuit, the Tax Court began its analysis with the language of the statute. However, in attempting to give effect to both section 469(b) and section 1371(b),[42] unlike the 10th Circuit, it examined available evidence of that intent beyond that language. The court identified SCI's arguments as falling "into two categories: (1) Suspended PAL's are not 'carryforwards' within the meaning of section 1371(b)(1), because the PAL rules ... constitute an accounting method which [SCI] should continue to use after its conversion to an S corporation; and (2) ... the specific language of section 469 ... precludes the application of section 1371(b)(1)."[43]

The Tax Court first addressed the carryforward issue. It noted that the provisions of section 469 were "transactional" in nature, as they deal with the treatment of particular activities, while the provisions of subchapter S deal with the status of a taxpayer.[44] These conclusions represent the underlying premise upon which the balance of the Tax Court's opinion was constructed. The Tax Court held that the legislative history of section 1371(b) supported an interpretation of that section broad enough to cover suspended PALs.[45]

The Tax Court's reasoning concerning the breadth of section 1371(b) has been sharply criticized.[46] This criticism is misplaced. Section 469(b) provides that, "any loss ... from an activity which is disallowed ... shall be treated as a deduction ... allocable to such activity in the next taxable year." Section 172(a) provides that, [t]here shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year." Section 172(c) defines the term "net operating loss" to mean "the excess of the deductions allowed by this chapter over the gross income." Both section 469(b) and section 172(a) refer to the allowance of a deduction in another taxable year of an amount by which deductions or losses in any particular year exceed the relevant income from that year. In essence both sections are designed to permit a taxpayer to utilize this excess in a taxable year other than the year in which the excess arose.[47] Section 469(b) would have continued to operate in the same manner as it does now had Congress drafted it so as to provide that, a disallowed PAL "shall *be a carryover to the next taxable year and* be treated as a deduction ... allocable to such activity in *that taxable year*." The Tax Court correctly concluded "PAL's are in effect NOL's albeit computed separately for a particular activity, and thus should not be treated any differently than NOL's to which section 1371 unquestionably applies."[48] The 10th Circuit did not directly address the equivalence issue. Rather, that court held that the language of section 1371(b) only serves to restrict "carryovers," and that section 1371(b) "says nothing about the deductibility of carryforwards." Of course, the principal difference between PALS and net operating losses is that the latter can be carried over for a fixed number of years, whereas, a PAL can be carried over indefinitely.[49]

In further support of its position, SCI argued that section 469 constitutes a method of accounting.[50] It urged that, as such, and consistent with the treatment accorded other accounting methods, section 469 survives a C corporation to S corporation conversion. In proffering this position, SCI relied heavily upon the placement of section 469 within subchapter E of the Internal Revenue Code. In response to this placement argument, the Tax Court noted that in both the Tax Reform Act of 1986, and its legislative history, Congress treated the PAL rules separately from those provisions dealing with accounting matters.[51] The Tax Court went onto to note that even if section 469 were treated as an accounting method, that does not mean that section 1371(b) would not apply to the PALs.[52] In its opinion, the 10th Circuit did not address SCI's "accounting method" argument.

Having determined that the PALs at issue were "carryforwards" within the scope of section 1371(b), the Tax Court then turned to SCI's exclusivity argument. The Tax Court essentially rejected SCI's argument out-of-hand, stating "when two statutes are capable of coexistence, 'it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective.'"[53] Section 172(b)(1)(A), which delineates the carryback and carryforward periods in the case of net operating losses, also contains the "except as otherwise provided" language relied on by SCI and the 10th Circuit. There can be no question, however, that a carryforward of a net operating loss fits squarely within the scope of section 1371(b). This would seem to lend additional support to the Tax Court's rejection of SCI's exclusivity argument.[54]

C. COMPARATIVE ANALYSIS

The 10th Circuit clear view is that section 469(b) erects a wall that prevents section 1371(b) from interfering with the operation of section 469(g)(1)(a). Indeed, even if section 469(b) contained "carryover" language it is reasonable to conclude that the 10th Circuit might nevertheless view the "except as otherwise provided" language of that section as precluding the intervention of section 1371(b).[55] The Tax Court, on the other hand, views section 1371(b) as erecting a wall that prevents the suspended PALs, those that arose when SCI was a C corporation, from being taken into consideration so long as it remained an S corporation.[56] Both courts agree, albeit in differing context, that section 469(g)(1)(A) only takes effect after the application of section 469(b).[57] In the Tax Court's view, there is no loss to deduct upon the disposition because section 1371(b) effectively blocks the PALs from coming into the S corporation year. In the 10th Circuit's view once the PALs make their way into the S corporation year, because of the preeminence of section 469(b), nothing in subchapter S prevents their deduction.

As noted earlier, SCI argued that if it were not allowed to deduct the PALs in the year of disposition, 1991, they would be lost forever.[58] That position was rooted in the language of section 469(g)(1)(A), which refers to the year of disposition as the year in which "excess PALs"[59] are treated as losses that are not from a passive activity. In addition, SCI also maintained that there is no mechanism within section 1371(b) to provide for PALs to survive an S corporation to C corporation conversion.

Addressing the latter contention first, it has been argued that section 1371(b)(3) merely provides for the inclusion of S corporation years in computing the remaining years of a fixed carryover period.[60] This argument fails to note that section 1371(b)(3), makes no reference to any specific carryover period, fixed or otherwise. That section simply provides that S corporation years are considered "years." If SCI was correct, and section 1371(b)(3) does not preserve PALs, it similarly could not serve to preserve net operating losses either. However, it is not disputed that an S corporation can use its C corporation net operating losses when it reverts back to C corporation status.[61] Given the similarity between PALs and net operating losses, the same construction that preserves net operating losses for a specific period of time, also preserves PALs indefinitely.[62] The clear weight of authority supports the conclusion that PALs do survive a subsequent S corporation to C corporation conversion.

The question of whether excess PALs must be deducted in the year the activity to which they relate is disposed of, is a more difficult one. The literal language of section 469(g)(1)(A) would at first glance appear to require that this question be answered in the affirmative. Whether that is the correct, however, is not entirely clear. The Tax Court held that the application of section 1371(b) does not destroy the availability of excess

PALs, but rather serves to preclude their use while the corporation is subject to the taxing regime of subchapter S.[63] In the view of the Tax Court, the event that triggers the deduction of excess PALs, is the relinquishment of S corporation status, not the fully taxable disposition of the passive activity.[64] The analytical problem presented is how does one bridge the gap between the year of disposition and the year of relinquishment of S corporation status? [65] The Tax Court's solution appears to be reasonably straight forward, and consistent with its position that 1371(b) does not destroy PALs. First, "excess PALs" are derived from PALs that were subject to 1371(b). Next, since "excess PALs" were derived from PALs that were subject to section 1371(b), they too are subject to section 1371(b). Finally, since section 1371(b) preserves PALs until the corporation reestablishes C corporation status, it similarly operates to preserve "excess PALs." The problem with this approach is that according to the Tax Court, the application of section 469(g)(1)(A) is dependent upon the application of section 469(b), and section 1371(b) "walls off" S corporation taxable years from the effects of section 469(b). The question is how can "excess PALs" come into existence if the S corporation years are shielded from the pre-conversion PALs?

It appears that the Tax Court's solution was to view the PALs as having undergone a change in character as a result of the disposition, with that metamorphosis occurring outside of the S corporation. This character change was insufficient to penetrate the section 1371(b) prohibition against carrying C corporation losses into S corporation taxable years. Rather, these "changed" losses effectively took the place of the PALs. The Tax Court would have allowed the loss as a deduction from other than a passive activity in 1995, when SCI was converted back into a C corporation. While there is an element of fiction inherent in this approach, it serves to give effect to the intent of section 469(b) that PALs not be permanently lost. It also gives effect to the intent of section 1371(b) and section 469(a).

Moreover, neither of the alternative constructions is particularly attractive. As has already been demonstrated, the 10th Circuit's approach simply produces an absurd result entirely out of step with the intent of both section 1371(b) and section 469(a). The other alternative is that SCI was right when it argued that a PAL is lost forever when a C corporation converts to S corporation status and then disposes of the activity that gave rise to the PAL. This result, while "draconian" in nature, would not be unique to the tax law.[66] SCI and its shareholders elected to convert SCI from a C corporation to an S corporation and, thus, attempt to make available to those shareholders approximately $9 million of losses that otherwise would not have been available to them. Losses that likely would have been wasted had SCI sold the real estate while still a C corporation. If there is any hardship to be suffered as a result of the decision to dispose of property with C corporation PALs, following an S corporation election, it would seem appropriate that the burden of that hardship fall upon the corporation and its shareholders who were responsible for the conversion and the timing of the disposition.

III. UNANSWERED QUESTIONS

The 10th Circuit's opinion has ramifications beyond the factual situation that was before it. The opinion raises questions that do not arise under the Tax Court's approach. Two of these questions are: (1) What are the consequences where a C corporation to S corporation conversion occurs, and the pre-election passive activities are not disposed of, but rather continue to be conducted by the S corporation? and (2) What is the proper treatment of C corporation PALs when instead of the entity disposing of an activity, one or more of the converted S corporation's shareholders dispose of their stock?

A. THE EFFECT OF THE CONTINUED OPERATION OF THE FORMER C CORPORATION'S PASSIVE ACTIVITIES WHILE IT IS IN S CORPORATATION STATUS

In *St Charles*, SCI was careful to point out that it was only using suspended PALs allocable to properties that were sold, and not those that were allocable to the other activities it was continuing to conduct.[67] What if, SCI had attempted to utilize pre-S election PALs from the passive activities it was still conducting in an S corporation taxable year? It would appear that pursuant to the 10th Circuit's opinion, SCI would have been permitted to pass those PALs through to its shareholders as well.[68] Whereas, under the Tax Court's opinion, PALs from continuing activities would not make their way into an S corporation taxable year because of section 1371(b), but, rather, would only be available when the S corporation converted back to a C corporation.

A simple example serves to demonstrate the effect of the 10th Circuit's opinion. Assume that ABC was a C corporation that was engaged in an activity that is properly characterized as passive one. Assume further, that immediately before its conversion to S corporation status, effective January 1, 2001, ABC's suspended PAL for activity X is equal to $240,000. Additionally, assume that ABC continued to engage in activity X in 2001, and also engaged in a new passive activity, Z, and that these activities produced passive income for the year 2001 in the amounts of $60,000 and $75,000, respectively. To begin with, the pre-S corporation PAL (from activity X) should not be available to offset income other than passive activity income after the C corporation to S corporation conversion. Stated differently, these PALs should not be available to offset net active income.[69] Nevertheless, the ramifications of the 10th Circuit's opinion are still significant. ABC would be permitted to apply the PAL from activity X, in the amount of $240,000, against the $60,000 of income from that activity. This would leave $180,000 of passive loss from activity X. This $180,000 of loss would offset the $75,000 of passive income from new activity Z. The remaining $105,000 of PAL from activity X would be available to offset any passive activity income the ABC shareholders might have from passive activities other than those conducted by ABC. This result, a pre-S corporation conversion PAL being deducted against S corporation passive activity income, and a pre-S corporation conversion PAL being deducted against the unrelated passive income of the ABC shareholders, are the unavoidable consequences of the 10th Circuit's opinion.[70]

B. THE EFFECT OF A SHAREHOLDR'S SALE OF HIS INTEREST IN AN S CORPORATION

Another unavoidable consequence of the 10th Circuit's opinion is the allowance of pre-S corporation conversion PALs to the shareholders of a former C corporation when they sell their stock in the corporation. Assume in the example set forth in the previous section, that, in 2002, shareholder A sells his interest in ABC to N, with a recognizing a gain of $30,000 as a result of the sale. This gain would be apportioned between passive activities X and Z, and any portfolio assets owned by ABC. Under the existing regulations, the $30,000 of gain is apportioned to passive activities X and Z and the portfolio assets in the amounts of $10,500, $15,000 and $4,500, respectively.[71]

The sale by A of his ABC stock would be considered a disposition by him of each of the activities.[72] A's share of the $105,000 PAL from activity X would be equal to $35,000.[73] This $35,000 would first offset the gain recognized on the deemed disposition of activity X in the amount of $10,500. The balance of the PAL attributable to activity X, $24,500, would offset the $15,000 of gain attributable to the deemed disposition of activity Z, with the balance of $9,500 being treated as a loss from an activity that is not passive.[74] Since ABC has not actually disposed of passive activity X, the acquiring shareholder, N, would have a portion of the X PALs attributed to him by virtue of his status as a shareholder of ABC.[75] Thus, the 10th Circuit's opinion would permit new shareholders, such as N, taxpayers having no connection at all to the former C corporation that gave rise to a PAL to reap the benefits of that loss. Stated another way, passive activity income earned by ABC during the period that N is a shareholder, can be offset by a PAL, such as the one attributable to activity X, which arose before N was a shareholder, and while ABC was a C corporation.

