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BUSINESS ENTITIES: A RECONSIDERATION FOR SMALL BUSINESSES

by

Susan L. Martin*

Traditionally, the ability to pass tax losses through to the business' owners, avoiding double taxation on earnings, was the main reason owners organized their businesses as pass-through entities rather than in the classic corporate form, the C corporation.[1] Moreover, avoiding the accumulated earnings tax, personal holding company status and reasonable compensation issues added to the attractiveness of pass-through entities.[2] The Tax Reform Act of 1986, that made the top corporate tax rate higher than the maximum rate for individuals for the first time ever,[3] was the crucial factor that impelled may small business owners to give up C corporation status in favor of a pass-through entity. Now, with the passage of the Omnibus Budget Reconciliation Act of 1993,[4] many small business owners are reexamining the legal organization of their companies.[5] A brief review of business entities will outline the options available to the small business owner and suggest factors to be considered before making a change.

The Sole Proprietorship and the Partnership

A sole proprietorship is the simplest form of business organization.[6] The business entity has no existence apart from the owner.[7] Its legal liabilities are the personal liabilities of the owner to the extent of all the owner's assets.[8] When sole proprietors figure their individual taxable income for the year, they must add in any profit, or subtract any loss, they may have from their businesses.[9]

When more than one person owns the business, they may run

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it as a partnership.[10] A partnership is the relationship between two or more people who join together to carry on a business.[11] Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business.[12] As in the sole proprietorship, the partners are personally responsible, to the full extent of all their assets, for the legal liabilities of the partnership.[13] A partnership is not a taxable entity; however, it must figure its profit or loss and file a return.[14] All losses and profits, even if they are not distributed, must be reflected on the partners' individual tax returns.[15] Partnerships have many advantages over other operating forms including the ability to structure varying economic interests by using multiple classes of equity interests and flexibility in allocating profits and losses.[16] Unlike shareholders of an S corporation, partners may disproportionately allocate certain items of income, loss, deductions, and credits. Thus, the partnership form has particular merit when the different interests of the partners call for distributions varying in amount, timing or type from a strictly proportional allocation. Furthermore, there are no limitations on the number of partners or on who can own a partnership interest.[17]

The disadvantage of personal liability associated with a partnership can be assuaged somewhat by insurance. Nevertheless, because of the tremendous liability potential entailed in operating a business enterprise in the form of a general partnership, this form of organization is rarely used outside of certain small businesses and professional organizations which, until recently, were required to be operated in the partnership form.

The Limited Partnership

Personal liability can be circumvented to some extent by using the limited partnership form. The great advantage of a limited partnership is that it permits its limited partners to enjoy both limited liability and the benefits of flow-through taxation.[18] Thus, limited partnerships have become the organizational form of choice for tax advantaged investments in real estate, oil and gas and other types of ventures which are either intended to generate substantial business losses for an initial period, or do not require the accumulation of earned income in order to expand the operations of the enterprise.[19]

A limited partnership functions in the same way as a general partnership but, in addition to the general partners who run the business, there are limited partners who have no part in daily business operations. The liability of a limited partner will not exceed the amounts already invested in the business and amounts the partner is obligated to contribute. Limited partners, however, pay a price for limited liability in that they forfeit the right to participate in the management of their business. If they violate this restriction, they can be held personally liable. The best a partnership can do in approaching full limited liability is to have the general partner be a corporation. Having the general partner be an S corporation will limit the liability exposure of the S corporation's shareholders to their interests in the assets of the S corporation's assets; however, if the S corporation shareholders own their stock in the same proportion as their partnership interests, the corporation may be deemed a "dummy" or a "shell." Then, the limited liability will be lost. If the general partner is a C corporation, the partnership runs the risk of losing its partnership status and being taxed as a regular corporation if the corporation is deemed a "dummy." The corporation will be viewed as a "dummy" by the IRS if the limited partners own more than 20 per cent of the corporation or the corporate net worth is not at least 10 or 15 per cent of the total contributions to the partnership.

The C Corporation and the S Corporation

These difficulties can be avoided by organizing the small business as a corporation. The legal liability of the shareholders of the corporation is limited to their investment in corporation stock. It is this limited liability characteristic which has made corporations the business form of choice for the vast majority of business enterprises in the United States.