IV. CONCLUSION

From an analytical and policy point of view, the Tax Court's opinion is reflective of a better approach than the one adopted by the 10th Circuit. The most troubling aspect of the 10th Circuit's opinion is that it allowed one group of taxpayers, the shareholders of SCI, to deduct losses sustained by another taxpayer, SCI.

The decision to have SCI elect S corporation status was motivated by a desire to garner a tax benefit from real economic losses sustained by SCI.[76] While the Tax Court's opinion would have preserved the PALs, and allowed for their deduction in 1995, it is reasonable to conclude that these losses would have produced no meaningful tax benefit at the corporate level. In order to derive any tax benefit from the losses sustained by SCI, its shareholders would have had to wait until they either sold their stock, or SCI was liquidated. At that point, they would have been able to recognize a loss on their individual tax returns. Even then, however, that loss would have been a capital loss.[77] By permitting the excess PALs to be passed through to SCI's shareholders, the 10th Circuit essentially allowed the shareholders of SCI to convert what would have been a capital loss upon the sale of their SCI stock to any ordinary loss. There is a certain element of charm and appeal associated with the 10th Circuit's effort to provide assistance to the SCI shareholders. Unfortunately, in its effort to be "helpful," the 10th Circuit did damage to section 469 as well as the subchapter S rules.

ENDNOTES

[1] 232 F.3d 773 (10th Cir. 2000)

[2] *See*, sections 1361-1378

[3] Section 469

[4] The 10th Circuit portrayed the question as – Does section 469 defeat section 1371, or does section 1371 defeat section 469? The Internal Revenue Service ("Service") did not advocate the latter position.

[5] *St. Charles Investment Co. v. Commissioner,* 110 T.C. 46 (1998).

[6] A closely held C corporation is one where during the last half of a taxable year more than 50% of the value of its outstanding stock is held, directly or indirectly, by, or for, five or fewer shareholders. Section 469(j)(1).

[7] 110 T.C. at 47-48. Perhaps influenced by the more than four years that SCI retained its S corporation status, the Service apparently did not argue that the Subchapter S election was invalid or should otherwise be disregarded. In any event, such an argument would have been inappropriate in a motion for summary judgment given its inherent factual underpinnings. Query, whether judicially created doctrines such as the sham transaction doctrine or step transaction doctrine could be applicable in a case where a C corporation to S corporation conversion, is quickly followed by an S corporation to C corporation conversion. *See, e.g., Commissioner v. Tower*, 327 U.S. 280 (1946) (partnership between husband and wife disregarded where the sole purpose of the arrangement was to divert income to the wife); *Higgins v. Smith*, 308 U.S. 473 (1940) (taxpayer denied loss on sale of securities to corporation owned by him); *Associated Wholesale Grocers, Inc. v United States*, 927 F.2d 1517 (10th Cir. 1991) (disregard of stock ownership as transitory under the interdependence test of the step transaction doctrine); *Boyter v. Commissioner*, 668 F.2d 1382 (4th Cir. 1981) (divorce/remarriage case holding that the sham transaction doctrine may be applicable); *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980) (liquidation followed by reincorporation disregarded).

[8] Section 1362(c) provides that the election of S corporation status is effective for the year in which it is made and all subsequent years.

[9] Pub. L. No. 99-514, §501(a)

[10] *Schaefer v. Commissioner*, 105 T.C. 227, 230 (1995). This concern is reflected in the legislative history of section 469. *See*, S. Rept. 99-313 (1986) ("decisive action is needed

to curb the expansion of tax sheltering and to restore to the tax system the degree of equity that is a necessary precondition to a beneficial and widely desired reduction in rates").

[11] Section 469(a)(2)

[12] Section 469(d)(1). A closely held C corporation may also use its PAL's to offset its net active income. Section 469(e)(1). This advantage is not provided to other taxpayers subject to the PAL rules.

[13] Section 469(c)(1)

[14] Section 469(c)(2), *but see*, section 469(c)(7) for an exception in the case of rental real estate activities engaged in by real estate professionals.

[15] Section 469(g)(1)(A). This section provides that, when a taxpayer disposes of his entire interest in a passive activity in a fully taxable transaction (*i.e.*, gain or loss is recognized in full), then as a general rule, the excess of any loss from such activity for such taxable year (determined after the application of subsection (b)), over any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)), is treated as a loss which is not from a passive activity.

[16] *See*, section 469(f)(2), which provides that, "If a taxpayer ceases for any taxable year to be a closely held C corporation or personal service corporation, this section shall continue to apply to losses and credits to which this section applied for any preceding taxable year in the same manner as if such taxpayer continued to be a closely held C corporation or personal service corporation, whichever is applicable."

[17] Pub. L. No. 97-354

[18] S. Rept. No. 97-640 (1982)

[19] *Frederick v. Commissioner*, 101 T.C. 35, 43 (1993)

[20] *Rosenberg v. Commissioner*, 96 T.C. 451, 455 (1991)

[21] 232 F.3d at 777. ("Section 469(b) sets forth the general rule that PAL's that are non-deductible pursuant to §469(a) shall be 'suspended' and treated as deductions in the following year. Section 469(b) further states that the only exceptions to the general rule are those enumerated in §469 itself -- namely, the limitation on deductibility found in §469(a). Under our accepted rules of statutory construction, we hold that the 'except as otherwise provided in this section' language of §469(b) prevents the application of un-enumerated exceptions to the general rule of the statute. Because §1371's restrictions on carryforwards from a C year to an S year are not enumerated in §469, they have no effect on the operation of §469(b), and St. Charles's suspended PALs from the years 1988-1990 are deductible in the year 1991 subject only to §469 itself.")

[22] 232 F.3d at 776. ("Either the language of §469(b) functions as a statutory 'traffic cop,' preventing any provision of the Code outside of § 469 itself from negating the general rule of §469(b), or, §1371(b)(1)'s clear prohibition on carryovers effectively trumps the general rules of §469.")

[23] 232 F.3d at 777. The 10th Circuit's refusal to examine the legislative history was predicated upon its reliance on the "plain meaning rule." See the discussion of the plain meaning rule at 5-6, *infra*.

[24] 110 T.C. at 51-56

[25] 110 T.C. at 55

[26] 110 T.C. at 55-56 (citations omitted)

[27] It is arguable that the allowance of C corporation losses incurred in 1988 through 1990 losses to its shareholders in 1991, is the clearest indication of the absurdity of the result reached by the Court. However, since this was the question before the court, reliance on this point alone would be akin to saying that the 10th Circuit was wrong because the effect of its opinion was to create a "windfall" for the shareholders of SCI.

[28] 232 F.3d at 775

[29] 232 F.3d at 775

[30] Section 469(a)(2)(B)

[31] Congressional reasoning behind the decision to limit the scope of section 469 to closely held C corporations, as opposed to C corporations in general is revealed by the following passage from its legislative history, wherein Congress stated "[t]he corporation's ownership has been so broadened that the reason for limiting the corporation's ability to shelter its portfolio income becomes less compelling. A corporation which is not closely held is less susceptible to treatment as the alter ego of its shareholders..." S. Rept. No. 99-313 (1986).

[32] The Court stated that:

> It is our primary task in interpreting statutes to "determine congressional intent, using 'traditional tools of statutory construction.' As in all cases requiring statutory construction, "we begin with the plain language of the law." ... In so doing, we will assume that Congress's intent is expressed correctly in the ordinary meaning of the words it employs. Therefore, "it is a well established law of statutory construction that, absent ambiguity or irrational result, the literal language of a statute controls." Where the language of the statute is plain, it is improper for this Court to consult legislative history in determining congressional intent." (emphasis added) (citations omitted).

232 F.3d at 776.

[33] The plain meaning rule is nothing more than a rule of statutory construction that provides that the starting point for divining Congressional intent is the language employed by Congress in the statute. *Boston Sand & Gravel Co. v. United States*, 278 U.S. 41, 48 (1928).

[34] That is not to say that the legislative history of a statutory provision should be used to create ambiguity where none exists. Rather, the legislative history should be examined in order to insure that the statutory language being interpreted is indeed clear. *See, United States v. American Trucking Associations, Inc.*, 310 U.S. 534, 543-544 (1940) ("When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no 'rule of law' which forbids its use, however clear the words may appear on 'superficial examination.'")

[35] In *Watt v. Alaska*, 451 U.S. 259, 266 (1981), citing, *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459 (1892) and *United States v. Ryan*, 284 U.S. 167, 175 (1931), the Supreme Court stated that "[t]he circumstances of enactment of particular legislation may persuade a court that Congress did not intend words of common meaning to have their literal effect."

[36] The Supreme Court in *Watt* stated "we decline to read the statutes as being in irreconcilable conflict without seeking to ascertain the actual intent of Congress." 451 U.S. at 266

[37] 232 F.3d at 779

[38] *See, Public Citizen v. United States*, 491 U.S. 440, 454 (1989) ("Where the literal reading of a statutory term would 'compel an odd result,' we must search for other evidence of congressional intent to lend the term its proper scope."). What makes the 10th Circuit's strict reliance on the plain meaning rule even more remarkable is its acknowledgement that where the application of the literal language of the statute produces an irrational result strict adherence to the plain meaning rule is inappropriate. 232 F.3d at 776

[39] There can be little doubt that the granting of a windfall constitutes an "odd result."

[40] It should be noted that the Tax Court also rejected the Service's argument that this section was not intended to apply where a closely held C corporation converted to an S corporation. 110 T.C. at 57. That is, however, a far cry from saying that Congress intended the result reached by the 10th Circuit.

[41] The legislative history of section 469(f)(2) provides clear evidence of Congressional concern with the potential for tax avoidance where a C corporation that was a closely held C corporation no longer falls within the purview of section 469(a)(2)(B). Congress stated, "[a] corporation which is not closely held is less susceptible to treatment as the alter ego of its shareholders, but competing considerations also apply. So as not to

encourage tax-motivated transactions involving free transferability of losses, the suspended passive losses are not made more broadly applicable (i.e., against portfolio income) by the change in ownership, but continue to be applicable against all income other than portfolio income of the corporation." S. Rept. 99-313.

[42] *See, e.g., Morton v. Mancari,* 417 U.S. 535, 551 (1974) (Courts should give effect to each statutory provision, if doing so preserves their intent and purpose.)