Corporate profits are taxed to the corporation. When the profits are distributed as dividends, the dividends are taxed to the shareholders. In effect, corporate income is taxed twice, once to the corporation and again to the shareholders. This double taxation is the primary drawback to the traditional C corporation form. This has been particularly true during the years from 1986 through 1992 when the corporate tax rate, 34 per cent, has been higher than the maximum individual marginal rate, 31 per cent.

To keep the advantage of corporate limited liability while avoiding double taxation, many business owners chose to be generally exempt from federal income tax.[20] Its shareholders then include on their separate returns, their share of the corporation's income, deductions, losses, and credits. A corporation making this choice is an S corporation.[21] To be eligible for S corporation status, several requirements must be met. The most significant of these is that there can be no more than 35 shareholders; there can be only one class of stock (no preferred stock, for example); only individuals, estates, and certain trusts (not partnerships and corporations) can be shareholders; and, shareholders must be citizens or residents of the United States.[22]

It is relatively easy for a qualifying corporation to elect S corporation status. The corporation merely files a two page form (Form 2553) any time during the previous tax year or during the first two and a half months of the tax year to which the election is to apply.[23] It is also very easy to

terminate S corporation status: a mere statement to the Internal Revenue Service (IRS) is enough to revoke the S corporation.[24] This does not imply that one can go back and forth between the S and the C corporate forms, and that is why the decision to give up S status should be made only after thorough consideration of all possible ramifications of such a decision. If a corporation's status as an S corporation has been terminated, it generally must wait five tax years before it can again become an S corporation.[25] If a C corporation converts to S corporation status, the business is subject to a mixed form of taxation: income from business operations will receive pass-through treatment, whereas large capital gains income or passive investment income may have corporate level taxes imposed.[26]

Use of the S corporation may be of particular benefit during the first years of the corporation's existence when it may be operating at a loss. Individual shareholders may benefit from a reduction in their taxable income when that loss is passed through to them. On the other hand, it should be recognized that the fledgling operation organized as an S corporation instead of as a partnership in order to achieve limited personal liability, may be getting a merely illusory advantage. It is unlikely that creditors will advance funds to a business with no track record without obtaining the personal guarantees of the shareholders.

Another time when it is advantageous to be organized as an S corporation arises when a business anticipates realizing large capital gains. If the business becomes very successful and the owners decide to sell, an S corporation would incur only a single tax on the profits from the sale instead of the double taxation that would occur for a C corporation.[27] Furthermore, an owner's cost basis in S corporation stock rises as the owner pays taxes on undistributed income, lowering the owner's taxable gain when the stock is sold.[28]

Since the late 1980's there has been an astounding growth in S corporations.[29] More than forty-two per cent of all corporate tax returns are filed by S corporations, representing over eleven per cent of corporate net income.[30]

Nevertheless, a C corporation has some distinct advantages. For example, it can accumulate its earnings for use in possible expansion or for other bona fide business reasons;[31] whereas, all profits, whether or not they are distributed, are passed through to the S corporation shareholders as taxable income. This advantage is tempered by the possibility of incurring an accumulated earnings tax.[32] The accumulated earnings tax applies to corporations that attempt to aid shareholders in avoiding income tax by retaining earnings and profits in the corporation rather then distributing them.[33] If a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax.[34] Generally an accumulation of earnings and profits is in excess of the reasonable needs of the business if it is more than a prudent business person would consider appropriate for present

business purposes and for reasonably anticipated future business needs.[35] IRS guidelines suggest that an accumulation of $250,000 or less is generally considered within the reasonable needs of a business.[36] A reasonable amount is $150,000 or less, however, in the case of a business whose principal function is performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.[37] If earnings are accumulated beyond these amounts without regular distributions being made to shareholders, the corporation will have to demonstrate a bona fide business reason for not doing so.[38] If the corporation is unable to do so, the corporation will be liable for the accumulated earnings tax.[39]