[43] 110 T.C. at 51. SCI also maintained that if it were not able to use the PALs in the year of disposition, they would lose the right to use the PALs forever. *See*, discussion at 10-11, *infra.*

[44] 110 T.C. at 49-50

[45] The Tax Court offered that "[t]he legislative history of section 1371(b) supports a broad interpretation in that the prohibition reflected in this provision appears in similar terms and follows a list of specific examples of passthrough items. Although section 469(b) does not use the term 'carryforward', we think the phrase 'shall be treated as a deduction * * * allocable to such activity in the next taxable year' has the same meaning." 110 T.C. at 52. The Tax Court found additional support for its view in the language of both the Senate Finance Committee report and the Conference Committee report, noting that both indicated that suspended PALs were to be "carried forward" indefinitely. 110 T.C. at 52

[46] *See*, Sohng, *Suspended Passive Activity Losses Not Deductible Upon a C to S Conversion: St. Charles Investment Co. v. Commissioner,* 52 TAX LAW. 217 (1998), wherein the author found the Tax Court's reliance upon the "carried forward" and "carried to" language of the legislative history to have the effect of "tainting any term incorporating the root 'carry' as constituting a prohibited 'carryforward' or 'carryback' under section 1371(b).

[47] The similarity of the language used by Congress, and the fact that they are employed in a similar context would indicate that they should be applied in a similar manner. *Cf.*, *Merrill v. Fahs*, 324 U.S. 308, 311 (1945).

[48] 110 T.C. at 59. *See, also*, Kalinka, *St. Charles Investment Co. and the Carryover of PALs From C to S Years,* 90 TAX NOTES 1849 (March 26, 2001), wherein the author observed that the principal distinction between PALs and net operating losses is that PALs are computed separately for a given activity, while a net operating loss can be comprised of losses from more than one business.

[49] *Compare,* section 172(b)(1)(A) with section 469(b).

[50] 110 T.C. at 51

[51] 110 T.C. at 52-53

[52] 110 T.C. at 53-54. *See, also*, Treas. Reg. §1.446-1(a)(1), which states "These methods of accounting for special items include the accounting treatment prescribed for ... net operating losses, etc." Section 1371(b) clearly precludes the carryover of net operating losses arising in C corporation years to S corporation years. Assuming that section 469 does represent a method of accounting, like all other methods of accounting, it would be subject to the "clear reflection of income" requirement. Treas. Reg. §1.446-1(a)(2) states that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." This requirement not only applies to an overall method of accounting, but also to the method of accounting used for specific items as well. *See, e.g., Burck v. Commissioner*, 63 T.C. 556, 561 (1975), *aff'd*, 533 F.2d 768 (1976). SCI's argument suggests that Congress, without any indication to that effect, intended for section 469 to produce a result contrary to the generally accepted historical rule that a taxpayer's deductions must clearly reflect income by permitting its shareholders to deduct losses incurred while it was a C corporation.

[53] 110 T.C. at 56, quoting, *Vimar Seguros Y. Reaseguros, S.A. v. M/V Sky Reefer*, 515 U.S. 528, 533 (1995), and citing, *DeSalvo v. IRS*, 861 F.2d 1217, 1219 (10th Cir. 1988).

[54] *See, also*, Kalinka, 90 TAX NOTES 1849

[55] 232 F.3d at 777 ("Under our accepted rules of statutory construction, we hold that the "except as otherwise provided in this section" language of §469(b) prevents the application of un-enumerated exceptions to the general rule of the statute. Because §1371's restrictions on carryforwards from a C year to an S year are not enumerated in §469, they have no effect on the operation of §469(b), and St. Charles's suspended PALs from the years 1988-1990 are deductible in the year 1991 subject only to §469 itself.")

[56] The Tax Court acknowledged that section 1374 could permit the use of the pre-S corporation PALs in situations where a taxpayer disposed of pre-S corporation passive activities and recognized a gain on that disposition. 110 T.C. at 53, n.5.

[57] *Compare*, 232 F.3d at 778 ("Section 469(g)(1)(A), by its own language, does not take effect until *after* the application of § 469(b). This is the key point."); 110 T.C at 57 ("In our view, a precondition to the applicability of the of the parenthetical language in section 469(g)(1)(A) is that the suspended PAL's be available under section 469(b).")

[58] Regardless of whether the Tax Court's analysis is correct, or whether the 10th Circuit's analysis is correct, it is clear that the PALs will be preserved so long as there is no disposition of the activity that gave rise to them.

[59] The term "excess PALs" refers to that amount determined in accordance with provisions of section 469(g)(1)(A).

[60] *See*, Sohng, 52 TAX LAW. 217

[61] *Amorient v. Commissioner,* 103 T.C.161, 167 (1994) ("the net operating loss, although unavailable as a deduction in fiscal year 1980, is kept in suspense until a year in which APD can use it as a C corporation")

[62] It is apparent that the 10th Circuit did not grasp this point when it stated "If the Commissioner concedes that Congress contemplated in §469 that a taxpayer's suspended PALs can be 'repeatedly carried over for successive years without limitation' then §1371(b)(1) cannot prevent the carryover." 232 F.3d at 777.

[63] 110 T.C. at 59

[64] 110 T.C. at 57. ("Our previous analysis indicates that section 1371(b) makes the PAL's unavailable in the year at issue and therefore precludes the application of section 469(b) and consequently section 469(g)(1)(A).")

[65] There is no need to answer this question under the 10th Circuit's analysis since it views section 469(b) as not permitting any intrusion into the workings of section 469.

[66] For example, the basis rules of section 1015 (dealing the basis of property to a donee following the receipt of a gift) have the effect of denying both the donor and the donee the benefit of losses that accrued before the gift is made. Also, section 267 operates to not only deny a loss when property is sold to a related party, but also to generally saddle the related party with a basis equal to his cost. With certain exceptions, the effect of section 267 is to deny both the original seller, and the related party the tax benefit associated with the pre-sale decline in value.

[67] 110 T.C. at 56

[68] Recall that the 10th Circuit views section 469(b) as permitting the deduction of suspended PALs in the next taxable year.

[69] This analysis is complicated by the fact that ABC's loss of closely held C corporation status (as a result of the subchapter S election) would appear to cause activity X to be viewed as a "former passive activity." *See,* section 469(f)(3). This would permit an argument that ABC could offset its net active income while in S corporation status with the PAL from activity X because of the interaction of section 469(f)(2) and section 469(e)(2). However, activity X, while conducted by ABC while it is an S corporation, should still constitute a passive activity, since the shareholders of ABC are themselves subject to the PAL rules with respect to activities X and Z.

[70] The Tax Court's opinion would have resulted in ABC passing through to its shareholders passive activity income in the amount of $135,000 ($60,000 income of income from activity X + $75,000 of income from activity Z). The difference represents the $240,000 of C corporation PALs that the Tax Court would not have allowed into the S corporation taxable year.

[71] Assume that the fair market values and adjusted basis of activities X and Z and the corporation's portfolio assets are as follows:

Activity	Fair Market Value	Adjusted Basis	Gain(Loss)
X	165,000	123,000	42,000
Z	160,000	100,000	60,000
Portfolio Assets	45,000	27,000	18,000

The gain on the sale of the ABC stock would be allocated to passive activities X and Z, and the portfolio assets, based upon the relationship that the gain for each activity (including the portfolio assets) bears to the total gains from all activities (including the portfolio assets). Had ABC disposed of each of the activities, A share of the gain (1/3) on a disposition by ABC of passive activities X and Z and the portfolio assets would be equal to $14,000, $20,000 and $6,000, respectively. His $30,000 gain on the sale of his ABC stock to be apportioned to each activity based upon the following formula:

$$\text{Gain on Sale of Stock} \quad x \quad \frac{\text{Gain On Each Activity}}{\text{Total Gain From All Activities Producing Gains}}$$

The application of this formula results in the allocation of $10,500 of gain to activity X, $15,000 of gain to activity Y and $4,500 to the portfolio assets. *See*, Treas. Reg. §1.469-2T(e)(3)(ii).

[72] Treas. Reg. §1.469-2T(3)(i)

[73] It is unclear whether A would receive the benefit of the full $35,000 if he sold his stock before December 31, 2002. Generally, losses passed through to S corporation shareholders must be apportioned both on the basis of the percentage of stock ownership and length time within a particular year that the stock is owned. Treas. Reg. §1.1377-1(a). However, it is arguable that the application of section 469(b) might cause the PAL to be treated as arising on the first day of the year, with the possibility that it would then not be subject to the apportionment rules. Apportionment would appear to be the better approach.

[74] Section 469(g)(1)(A)

[75] *See*, note 73, *supra*. The amount apportioned to N would be computed in the same manner as the amount apportioned to A. Together the loss apportioned to A and N should be equal to $35,000. Query, what the amount of PAL from activity X apportioned to shareholders B, C and N would be in the year 2003? Since section 469(b) is viewed by the 10th Circuit as creating a new deduction each year from activity X, and ABC has not disposed of that activity, would N be entitled to one-third of the remaining loss? What would be the amount of that remaining loss?

[76] If the PALs at issue had been depreciation driven paper losses, gain would have been recognized on the disposition of the properties, and the PALs would have been used to offset that gain.

[77] *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988)

TAX COURT SCRUTINIZES ALLOCATION OF PURCHASE PRICE ON SALE OF BUSINESS ASSETS *

by
Martin H. Zern **

I. INTRODUCTION

Corporations are divided into two fundamental categories for income tax purposes. The basic corporation under our federal tax structure is known as a "C" corporation.[1] Its taxable income is subject to a graduated tax rate structure. If the corporation's profits and gains were then distributed, they would again be subject to tax at the shareholder level as a dividend. Therefore, the tax paradigm applicable to a "C" corporation is double taxation of profits and gains: first to the corporation and, as reduced by the corporate level tax paid, once again to the shareholders upon a distribution to them. As noted hereafter, although a liquidating distribution made by a corporation generally would not be a dividend, a second tier of taxation would nevertheless arise with respect to any shareholder who realizes a gain on the liquidation.

The other category of corporation is known an "S" corporation,[2] which if certain requirements are met is an optional elective status.[3] With a couple of minor exceptions not relevant to this paper, an "S" corporation is subject to a single tax regimen.[4] An "S" corporation is commonly referred to as a flow-through entity in that its income and deductions – retaining their categorization where necessary to determine the correct tax liability of any shareholder – flow through to the shareholders of the corporation who must include these items on their individual tax returns. Thus, there is only one level of tax, and that is at the shareholder level.

If a "C" corporation sells all of its tangible assets for a price exceeding their fair market value, the excess price paid is commonly referred to as goodwill and/or going concern value. Since the selling corporation generally has no tax basis for this intangible value, the amount allocated to goodwill and/or going concern value results in corporate level gain with respect to these items with consequent corporate level tax. As mentioned above, if the corporation is then liquidated, there is the potential for a second level of tax to any shareholder who has a gain on the liquidation, which would be the difference between the amount distributed in liquidation (cash and/or the fair market value of any property distributed) and the tax basis to the shareholder of his/her stock.

In order to avoid the foregoing type of double taxation scenario, taxpayers have an incentive to avoid payment to the corporation for its intangible assets of goodwill and/or going concern value. Rather, they may try to circumvent the corporation by entering into a covenant-not-to-compete and/or a consulting agreement directly with the shareholder or shareholders of the corporation. Consequently, the amount that would otherwise be paid to the corporation for its intangible value is paid directly to the shareholder or shareholders thereby shortchanging the corporation. If this maneuver is successful, to the

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extent funds are diverted from the corporation to a shareholder, there will be only a tax on the amount paid to the shareholder and the corporate level tax will be circumvented. This type of *planning* is quite often attempted with closely held corporations. However, as a recent Tax Court decision that will be discussed in this article cautions, the economic reality of the situation will be controlling. Allocations that are arbitrary or unrealistic, based upon the particular facts and circumstances, could result in a controversy with the Internal Revenue Service ("IRS"), and ultimately will not be upheld by the courts.

A related issue deals with costs of the transaction that are correctly the obligation of a shareholder but are paid by the corporation. The recent Tax Court decision also analyzes this situation.

II. ALLOCATION RULES

A. *Statutory Background.*

Section §1060 of the Internal Revenue Code ("I.R.C.") sets forth allocation rules for certain asset acquisitions. The section is applicable to an "applicable asset acquisition," defined in substance as a transfer of assets which constitutes a trade or business and where the tax basis of the assets in the hands of the transferee is determined by reference to the consideration paid for the assets.[5] In other words, a taxable acquisition as contrasted with a non-taxable acquisition like a merger.[6]

Where there is such an acquisition, then for purposes of determining both the transferee's basis for the assets acquired and the gain or loss to the transferor, the consideration received for the assets must be allocated pursuant to regulations prescribed by the Treasury Department.[7]

I.R.C. §1060 goes on to provide that an allocation of the purchase price among the assets acquired, or as to the fair market value of any asset, that is agreed upon between the transferor and transferor in writing shall be binding upon them, *unless the IRS determines that the allocation (or fair market value) is inappropriate*.[8] This provision is generally a one-way street as far as the parties to the transaction are concerned. Once they agree to an allocation in the sales agreement, they cannot at some later date attempt to refute their own allocation if they subsequently discern that they should have made the allocation differently and more tax favorably. The only possible exception is where a party wishing to challenge an allocation in an agreement, as construed by the IRS, offers proof that would be admissible in an action between the parties to alter the construction of the agreement or show its unenforceability due to mistake, undue influence, fraud, duress, etc.[9] With respect to the IRS, however, the italicized phrase above emphasizes that it is not bound by an allocation agreed upon by the parties to the transaction that lacks economic reality.

I.R.C. §1060 further provides for regulations to be promulgated requiring the parties to submit information concerning the amount of the purchase price to be allocated to certain intangibles under I.R.C. §197 – discussed later in this paper -- any modifications thereto, and any other information concerning the assets transferred that the IRS may deem necessary.[10]

Finally, I.R.C. §1060 requires information to be submitted to the IRS, in accordance with regulations, concerning certain collateral agreements entered into with a person who is a "10-percent" owner of an entity and who transfers an interest in the entity. The information is to be supplied where such owner (or a related person) enters into an employment contract, covenant-not-to-compete, royalty or lease agreement, or other agreement with the transferee.[11]

B. *Regulatory Guidance*.

The regulations under I.R.C §1060 provide that for purposes of determining the amount realized by the seller for each of the assets sold, the seller must allocate the consideration received to all the assets sold in accordance with a methodology called the "residual method."[12]

Under the residual method, assets are divided into seven possible classes:

Class	Description
I	Cash and general deposit accounts (including savings and checking).
II	Actively traded personal property, such as U.S government securities and publicly traded stock.[13]
III	Assets marked to market at least annually (including accounts receivable).
IV	Inventory or property held primarily for sale.
V	All assets other than assets falling into Classes I through VII. An example given in the regulations is an investment in a subsidiary corporation.
VI	All assets described in I.R.C §197, other than goodwill and going concern value.[14]
VII	Goodwill and going concern value.

A lump sum purchase price is first allocated to Class I assets. The amount of the purchase price after being reduced by the amount allocated to Class I assets is then allocated among the remaining assets. The next allocation would be to class II assets in proportion to the fair market values of such class II assets, then among Class III assets in such proportion, and so on. If an asset falls into more than one class, it is included in such class with the lower number (e.g., Class III is a lower number than Class IV).

The key to this method is *fair market value*, which is obviously something that reasonable persons can disagree about. But even if the parties to the transaction are in accord with the allocation of the purchase price, there is another interested party, and that is the IRS. It could assert that the allocation to which the parties agree lacks economic substance in that it was not based upon true fair market value, and should be done in a less tax favorable manner. If the IRS is upheld in re-allocating the purchase price, the end result, of course, will be additional tax due.

III. TAX COURT ANALYSIS

The Tax Court, in a recent memorandum decision (filed October, 2001), had occasion to delve into the foregoing issues in *Bemidji Distribution Co., Inc. v. Commissioner*.[15]

A. *Salient Facts.*

Bemidji Distribution Co. ("BDC"), a beer distributor, sold its assets to Bravo Beverage, Ltd. ("Bravo") in 1992 for $2,017,461. Cortland V. Langdon ("Mr. Langdon") wholly owned BDC and was also the president of the company. The purchase agreement between BDC, Bravo and Mr. Langdon allocated $1 million of the $2,017,461 to a 5-year covenant-not-to-compete on the part of Mr. Langdon and $200,000 to a consulting agreement with him. No part of the purchase price was allocated to intangible assets of the corporation, such as goodwill, going concern value or exclusive distributorship rights with two major brewing companies.

BDC was the largest wholesale beer distributorship in northern Minnesota enjoying 53% of the sales in its geographic market by 1990. Mr. Langdon's father originally founded the company back in 1943. Ultimately, Mr. Langdon became the owner and operated the business for 46 years until the sale to Bravo. BDC operated in a number of counties in northern Minnesota. Over the years, Mr. Langdon got to know many of his customers personally and counted some as personal friends, but there was a large turnover of other customers because tavern owners tended to turn over their businesses. Mr. Langdon worked every day and was actively involved in managing all aspects of the business.

By early 1990, Mr. Langdon began to consider selling BDC. He and his wife were 69 and 68 years of age, respectively, although both were in good health. However, he was somewhat ambivalent about selling and consistently expanded the business, or at least made efforts to do so right up to the time of its sale. However, Mr. Langdon had no sons and didn't want to pass the business on to his daughters. Additionally, there was a forthcoming difficult labor contract to negotiate with the Teamsters Union. Accordingly, Mr. Langdon contacted Pohle Partners ("Pohle"), a company specializing in appraising and brokering wholesale beer distributorships to discuss a possible sale. If a sale were to be consummated, Pohle was to get a specified percentage of the total sales price, including any amounts paid for a covenant-not-to-compete and consulting agreement. Pohle appraised the company and put together an information package showing the estimated price of the various assets:

Asset	Price
Accounts Receivable (1)	$ 60,000
Inventories (1)	300,000
Equipment (1)	105,000
Warehouse and Land	300,000
Intangibles (2)	1,200,000
Total	$1,965,000

Notes: (1) Estimates with actual amounts to be determined at closing.
(2) Amount to be allocated among customer lists, franchise rights, goodwill, etc., and agreements with owner.

A deal was ultimately struck with Bravo and, as noted, the purchase price that was negotiated came to $2,017,461. In the negotiations, the principals of Bravo insisted on both a consulting contract and a strong covenant-not-to-compete. Since $1,200,000 was allocated to these items, only $817,461 was allocated to BDC's tangible operating assets. In fact, the purchase agreement specifically provided for no allocation to BDC's intangible assets, such as goodwill, going concern value or exclusive distribution rights. Actually, Mr. Langdon did not negotiate with Bravo over the allocations and accepted its proposal that the full value for the intangibles be allocated to the consulting agreement and the covenant.[16]

B. *IRS Deficiency.*

A notice of deficiency issued to BDC for 1992 determined that BDC failed to report $1.2 million of income received from Bravo. As an alternative, the IRS asserted that, if the allocation should be upheld, the selling expenses incurred by BDC were improperly allocated and that some of the expenses should be allocated to the consulting agreement and covenant to the extent of 59.48%. Consistent with this alternative, the IRS issued a notice of deficiency to Mr. Langdon determining that this percentage of the selling expenses was a constructive dividend to him. Shortly before trial, the IRS conceded that the consulting agreement was in fact worth $200,000, but that the covenant had a value of only $121,000. Consequently, the IRS was claiming that $879,000 of income ($1,000,000 - $121,000) had been wrongfully diverted from the corporation and should be taxed to it.

C. *Tax Court's Analysis.*

The first issue considered by the Tax Court was the fair market value of the covenant-not-to-compete. As detailed above, under the residual method of allocation, after allocation of the purchase price is made to the tangible assets based upon fair market value, the balance of the purchase price, if any, is allocated to goodwill, going concern value and other claimed intangibles of value. In the instant case, the allocation that was made in effect claimed that the goodwill and going concern value had no fair market value whatsoever.

1. *The Stakes.*

The Court pointed out that the amount properly allocable to the corporation for its intangibles would be taxable to it as a capital gain, and when distributed to Mr. Langdon, would be treated as a non-deductible dividend and again taxed to him.[17] On the other hand, the amount allocated to the covenant-not-to-compete would be taxed only to Mr. Langdon and would thus escape the corporate level tax. As a result, such amount would escape the double tax regimen applicable to corporations. The same would be true for the amount allocated to the consulting agreement. The Court noted that the Bravo's interests were *not adverse* to the allocation since it could amortize the covenant-not-to-compete over its 5-year term.[18] Moreover, the amounts paid under the consulting agreement would be deductible as and when paid.

2. *Legislative History.*

The Court first emphasized the language contained in I.R.C. §1060, which provides for the parties to a transaction to be bound by an allocation to which they agree in writing "unless the Secretary determines that such allocation (or fair market value) is not appropriate."[19] The legislative history concerning the foregoing essentially states that the IRS should not be restricted "to challenge the taxpayers' determination of the fair market value of any asset by any appropriate method, particularly where there is a lack of adverse tax interests between the parties."[20] As noted, the Court had concluded that there was a lack of adverse tax interests between the parties. Accordingly, it observed that it should strictly scrutinize the allocation since "adverse tax consequences deter allocations which lack economic reality."[21]

3. *Applicable Tests.*

The Tax Court remarked that where the IRS challenges a contractual allocation, such as the one at hand, the courts have applied two tests. One test is the business reality test, which revolves around what reasonable persons might bargain for considering their economic future. The other test simply is a consideration of whether the allocation is unrealistic.[22] Although the Court mentioned two tests, it was not clear which one it was applying, perhaps because the factors to be considered under either one of them are essentially the same.

4. *Relevant Factors.*

Valuation controversies are frequently before the courts and are difficult to resolve since the particular facts and circumstances must be considered in detail, and expert testimony is generally necessary. However, case law has spelled out the relevant circumstances that must be considered in evaluating a covenant-not-to-compete. These include: (a) the ability of the seller to compete, (b) the seller's intent to compete, (c) the seller's economic resources, (d) the potential damage to the buyer posed by the seller's competition, (e) the seller's expertise in the industry, (f) the seller's contacts and relationships with customers, suppliers and others in the business, (g) the buyer's intent in eliminating competition, (h) the duration and scope of the covenant, and (i) the seller's intention to remain in the same geographic area.[23]

The taxpayer did not offer an expert witness at trial, but relied upon the above factors and testimony to sustain the allocation. The IRS, however, did not discuss the factors either in its brief or at trial. Rather, it relied upon an expert witness to establish the value of the covenant-not-to-compete.

The Court ultimately concluded that all of the factors, with one possible exception, favored a substantial allocation to the covenant. The Court's conclusion was reached after a quite detailed and extensive review of the facts as applicable to each of the foregoing factors. More specifically, the Court's findings may be summarized as follows:

(a) Ability to Compete. Mr. Langdon was found to have the ability to compete. Neither his health nor age was an impediment. Up until the sale, he was working hard and expanding the business.

(b) Intent to Compete. Although at the time of the sale, Mr. Langdon did not intend to compete, the Court pointed out that he could have changed his mind. The consulting agreement could be abrogated or he could have been terminated for cause. His main reason for selling was the forthcoming union negotiations, but since other distributorships were not unionized, this factor would not have prevented him from re-entering the business. Despite his apparent intention at the time of sale not to compete, the Court found that overall this factor favored the IRS, but only slightly.

(c) Economic Resources. It was abundantly clear that Mr. Langdon had substantial economic resources to start a competing business.