In J.H. Rutter Rex Mfg. Co., Inc. v. Comm'r,[40] for example, the corporation, which manufactured work pants and work shirts and other casual clothing items, asserted that it needed to retain large amounts of accumulated earnings in order to cover the expenses associated with swiftly changing styles.[41] It pointed to the costs of adapting its manufacturing facilities and retraining workers to respond to the needs of its customers.[42] Thus, it attempted to justify its retention of earnings and profits of $1,188,723 in 1977 and $1,582,018 in 1978.[43] The United States Court of Appeals for the Fifth Circuit noted that the relevant inquiry in assessing business plans to retool and retrain is "'whether the company's plans appear to have been a real consideration during the tax year in question rather than simply an afterthought to justify the challenged accumulations.'"[44] The court then held that there were no specific plans by Rutter for training and improvements and, therefore, the only amounts not subject to the accumulated earnings tax were those actually spent for machinery purchases, $200,665 in 1977 and $875,937 in 1978.[45]

Rutter indicates the need for careful documentation. If business owners want to retain earnings in the traditional corporation for future expansion or retooling or retraining, then business meeting minutes should reflect such plans. Such before-the-fact evidence will make it more likely that the IRS will make allowances for retained earnings.[46]

In assessing the double tax disadvantage of the C corporation, it should also be recognized that many small business owners can take all the profits out of the business as salary as long as the salary does not exceed the value of services provided.[47] In that case, there will not be any profits on which to pay corporate income taxes. If, however, the owners of a new business take relatively little in salary during the early years and then, suddenly, when the business becomes more successful, increase their compensation dramatically, the IRS could elect to treat only part as salary and declare the rest to be dividends subject to double taxation.[48] The United States Supreme Court has held that

> extraordinary, unusual and extravagant amounts paid by a corporation to its officers in the guise and form of compensation for their services, but having

> no substantial relation to the measure of their services and being utterly disproportionate to their value, are not in reality payment for service, and cannot be regarded as 'ordinary and necessary expenses' within the meaning of [the predecessor of I.R.C. § 162].[49]

This problem, too, can be mitigated by good record keeping. Corporate minutes that reflect a business plan not to compensate fully for services rendered during a growth period, but then to increase officers' salaries or to provide bonuses in later years in order to make up for undercompensation, can be important evidence that compensation is reasonable and not disguised dividends.[50]

Taking all the profits of the business out as salary also will not work if the company grows beyond the services provided by the owner. In addition, it will not be helpful in eliminating double taxation if the business grows and the owner wants to sell it. Double taxes will be owed on the profit. Realistically, this will not be a problem for very small businesses where the owner is the business and has nothing to sell beyond his or her own services.

There are other savings that can also be realized through a C corporation. For example, the corporation can deduct as a business expense the premiums for up to $50,000 of group life insurance and the premiums for long-term disability insurance.[51]

The Limited Liability Company

Limited liability companies are the newest business entities and, therefore, probably the least familiar to the small business person. They may become, however, arguably the most advantageous form of business organization given their income tax benefits, their limited liability for all participants, and their flexibility.[52]

The first state statute authorizing the limited liability company was enacted in 1977 in Wyoming.[53] It was adopted in order to attract South American investors for a mining operation.[54] Limited liability companies are similar to subchapter S corporations without the latter's disadvantages of disallowing foreign investors, subsidiaries and multiple classes of stock and without a limit on the number of investors.[55] A limited liability company also resembles a limited partnership without the latter's disadvantages of requiring personal liability and capitalization on the part of the general partner and without a complicated agreement.[56]

Other states did not quickly follow Wyoming's lead in authorizing the limited liability company because of the uncertainty created by the Treasury Department's inconsistent treatment of the partnership classification of limited liability companies. However, in 1988, the IRS issued a Revenue Ruling[57] classifying a Wyoming limited liability company as a partnership for federal tax purposes.[58] The IRS took the following factors into consideration in making its

determination. There are six basic characteristics of a corporation: associates; an objective to carry on business for profit; continuity of life; free transferability of an interest; centralized management; and liability for corporate debts limited to corporate property.[59] If an organization lacks two of the latter four characteristics, it will be classified as a partnership.[60] In the instant case, Wyoming law provided that upon the death or withdrawal of any member, the business would dissolve unless all the remaining members consent to continue it.[61] Therefore, the company lacked the corporate characteristic of continuity of life.[62] Secondly, under the Wyoming statute, company members cannot assign all the attributes of their interests in the company unless all the other members approve the assignment.[63] Therefore, the company lacked the corporate characteristic of free transferability of interests.[64] Without those two characteristics, the company was classified as a partnership for federal tax purposes.[65]