(d) Potential Damage to Buyer. The Court found that there would be substantial economic harm to Bravo if Mr. Langdon decided to compete. He had long-standing personal relationships with many customers. On the other hand, many customers would most likely continue to purchase from Bravo since it was acquiring some exclusive distributorships. Another aspect of possible harm to the buyer was the possibly of Mr. Langdon attracting some former valuable employees if he decided to compete. Overall, the Court found that he would be able to divert one-third of the business away from Bravo if he competed.

(e) Business Expertise. Mr. Langdon's expertise could not be doubted since he had been in the beer distribution business for 46 years.

(f) Relationships with Customers, Suppliers and Others. Due to Mr. Langdon's long-standing relationships with customer and suppliers, it was reasonable to assume that they would be loyal to him if he decided to compete.

(g) Buyer's Interest in Eliminating Competition. Bravo was found to have had a clear-cut interest in eliminating competition from the start of the negotiations and had always insisted on a strong covenant-not-to-compete.

(h) Duration and Geographic Scope of the Covenant. Five years was determined to be a reasonable length of time to extend the covenant since Mr. Langdon would have been 76 years old by then. The geographic scope of the covenant was also found to be reasonable.

(i) Seller's Intention to Remain in Same Geographic Area. Mr. Langdon had lived in the area all his life and the Court found he intended to remain there; in fact, he was living in his same hometown at the time of trial.

5. *The IRS Expert.*

The Court observed that expert testimony is often used to "help the Court understand an area requiring specialized training, knowledge or judgment."[24] However, the Court also pointed out that it "may be selective in deciding what part of an expert's testimony we accept."[25]

In the instant case, the expert was employed as a general and industrial engineer by the IRS and had valued closely held businesses and various types of tangible and intangible property. His credentials were a B.S. in industrial engineering and an M.B.A. with a major in finance. However, only 20% of his job involved doing valuations, and he was not certified by any professional organization. He had never valued a beer distributorship, although he had valued a covenant-not-to compete in other businesses over the past five years on three occasions.

The IRS expert valued the covenant-not-to-compete at only $121,000. The Court then delved in considerable detail into the various assumptions used by the expert and concluded they were of "dubious validity." For instance, among other items, the Court questioned the growth rate percentage he utilized, the discounts he used for loss of potential business, the percentages he used for the likelihood of Mr. Langdon re-entering the business in succeeding years, the personal reasons he took into account for Mr. Langdon not re-entering the business, and numerous other assumptions.[26]

6. *Court's Conclusion.*

Although the Court determined that a substantial allocation should be made to the covenant-not-to compete, it agreed with the IRS that the $1 million allocation made by the parties to the deal was not the result of arm's-length bargaining, and that in agreeing to the allocation the parties did not have competing tax interests. The Court determined that the parties were well aware of the favorable tax consequences of the allocation, and that it was unreasonable to allocate nothing to goodwill and going concern value, including the value of the exclusive distributorships.[27]

The Court pointed out that there is frequently an overlap between goodwill and going concern value. It then reviewed some definitions of the terms. In sum, it stated that goodwill is the expectation of continued customer patronage resulting in excess earning capacity, and that going concern value is additional value arising by virtue of mere existence as a going concern.[28] In the instant case, Bravo was purchasing a distributorship that had been in business many years with a workforce in place and no startup expenses. It also acquired all the real estate and personal property of the business, customer lists and exclusive brand and distributorship rights. With all this in mind, the Court concluded that substantial goodwill and going-concern value was transferred by BDC.[29]

On the other hand, the Court rejected the IRS determination and its expert's testimony that the covenant was worth only $121,000 as "unrealistically low" and "built upon faulty assumptions." Accordingly, it decided to use its "best judgment," based on the record of the case.[30] Looking at certain information contained in the record, the Court concluded that if Mr. Langdon competed, he might divert upwards of one-third of Bravo's business, taking into consideration that certain exclusive distributorships had been sold. Considering projected profits that might be lost over the next five years if Mr. Langdon competed, the Court came to the conclusion that the covenant was worth $334,000 and that the remaining $666,000 of the $1,000,000 in issue should have been allocated to goodwill, going concern value or other intangibles.[31]

6. *Constructive Dividend Issue.*

A shareholder in a corporation realizes ordinary income in the form of a dividend when there is a distribution by the corporation with respect to the shareholder's stock interest of money or other property (to the extent of fair market value in the case of property) out of the corporation's earnings and profits.[32] The most common type of dividend results from an actual cash distribution intended as a dividend payout. However, some transactions that facially in form do not appear to constitute a dividend nevertheless are held to be dividends in substance, in whole or in part, under the *constructive dividend* doctrine. This doctrine might arise in a number of contexts, some examples of which are: (1) payment of personal expenses or debts of a shareholder by the corporation, (2) loans to a shareholder where there is no intention of repayment, (3) excess salary payments, (4) personal use of corporate assets with no or inadequate compensation or rent for such use, (5) sale by a shareholder to the corporation at an inflated price, (6) bargain purchase by the shareholder of corporate assets, (7) rental of property by a shareholder to the corporation at an inflated rental price.

Basically, the constructive dividend problem arises where a corporation bestows an economic benefit to a shareholder in an indirect manner. The problem usually crops up in the context of a closely held corporation where the controlling shareholders, officers and directors are one and the same. The controlling shareholders are attempting to *bail out* corporate earnings in manner that would be either tax deductible to the corporation or that would not be ordinary dividend income to the shareholders.

The constructive dividend issue that arose in *Bemidji* was whether the corporation paid personal expenses of the shareholder, Mr. Langdon. BDC had incurred and paid $107,815 for expenses related to the sale of its assets, which it took as a tax deduction. The IRS asserted that a pro rata portion of this amount, specifically $60,581, related to Mr. Langdon's consulting agreement and covenant-not-to-compete, which were personal to him. Consequently, the payment of this personal obligation by the corporation was a constructive dividend to Mr. Langdon and collaterally was not deductible by the corporation.

The Court observed that "[i]n determining whether an expenditure by a corporation represents a constructive dividend to the shareholder, it is also necessary to decide whether the expenditure primarily benefited the shareholder personally rather than furthered the interest of the corporation."[33] In essence, the Court noted that the corporation had to strongly show that it *primarily* benefited from the payment of the shareholder's expense in order to avoid constructive dividend treatment.[34]

In the instant case, the Court found that BDC did not require Mr. Langdon to pay his pro rata share. Based upon a determination that Mr. Langdon received $200,000 for the consulting agreement and $334,000 for the covenant-not-to-compete, or a total of $534,000 of the $2,017,461 total purchase price, the Court held that a pro rata share of the selling expenses was a constructive dividend to Mr. Langdon taxable to him and not deductible by BDC.

IV. CURRENT RULES ON AMORTIZATION OF INTANGIBLES

Because purchased goodwill and going concern value historically could not be amortized, taxpayers came up with creative ways to allocate the purchase price of the assets of a business away from goodwill and going concern value. For example, taxpayers would claim that they were acquiring such assets as a trained workforce, an information base, know-how, customer lists, suppliers, contracts of key employees, or similar intangible items. They then argued that each of these items had a determinable life and could be amortized. The IRS, on the other hand, asserted that these were all elements of goodwill or going concern value and not amortizable. Case law in the area was not consistent and the area was one of considerable uncertainty. The result was extensive litigation and a large and growing backlog of cases,[35] especially in the case of attempts to amortize customer or subscriber lists.[36] In order to provide for some certainty in this area and avoid further litigation, Congress enacted I.R.C. §197 in 1993.[37]

A detailed analysis of I.R.C. §197 is beyond the scope of this paper.[38] But basically, the section allows an amortization deduction with respect to the capitalized cost of any amortizable §197 intangible over a term of fifteen years. The term "amortizable §197 intangible" means any intangible acquired and held by a taxpayer in connection with the conduct of a trade or business or an activity describe in I.R.C. §212.[39] Consequently the section is applicable whether the intangible is acquired separately or as part of the acquisition of assets of a trade or business. It may be noted that the section is inapplicable to self-created intangibles (with some exceptions) provided such intangible is not created in connection with a transaction (or series of related transactions) that involve the acquisition of the assets of a trade or business.[40] Thus, the section does not affect the current deductibility of expenses that create intangible value (e.g. expenses for advertising, employee training, customer relations, creation of data base information systems, creation of know how, etc.). However, if the intangible is created ancillary to the acquisition of the assets of a trade or business, then IRC §197 is applicable and such created intangible would have to be amortized over fifteen years. *An example of an ancillary intangible is a covenant-not-to-compete which is created concurrent with and incident to an asset acquisition.* Thus, despite the fact that the covenant may run for only a few years, it will nevertheless have to be amortized over fifteen years. It is important to recognize that IRC §197 is *exclusive*. Accordingly, taxpayers may fare worse under the new law since no depreciation or amortization is permitted for amortizable §197 intangibles except as permitted by the section.[41]

V. CONCLUSION

The sale of business assets is a frequent occurrence that arises in a variety of situations ranging from a liquidating or bankruptcy sale to the sale of an established and profitable business, as in *Bemidji*. As can be seen, the allocation of the purchase price among the assets being sold has significant tax consequences to both parties. The IRS unfortunately, or perhaps fortunately depending on one's viewpoint, audits relatively few returns. Accordingly, many taxpayers are willing to gamble and engage in tax planning that basically amounts to nothing more than audit roulette, or *I'll take my chances*. In the writer's opinion, the *Bemidji* case is an egregious example of betting that one won't get caught. The parties to the contract took it upon themselves to allocate *absolutely nothing* to the intangible assets of goodwill and going concern value of a clearly valuable, long-standing business. Did they really think they could get away with it? They were not naïve since the Court found as a matter of fact that they were well aware of the tax significance of the allocations. The only reasonable conclusion is that they were playing audit roulette. There was evidence introduced that Mr. Langdon simply acceded to the wishes of Bravo. However, why wouldn't he since the tax consequences were clearly favorable to him? Insofar as Bravo was concerned, paying a large amount for a covenant-not-to-compete was a better tax pick than paying for goodwill or going concern value. Under the law at the time, a covenant-not-to-compete could be amortized over its life, whereas goodwill and going concern value could not be amortized at all. As discussed, under current law, amortization of these items is now permitted, but the write off period is a fixed fifteen years even though the covenant may be for a lesser term. An important lesson of the case, however, is that when valuation is an issue, the courts will engage in a detailed factual analysis. Accordingly, when valuation issues arise there are no easy answers since the resolution will depend upon the facts and circumstances of the particular situation.

The *Bemidji* case, however, at least provides a roadmap to what factors are relevant in valuing a covenant-not-compete, and should give some guidance to practitioners who become involved in negotiating contracts for the sale of a business, or in dealing with the IRS when the issue arises.

Although expert witnesses frequently testify as to valuation, an important message is that the methodology and assumptions of the expert, and his/her specific experience in the area, must be well grounded. Otherwise, the court will ignore the testimony of the expert or discount his/her relevance. Often the law is clear enough – it's the facts that cause the difficulty. The bottom line, of course, is that the courts must come up with a number when valuation is at issue, but the ultimate number is often little more than speculative prognostication.

Finally, where the corporation pays the personal expenses of a shareholder, constructive dividend treatment may result with income to the shareholder and no corresponding deduction by the corporation, and with the imposition of penalties most likely. In an egregious case, however, adverse tax consequences may be the least of a taxpayer's problems. The IRS could proceed on criminal tax evasion grounds against the shareholder orchestrating the corporate payment of his/her personal expenses, and possibly others who facilitate such payment. A notorious example of this is the Leona Helmsley tax case that resulted in her going to prison on account of the payment of her personal expenses by the corporation she controlled.

ENDNOTES

[1] The acronym "C" refers to Subchapter C of the Internal Revenue Code ("I.R.C."). All references to "I.R.C." are to the Internal Revenue Code of 1986, as amended to date.
[2] The acronym "S" refers to Subchapter S of the I.R.C.
[3] In order for a corporation to qualify to make an "S" election it must be a "small business corporation" and not an "ineligible corporation." The specific requirements are set forth in I.R.C. §1361(b).
[4] Under certain circumstances, an "S" corporation may be subject to tax. In this regard, see I.R.C. §§ 1374 and 1375.

[5] A group of assets constitutes a trade or business if the use of such assets would constitute a trade or business under I.R.C. §355 (dealing with "spin offs" in general) or the character of the assets is such that goodwill or going concern value could under any circumstances attach to such group (Reg. §1.1060-1(b)(2) (2001)). All references to "Reg." are to Treasury Department Regulations interpreting the Internal Revenue Code of 1986, as amended to date.
[6] I.R.C. §1060(c). The section provides that an "applicable asset acquisition" includes a situation where part of the transfer is a tax-free exchange under I.R.C. §1031.
[7] I.R.C. §1060(a). Actually, the section states the allocation is to be made in the same manner as an asset acquisition under I.R.C. §338(b)(5). However, this section simply calls for an allocation to be made pursuant to regulations prescribed by the IRS.
[8] I.R.C. §1060(a).
[9] Commissioner v. Danielson, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967); Reg. § 1.1060-1(c)(4) (2001).
[10] I.R.C. §1060(b). The seller and purchaser must each file asset acquisition statements on Form 8594, "Asset Allocation Statement," with their income tax returns for the taxable year that includes the first date assets are sold pursuant to an applicable asset acquisition (Reg. § 1.1060-1(e) (2001)).
[11] I.R.C. §1060(c). A "10-percent" owner refers to any person who holds 10 percent or more, by value, of the interests in the entity just before the transfer (I.R.C. §1060(e)(2)(A)). The constructive ownership rules of I.R.C. §318 are made applicable in determining stock ownership (I.R.C. §1060(e)(2(B)). References to other code sections, I.R.C. §§ 267(b) and 707(b)(1), are cross referenced for purpose of determining who is a "related person" (I.R.C. § 1060(e)(3)).
[12] Reg. §1.1060-1(c)(2) (2001) referring to Regs. §§ 1.338-6 and 1.338-7 (2001). These latter regulations, which contain the details of the "residual method," provide guidance with respect to situations where stock in a corporation is acquired and a special election is made to treat the stock purchase as an asset acquisition (I.R.C. §338).
[13] Includes certificates of deposit and foreign currency even if not publicly traded (Reg. §1.338-6(b)(2)(ii)) (2001).
[14] I.R.C. §197 permits tax amortization of certain acquired intangibles over a 15-year period. Examples, apart from goodwill and going concern value, which are included as I.R.C §197 intangibles, are an information base, know-how, customer lists, suppliers, trained workforce, price paid for a contract for a key employee, licenses, permits, covenant-not-to-compete, franchises, trademarks, tradenames, or similar items.
[15] T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295 (2001).
[16] It may be noted that at the time of the transaction, tax amortization was not allowed for goodwill and going concern value, while the amount paid for a covenant-not-to-compete could be amortized over the term of the covenant. Of course, any amounts paid under the consulting agreement would be deductible by Bravo. Accordingly, the resulting allocation was tax favorable to Bravo. Now, I.R.C. §197 permits the amortization of intangibles such as goodwill and going concern value over 15 years.
[17] It may be noted that the intangibles had a zero tax basis, so that the amount properly allocable to them would be fully taxed to the corporation. Furthermore, there is no lower tax rate for corporate capital gains as there is for individuals.
[18] Under current law, the amount paid for a covenant-not-to-compete is classified as an I.R.C. §197 asset and must be amortized over 15 years regardless of the actual life of the covenant.
[19] I.R.C. §1060(a). This language was an amendment to the section and was added by the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990), Pub. L. 101-508, sec. 11323(a), 104 Stat. 1388, 1338-464, section 1060(a).
[20] H. Rept. 101-881, at 351 (1990).
[21] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *17 (2001), citing Wilkof v. Comm'r, 636 F.2d 1139 (6th Cir. 1981), affg. per curiam T.C. Memo 1978-496.
[22] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *17 (2001), citing Buffalo Tool & Die Manufacturing Co. v. Comm'r, 74 T.C. 446-448 (1980) (and cases cited therein).
[23] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *18 (2001), citing Lorvic Holdings v. Comm'r, T.C. Memo 1998-281 (1998) (and cases cited therein).

[24] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *23 (2001), citing Snyder v. Comm'r, 93 T.C. 529, 534 (1989).
[25] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *23,*24 (2001), citing Helvering v. Nat'l Grocery Co., 304 U.S. 282 (1938) (and other cases).
[26] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *24-28 (2001).
[27] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *28 (2001).
[28] *See* Reg. § 1.1060-1(b)(2)(ii) (2001) for an explication of the characteristics of goodwill vis-à-vis going concern value.
[29] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *31 (2001).
[30] *Id.* at *32
[31] *Id.* at *33.
[32] I.R.C. §§ 301 and 316. Earnings and profits is a technical term, the determination of which is beyond the scope of this paper. Basically, however, it is a calculated amount representing the economic income of the corporation as contrasted with taxable income. *See* I.R.C. § 312
[33] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *35 (2001), citing Hagaman v. Comm'r, 958 F.2d 684, 690-691 (6th Cir. 1992), affg. on this issue T.C. Memo 1987-549 (1987) (and other cases).
[34] Bemidji Distributing Co., Inc. v. Comm'r, T.C. Memo 2001-260, 2001 Tax Court Memo LEXIS 295, *35 (2001).
[35] In 1991, the General Accounting Office estimated that there were $8 billion in deficiencies asserted against taxpayers attempting to amortize intangibles (GGD-91-88, *"Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets, "* (8/9/91)). A later estimate upped the ante to $14.4 billion of asserted adjustments related to amortization of intangible that were either in the audit or litigation pipeline (*Tax Notes Today* (10/4/93)).
[36] For taxpayer wins in this area, *see, e.g.*, Houston Chronicle Publishing Co. v. U.S., 481 F2d 1240, 1249 (5th Cir. 1973), *cert. denied* 414 U.S. 1129 (1974) and Newark Morning Ledger Co. v. U.S., 945 F2d 555 (3rd Cir. 1991), *rev'd* 113 S.Ct. 1670 (1993).
[37] Pub. L. 103-66, Title XIII, Sec. 13261(a), 107 Stat. 540 (August 10, 1993).
[38] For a detailed analysis of I.R.C. §197, *see* Martin H. Zern, *New Tax Amortization Rules: Good News for Goodwill – Some Bad News*, Journal of Legal Studies in Business, Volume 4 (1996).
[39] I.R.C. §197(c).
[40] IRC §197(c)(2)(B). IRC §197 expands on the term " trade or business" to include a "substantial portion thereof."
[41] I.R.C. §197(b).

TEACHING MORE THAN THE SUBSTANCE OF A COURSE*

by

Peter M. Edelstein**

I. Introduction. After teaching commercial law courses for almost thirty years, when Pace University adopted a new course entitled *Contemporary Business Practices,* I took a chance at diversifying my repertoire.

The course, designed to be an interdisciplinary course to introduce freshmen and sophomores to the basic components of a business education, included areas from accounting, finance, management, marketing, economics and law. The objective was not only to expose them to the substance of these subjects, but to illustrate the interrelationships among them. The three-credit course was a required part of the business core with a prerequisite of one semester of course work (a minimum of 12 credits). I intended that my personal contribution would be to emphasize the importance and affect of the law on virtually all aspects of business.

The chapter headings[1] in the text gave me the feeling that I was going to be teaching a four year business curriculum in fifteen weeks. While it was easy to appreciate the logic, inevitability and intellectual reward of having an *offer,* followed by an *acceptance*, in the presence of *consideration*, result in a contract, it was difficult to image that my students would find any real satisfaction in having me scratch the surface of fifteen heavy-duty subjects in fifteen weeks. Sort of like being rushed through a buffet with only the chance to sniff the different items.

The volume of the material to be covered in the allotted one semester time period presented a real challenge. I suppose it would have been possible to schedule lecture coverage of one chapter a week and hope that the students were understanding and retaining something out of our time together. But these students had no meaningful college business background nor business experience. Everything about this course would be new to them. They could find no comfort in relating our material to or building upon something they had learned in earlier courses or life experiences.

It seemed that it would be unfair, difficult and unprofitable to fly through the material. I wanted to present the subject matter of the course in an interesting and perhaps even enjoyable format. I needed a plan.

** Professor of Law, Pace University, Lubin School of Business

[1] See Exhibit "A" for chapter headings.

II. The Objectives.

- Devise a methodology to get and keep the students interested in the subjects to be covered.
- Encourage their active and frequent participation in the teaching and learning process by providing the opportunity for open dialogue.
- Instill in them a desire to participate and learn.
- Avoid disincenting them by dull lectures or onerous assignments.
- Teach business communications skills while pretending not to.
- Introduce an element of real world business.
- Make it all fun.

III. The Plan. I thought I could achieve some or all of my objectives by creating competition among teams of students. The competition would include not only the quality of the substance of their assignments but also the quality of their communication skills.

To set up the teams, the class was divided into groups of four or five members each. The team members were selected randomly by going down the alphabetically arranged attendance list. By creating teams I hoped to achieve a simulation of a real world business environment in which the students could learn to communicate with each other and work in a cooperative fashion to achieve a defined goal within a specified time. The teams, themselves would then compete for grades for each assignment.

Approximately each week the class was given two types of assignments: first, they were to read and master assigned material in the text. Second, they were given a team project to be completed by all team members and then submitted.[2] Guidelines for the team project were distributed.[3]

I had observed over the years a decline in the quality of language skills. By requiring submission of approximately weekly written team assignments I hoped to teach the students to learn basic business communication techniques including how to write a literate memorandum and a business letter.

I prepared a total of seven related team assignments. They were progressively more sophisticated in order to keep the students engaged in a continuing competitive theme involving the creation of a profitable business venture.

The initial team assignments were somewhat broad to introduce the students to basic concepts, but by team assignment number four, they focused on a particular business venture. Last year the proposed business was a retail company that would apply long lasting (six months) temporary tattoos. This year it was a retail company that combined dog and cat grooming with obedience training at each session.

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[2] See Exhibit "B" for team projects.

[3] See Exhibit "C" for team guidelines.

The class sessions, which met twice a week for an hour and a half, developed a familiar format and rhythm. At class sessions when no team assignments were due, I would highlight the substance of the assigned material and take questions. At approximately every other class session the then current team assignment was due and team members were called upon to present their project which required some type of written business communication addressing the particular business situation assigned. This process involved each team member reading a portion of their project. Class members and I asked questions about the project and the team members were required to defend or explain their positions.

The students were given their next assignments sequentially after they made a presentation so they did not know in advance what the next assignment would be. They were told that each successive assignment would be based on cumulative facts from the earlier assignments.

The intention was that each team would complete the team assignments by a general process involving an initial group meeting in class for organizational purposes, followed by additional in or out-of-class meetings or e-mail or telephone communications to create the project. The details of the functioning of the teams was left to them. In some cases, one team member would draft the document for review by other team members; in others, each team member would draft initial documents that would then be crafted into a single document. The teams were instructed to collectively proofread and edit the draft before it was finalized and submitted.

My theory was that the team method of participation would be more interesting and stimulating than doing the assignments alone. I thought that working through the teams, would imitate a business environment in which a group, department, or team would be given an assignment forcing them to communicate, work together and achieve a goal in an efficient manner. To hone their verbal skills, the teams were required to speak to each other in the preparation of the assignment and to speak to the class on their presentation day. The process of drafting, editing and finalizing the written assignment would develop their written communication skills. The whole thing seemed like it should be fun.

IV. The Dynamics. Not surprisingly, as in business, there developed two distinctive patterns of recognizable behaviors: the relationships among the team members with each other, and the competitive relationship among the teams.

At the outset, I had some concerns: (i) how to select the members of the teams to achieve a balanced result. I did not want some teams made up of all brilliant, hard working, motivated students, and some teams to be devoid of these types of students, (ii) I wanted each team member to contribute, if not equally in effort, at least according to their best abilities. I wanted each member to pull his or her weight and not ride on the backs of the others.

To achieve balanced teams, because I could think of no other method, by default, I opted for the randomness of the alphabet. Randomness being what it is, at least one team turned out to have more than its share of very bright members. Another team, contained two athletes on the same team who both missed many classes and were not available to contribute to the team projects.

So I could learn about the effectiveness of the internal functioning of the teams, I devised a system of mandatory, confidential reporting to be submitted with each team project. At the time each project was due each team member was required to write me a letter advising on the functioning of his or her team for each project, including a description of their own and each other member's contributions. Even though I felt like a psychiatrist, the students' information enabled me to help motivate certain students, tame other overly controlling students, and generally have an insight into who was doing what.

Inter-team rivalries developed as each team strove to out-do the others. Some teams designed and developed logos and letterheads; some teams researched the Internet for truckloads of information. Not unlike business, the competitive spirit fostered by a free-market system flourished.

IV. The Results. After teaching for so many years, I thought nothing could surprise me. However, the quality of the team projects surprised me.

While all the team assignments required some real measure of effort by the students, the ultimate challenge was Team Assignment Number Seven. It was deceptively short and simple sounding, yet it invited the students to use unlimited imagination and in some cases, they responded with an absolutely shocking degree of skill and finesse.

> The assignment read, in part, as follows:
>
> "Assume you have taken all steps necessary to form your business. You now desire to obtain a commercial loan in the amount of $100,000 from your bank.
>
> Write a business letter to your bank requesting the loan. Include all information that bank might need or want to consider your request, including a Business Plan."

The results were most impressive. By the seventh assignment the students' business letters were generally in the proper form and had been checked for spelling and grammar. The quality of their writing skills were far superior to the first assignment. The accompanying Business Plans, however, were of such high quality, both in form and substance that they rivaled or even exceeded the quality of business plans that I have seen in the real world.

Each of the teams did sufficient research so their Business Plans typically covered the classic components: Summary of Business Proposal; Description of Company and Industry; Description of Products of Services, Market Information; Description of Management; Marketing Strategy; Design and Development Plans; Operations Plan; Schedule or Timetable; Risks and Foreseeable Problems; Financial Information; Exit Strategy. Some of the teams went far beyond. The coverage of each of these components universally showed great imagination, research, innovation and skill. Each Business Plan reflected the students' two-fold desires to disclose the information about their proposed business and to *sell* the concept of the project to the reader. All this from Freshman and Sophomores! I believe we attained our objectives. Small groups learned how to work together in a professional manner to achieve a goal. Students learned to communicate and interact with each other as individuals and as a group. Students learned to write a credible business communications. And some even learned the substance of the course.

Exhibit "A"

Part I

Conducting Business in the Global Economy

1. Understanding the Fundamentals of Business and Economics.
2. Practicing Ethical Behavior and Social Responsibility.
3. Competing in the Global Economy.

Part II

Starting a Small Business

4. Starting, Financing, and Expanding a Small Business.
5. Selecting the proper form of Business Ownership and Exploring Mergers, Consolidations, and Acquisitions.

Part III

Managing a Business

6. Understanding the Functions and Roles of Management.
7. Organizing to Facilitate Teamwork and Communication.
8. Producing Quality Goods and Services.

Part IV

Managing Human Resources and Labor Relations

9. Motivating Today's Work Force and Handling Employee-Management Relations.
10. Managing Human Resources.

Part V

Developing Marketing Strategies

11. Meeting Customers' Needs in the Changing Marketplace.
12. Developing Product, Pricing and Promotional Strategies.
13. Developing a Distribution Strategy.

Part VI

Managing Financial Information and Resources

14. Analyzing and Using Financial Information.

15. Understanding Banking and Securities

Taken from *Business in Action*, Bovée and Thill, Prentice Hall, 2001.

Exhibit "B"

BUS 150

TEAM ASSIGNMENT NUMBER ONE

Assume you desire to start a business with several other individuals.

Write a business letter to a friend who may want to join your group describing:

- why you want to go into business?
- what factors of production you would utilize?
- how supply and demand will affect your business?
- what types of competition can you expect?
- what role with the government play, if any?
- what the future holds for your business?

The letter should be sent to:

Stephen George
123 Main Street
San Diego, CA 12345

<u>BUS 150</u>

TEAM ASSIGNMENT NUMBER TWO

Related to your proposed business, write a memorandum to your spiritual advisor or your parents describing:

- what questions will you consider to assure the conduct of your business is ethical and legal?
- to whom will your business have any responsibility?
- how you intend to address environmental issues?

The letter should be sent to:

Marilyn Jane
456 Lord Street
Santa Monica, CA 78901

<u>BUS 150</u>

TEAM ASSIGNMENT NUMBER THREE

Related to your proposed business, write a business letter to your friend in Canada describing:

- opportunities in possibly conducting business outside the United States.
- any comparative advantages your business may have.

The letter should be sent to:

Cindy Joy
789 Toronto Avenue
Ontario, Canada 98765

<u>BUS 150</u>

TEAM ASSIGNMENT NUMBER FOUR

Assume you are a member of a small group of friends that now wishes to own and operate its first business. You have discussed different business opportunities that seem to have growth potential. One of the businesses you have researched and are interested in is a retail operation that combines dog and cat grooming with obedience training. The company will offer to train the animal to follow simple commands each time the animal visits for its grooming. The company represents that its training methods are successful and that this combination of services gives it an advantage over businesses that offer only grooming or only training. The retail store operation is franchised by the national company.

Write a business letter to the franchisor asking questions and soliciting information that will assist you in making your decision concerning the business.

The franchisor's address is:

Animal Beauty and Conduct, Inc.
491 Lexington Avenue
Inkjet, Kentucky 70777
Attn: John Fineline, Franchise Manager

<u>BUS 150</u>

TEAM ASSIGNMENT NUMBER FIVE

Assume you have made the decision to enter into a franchise arrangement with Animal Beauty and Conduct, Inc. ("ABC")

You are aware that businesses can take several forms, such as corporations, partnerships, limited liability companies, and others.

Write a business letter to your lawyer asking questions and soliciting information that will assist you in choosing a business form for your new business.

Your lawyer's address is:

Lori Anne, Esq.
Hiney, Head and Heart
123 First Avenue
Locus Parenti, New York 10549

<u>BUS 150</u>

TEAM ASSIGNMENT NUMBER SIX

Assume you have made a decision as to the business form you wish to use.

Write a business letter to your accountant: (i) advising of your decision as to the business form and the reasons therefor, and (ii) informing her of your anticipated start-up costs, and projected income and expenses for the first year of operation.

The address of your accountant is:

Ms. Penny Lane, CPA
Lane, Street and Drive
888 North Money Drive
White Plains, New York 10601

<u>BUS 150</u>

TEAM ASSIGNMENT NUMBER SEVEN

Assume you have taken all steps necessary to form your business. You now desire to obtain a commercial loan in the amount of $100,000 from your bank.

Write a business letter to your bank requesting the loan. Include all information the bank might need or want to consider your request, including a Business Plan.

The address of your bank is:

First National Lender
123 Main Street
Pleasantville, New York 10549
Attn: John Lockjaw

Exhibit “C”

GUIDE TO TEAM ASSIGNMENTS

1. All team assignments are to be prepared in multiple copies. The original is to be submitted and each team member is to retain a copy. On the due date of each team assignment each student must have his or her copy in class.

2. Attendance is required on the date each team assignment is due. Be prepared to defend and explain your work.

3. At the time each assignment is submitted, each team member is required to submit, in a sealed envelope: (i) a description of his of her specific contributions to the assignment (including contributions at all meetings and telephone conferences), (ii) a description of the specific contributions of each other team member, and (iii) an evaluation of each other team member as to their contribution and cooperation.

4. At the time each team assignment is given, team members should exchange telephone numbers and schedule periodic meetings.

5. If at any time during the project you feel that any team member(s) is (are) not contributing fairly, communicate confidentially with the instructor.

6. The team assignments provide an environment in which you can learn social and communication skills necessary to successfully act in a group. If your team members do well let them know. If your team members are not contributing fairly, let them know.

7. Each team should elect or appoint a team leader to coordinate meeting times, dates, contributions and production.

COLLEGIALITY AS A KEY FACTOR IN TENURE CASES

By

Arthur M. Magaldi*

The concept of tenure in higher education was originally begun in large measure to ensure the free speech rights of faculty members and encourage the free flow of ideas critical to the mission of schools of higher education, but over time tenure has evolved into something more. A high majority of faculty teaching in higher education seek tenure. The process generally begins with a letter of appointment which incorporates the terms of the faculty handbook. Acceptance of the appointment creates a contract incorporating the terms of the handbook. The faculty handbook may also reference other material. With the appointment letter beginning the process, the tenure-seeking faculty member travels a long, tortuous, and many would say, torturous road. Before being considered for tenure, a tenure track faculty member must generally prove him/herself during a probationary period lasting for as long as ten years.

Professors who obtain tenure have, in a sense, gained admittance to a select club, the "in crowd", the group of scholars deemed worthy of virtual lifetime employment and subject to termination only for cause. Tenure to the academic signifies that the professor has arrived and has attained a sought after status which recognizes his/her accomplishments and impliedly expresses confidence that these accomplishments will continue and be built upon in the future. To many, the lifetime security of tenure compensates in many ways for the possibly somewhat lower salary that the well qualified professor receives in academia when compared to what might have been earned in the larger society, e.g., the corporate world. It may be appropriate to analogize the granting of tenure to the lifetime appointment of federal judges. The granting of tenure also confirms the faculty member's lifestyle choice and assures that it will continue in the foreseeable future.

With tenure being so valuable and so sought after, it is understandable that it may be difficult to obtain. Generally, institutions of higher learning have rigorous standards in three areas, teaching, research, and service deemed most important for a successful career in academia. The Report of the Lubin School Select Committee on Tenure and Promotion Guidelines of Pace University, dated October 22, 2001, is fairly typical and provides in part: tenure shall normally be granted only to professors holding the rank of Professor, Associate Professor, or Assistant Professor, who possess the minimum departmental degree requirements, and who have demonstrated potential for long-term contributions to the university in the area of teaching. Teaching performance sufficient to demonstrate this long-term commitment and level of quality should include (1) a belief on the part of the faculty that this person has command of relevant subject matter, a capability for conveying material in a thorough and meaningful way to students, and a

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potential for increasing mastery and understanding over time of issues and topics in his or her domain, (2) a general perception by students that he or she is a good teacher, (3) perceptions by students and peers that this faculty member is keenly interested and dedicated to teaching Lubin students and appreciative of the need to motivate students to high levels of achievement, and (4) clear indications that this faculty member will continue over the long run to improve and refine his or her teaching skills and pedagogy.

Tenure is awarded for the scholarly accomplishments that the candidate has achieved and for the likely scholarship accomplishments the candidate will achieve in the future. Evidence submitted by the candidate should be of a quality and quantity that enables the TAP Committee to form a reliable opinion as to the likelihood of future scholarly productivity.

A faculty member considered for tenure must possess a propensity and willingness to serve the member's department, school, discipline and University. Candidates for tenure must have also demonstrated participation in the service components.

In addition to these general requirements, the responsibilities of those seeking tenure are set forth with greater specificity elsewhere in the report, e.g., there is a minimum number of publications in refereed journals in the research area. It should be borne in mind that the above cited reflects the position of those teaching in the Lubin School of Business and seeking the support of Lubin in the quest for tenure. These are in addition or supplementary to the requirements of the institution as set forth in the Faculty Handbook.

Numerous denial of tenure cases have been brought in federal and state courts. In many of these cases, the plaintiff faculty members contend that they have met the explicit criteria of teaching, research, and service established by the institutional defendants but have been denied tenure. The plaintiffs generally seek a jury trial on the issue. In most cases, the plaintiffs fail to recover. It is the position of this paper that the institutions enjoy great latitude in the awarding of tenure despite the fact that the applicant may have apparently met the requirements of good, even excellent, teaching, research, and service. A key factor in determination of tenure qualifications is whether the faculty member has been sufficiently collegial in his/her actions. The requirement of collegiality is often unstated in the tenure policies provided by institutions but it is often determinative of the issue.

Collegiality Cases

In the decided cases, faculty have frequently made the assertion that collegiality is not an appropriate consideration in the determination of tenure unless it is specifically set forth in the contract between the faculty member and the institution. The courts have consistently rejected this assertion and have held that collegiality is an appropriate consideration. In *Bresnick v. Manhattanville College*[1], the situation was of a type which may be considered fairly typical in that the record showed some evidence of support for the plaintiff at the college, but an ultimate denial for tenure. For example, the Status Committee, essentially the Tenure and Promotion Committee, voted four-to-one in favor of the granting of tenure. "The Provost stated that Bresnick had difficulty working with colleagues, and the President expressed concern about unwillingness to work with colleagues 'in a sufficiently collegial and collaborative manner,' raising doubts about his ability to offer the necessary leadership'..." [2] "Bresnick 's argument was that collegiality or working in a collegial manner were not part of the criteria specified in Manhattanville's letter of appointment or faculty handbook. The Court dealt with this claim by equating inability to work with colleagues with a failure to effectively teach and offer service to the College.

Mayberry v. Dees[3] presented a situation in which the plaintiff's claim was based on a claim of retaliation for exercise of free speech rights. The plaintiff's views of the best ways of teaching romance languages differed substantially from that of his chairman and the two got along very poorly. As the probationary years passed, the plaintiff received some favorable and some less favorable reviews of his teaching. Eventually, there arose a conflict about the composition of the tenure committee with the plaintiff asserting that the chairman was an unfit person to participate on the committee. The plaintiff demanded that the chairman recuse himself and advised other colleagues that the chairman was biased and unfit to participate in his review. Many of the remarks were made in what might be considered an inappropriate manner and not through established channels. The criticism of the chairman deteriorated into what might be considered personal attacks.

Upon denial of tenure, Mayberry claimed retaliation for exercise of free speech, but the Court held among other things that it would be appropriate to consider for the decision maker at the college level to determine whether a person who engaged in personal attacks, lacking in good taste, had the requisite degree of collegiality to receive an award of tenure.

McGill v. Regents of the State of California[4] involved a mathematics professor with a national reputation as a probabilist who had serious clashes with two other members of the mathematics department. Through a very long and winding process of review of the professor's tenure application it became clear that personality clashes played some role in the decision to deny tenure. Addressing the issue of the relevance of collegiality the Court stated, "McGill insists the denial of tenure was based solely on his lack of 'collegiality' which is not one of the listed criteria. The trial court concluded the denial was based on McGill's lack of 'congeniality.' Although not expressly listed as one of the tenure criteria, it is inescapable that collegiality is an appropriate consideration. The American Association of University Professors' Statement on Professional Ethics contemplates as much."[5] The appellate court reversed a decision ordering the chancellor of the university to grant tenure to the professor.

University of Baltimore v. Iz[6] provides perhaps the most comprehensive appellate opinion on collegiality as a factor in tenure consideration. Professor Iz brought suit against the university after a denial of tenure alleging constitutional and civil rights violations, breach of contract, and breach of the implied covenant of good faith and fair dealing. The trial court awarded Iz $425,000 as damages for breach of contract and the University appealed.

The factual pattern is similar to those of many denial of tenure cases. The letter of appointment and the faculty handbook formed the basis of the contract and the President was the only official authorized to award tenure. There was in place an established procedure for review of the professor's work. The steps in the review and the position of the reviewers on tenure may be summarized as follows: 1. professor's tenured colleagues (against); chairperson (in favor); Tenure and Promotion Committee (in favor); dean (against); provost (against); Faculty Appeals Committee (in favor); president (against). (It should be noted that this pattern or some variation of it exists in most colleges and the completeness of the review is generally a factor in favor of the institution.) During the course of the evaluations, it was established that Iz met or exceeded the formal requirements of research, teaching, and professional activity, but there were concerns expressed about her attitude and collegiality. She had difficulty dealing with colleagues in her department and was described to the Provost as "inflexible, defensive, and unwilling to take constructive advice."[7] The President made a very careful examination of the review, met with Iz, and discussed the situation with some of the reviewers, and finally concluded that tenure should be denied based on a lack of support from the members of her department.

"Dr. Iz claims that under her contract the University of Baltimore was required to judge her tenure and promotion application solely by the three explicit criteria of research, teaching and service set forth in the tenure and promotion policies."[8] The University contended that the requirement of collegiality was inherently a part of the three expressly provided criteria and was therefore an implied part of the contract.

The Court set forth a lengthy analysis of tenure and cited numerous cases which held that institutions have broad discretion in granting tenure which in many cases is a subjective judgment. In addition, the Court noted that there were many factors to be weighed in the granting of tenure and "The assessment of these factors is best performed by those closely involved in the life of the institution, not by judges."[9] Finally, after discussing the position of the American Association of University Professors, the Court concluded, "...we are persuaded by our review of contract principles and cases from other jurisdictions that the University did not breach appellant's contract when it considered Dr. Iz's collegiality. In our view, collegiality was a legitimate factor for consideration in the promotion and tenure process."[10] The thoroughness of the entire process and the thoroughness of the investigation made by the President convinced the Court that the review of Iz was not made in bad faith.

Some writers approach the collegiality issue in terms of personality indicating that personality factors are clearly a part of the tenure review process. Zirkel in his article, "Personality As a Criterion For Faculty Tenure: The Enemy It Is Us"[11], studied eighty-five faculty employment cases involving personality factors and noted personality disputes within the department, with colleagues, and with chairpersons as the most common in tenure denial cases. Clashes with deans, presidents, and students are other common sources of conflict. Whether viewed in terms of collegiality or personality issues, "Nevertheless, the fact exists that a substantial number of cases well within these confines have been litigated and the substantial weight of judicial resolution has been rendered against the faculty-plaintiffs, as is particularly notable D/T (denial of tenure) cases."[12]

Deference Doctrine

A second factor working against the faculty and in favor of the institution is courts generally are extremely reluctant to interfere in academic decision-making matters. Accordingly, there is great respect accorded the deliberative process at the institution. Where there has been an established procedure for review of tenure candidates which has been followed, the situation in most cases, the courts generally decline to substitute their judgment for the judgment of those who were in actual contact with the candidate. In so doing, the courts show respect for the academic process." The customary judicial approach in faculty-employment cases generally, and faculty-tenure cases specifically, is academic abstention, a doctrine deeply rooted in the tradition of institutional autonomy."[13]

Most of the cases which recognize collegiality as a legitimate factor to be weighed in tenure decisions further conclude that the institution, absent a clear Title VII or First Amendment violation should be left free to make its own decisions on tenure without judicial interference.

Mabey v. Reagan, et.al [14], was a case in which the professor tried to raise a constitutional issue of free speech. While the Court agreed that one cannot be fired for First Amendment expression, the Court found none and instead concluded that the institution should be left free to exercise its discretion and weigh collegiality without court interference. The opinion provided, "In all but the clearest cases, the decision to terminate a probationary teacher's employment entails the complicated weighing of many factors, almost all of which are subjective. An essential element of the probationary process is periodic assessment of the teacher's performance, including the person's ability and willingness to work effectively with colleagues...Thus, there is no precisely calibrated scale whose pointer indicates when an instructor's negative qualities outweigh his positive ones. There is a more or less broad grey area, in which we permit official discretion to operate and decide."[15]

Baker v. Lafayette College[16] presented another variation of the collegiality theme in which the instructor alleged that the College breached his employment contract by not acting in good faith in reviewing his reappointment status. The Court reviewed the steps in the review process and deferred to the College's procedures and process saying, "As in all aspects of life, no procedure is fool proof...The Faculty Handbook sets forth review procedures. In accordance with these procedures, the Appellant appealed to the president of the College and ultimately to the board of trustees. We would be hardpressed to conclude that the College acted in bad faith when it followed the required review procedures. This Court has no jurisdiction to review the factual determinations of a college's governing unless it can be clearly demonstrated that that body violated its own procedures."[17]

The desire not to impose the Court's views on an academic institution as long as the faculty member had received procedural due process was also part of the *Bresnick*[18] case. As previously mentioned, the relevance of collegiality as an unlisted criterion for tenure was at issue. The Court stated: "Courts, including those of New York the law of which is applicable in this diversity of citizenship case, are reluctant to intrude into decisions of this type, because doing so would substitute judicial evaluation of teaching effectiveness for the judgment of those charged with that function by the institution."[18] It is also worth noting that each of the cases cited in this paper cites other cases to support its holding, e.g., *Faro v. New York* University[19] and *Pauk v. Board of Higher Education.*[20]

Conclusion

Confronted by the collegiality standard and the doctrine of judicial deference to the findings of the institution, the instructor who seeks tenure and does not have constructive and congenial relations with departmental colleagues, his/her chairperson, dean, and other figures in the institution of note, may find him/herself in a tenuous position. Meeting or even exceeding standards for research, teaching, and service will not guarantee tenure where the applicant is found to be one who has not or does not act in a collegial manner. Indeed, Zirkel's[21] study of denial of tenure cases based on personality factors indicated the institution won a high percentage of cases which reached the stage of conclusive determination. "Specifically with regard to D/T, the plaintiff-faculty member was successful in only three (22%) of fourteen conclusive decisions. Success for the defendant institutions in this area may be partially attributable to the courts' general reluctance to award relief in the form of granting tenure."[22] It is also worth noting that in one of the three cases the plaintiff had already died, and in another the plaintiff had taken other employment.

There are many implications of the collegiality-judicial deference reality. One must wonder whether free speech may, in fact, suffer when potential tenure candidates become aware of the position they are placed in should they differ with important figures on campus. The risk that tenure candidates, even those who have compiled very strong dossiers and accomplishments in the three traditional areas of teaching, research, and service, may have to play politics. The free discussion of ideas in academia could be subject to a chilling effect.

Footnotes

1. 864 F. Supp. 327 (1994).
2. Id. at 329.
3. 663 F. 2d 502 (1981).

4. 52 Cal Reptr. 2d 466 (1996).
5. Id. at 470.
6. 123 Md. App. 135 (1998).
7. Id. at 139.
8. Id. at 140.
9. Id. at 142.
10. Id. at 143.
11. Perry A. Zirkel, *Personality As A Criterion For Tenure : The Enemy It Is Us,* 33 Clev. St. L. Rev. 222-244 (1985).
12. Id. at 237.
13. Id. at 238.
14. 537 F. 2d 1036. (1976).
15. Id. at 1041.
16. 516 Pa. 291. (1987).
17. Id. at 295.
18. 864 F. Supp. 327 (1994).
19. 502 F. 2d 1229 (1974).
20. 646 So. Ed 502, 505.
21. Supra note 11 at 235.
22. Supra note 11 at 237.