The reason for the popularity of this new form of business organization is that it helps shield the organization's members from liability extending beyond their investment in the business while allowing them to qualify for partnership tax treatment if it is structured, as described above, without all the attributes of a corporation.[66] Generally, the debts and liabilities of a limited liability company, no matter how they arise, remain solely those of the company and no member of the company is personally obligated for those debts and liabilities.[67] Another important characteristic of a limited liability company is the flexibility it gives its members in contractually deciding how business will be conducted.[68] For example, members can decide in their agreement about classes of equity, duties and liabilities of members and managers, allocation of profits, losses and assets, dissolutions and mergers.

Despite its advantages, the newness of this form of business organization may make small business owners reluctant to consider it even in states where it is already available. A body of statutory law and judicial interpretation has not yet developed and, therefore, variations of transferability and continuity of life provisions may not assure pass-through tax status. Another disadvantage is that if a limited liability company intends to do business outside the state in which it has been organized, it may not be assured of recognition in foreign jurisdictions.

Currently, at least thirty-two states have enacted statutes recognizing limited liability companies.[69] It is likely that additional states will be adopting the Limited Liability Company Act in the near future.[70]

Reconsidering the Business Entity

All these considerations make it extremely important for small business owners to seriously assess the present and projected size and success of their enterprises before making

any changes in the legal form of their businesses. After the Tax Reform Act of 1986 was enacted, the desirability of electing S corporation status, both for existing C corporations as well as for new businesses, substantially increased. This was primarily true because, for the first time since Subchapter S was enacted into law in 1958, the maximum rate of tax for individuals (31 per cent) was less than the maximum corporate rate (34 per cent).

Today, however, small business owners are looking at a maximum marginal rate for individuals of 39.6 per cent and a maximum corporate rate of 35 per cent.[71] That scenario is causing many of the approximately 1.6 million small business owners in the United States who operate their enterprises as S corporations to consider going to back to the pre-1986 approach of switching their profitable businesses from S to C corporate status in order to take advantage of the lower corporate rates. One business owner who operates his 150-employee business as an S corporation estimates that he will pay an additional $115,000 in income taxes on profits of approximately $1 million. The increase in individual tax rates may also make limited liability companies look somewhat less attractive than they did some few short months ago. Nevertheless, while small business owners are understandably upset about the new tax law, they should recall that the new marginal rate for S corporations (and limited liability companies) is no higher than it was before 1986.

Precipitous actions should be avoided and some tax practitioners are reporting that although they are having loud and vehement cries of unfairness from their small business clients, they have not experienced a rush of conversions. Before making a final decision on a possible shift, an accountant or tax attorney should be consulted to work up the actual tax savings available for each type of status, taking into consideration present business profits, losses, credits, and deductions, as well as the business' future possibilities. In addition to these personal reasons suggesting caution, possible additional changes in the law also indicate the wisdom of a wait-and-see attitude. Health care reform may affect different business entities differently. Furthermore, the S Corporation Reform Act of 1993[72] has been introduced in the United States Senate. This bill, if enacted, would make S corporations more attractive in a variety of ways.[73] Another factor to consider is the increasing availability and familiarity with the limited liability company. All these changes will probably make 1994 a year for small businesses to seriously reevaluate their operating status.

ENDNOTES

1. William M. Ruddy, Partnerships: Combination Can Provide Flexibility of Partnership with S Corporation Advantages, 18 Tax'n for Law. 186 (Nov./Dec. 1989).

2. Id. at 186.

3. I.R.C. §§ 1 & 11 (1986) (setting maximum rates on individuals at 31% and on corporations at 34%).

4. Pub. L. No. 103-66, 107 Stat. 312 (Aug. 10, 1993).

5. Eugene Carlson, Enterprise: Some Small-Business Owners Reconsider Tax Status, Wall St. J., Nov. 16, 1992, at B2.

6. I.R.S., U.S. Dep't of Treas., Pub. No. 334, Tax Guide for Small Business 4 (1991).

7. Id.

8. Id.

9. Id.

10. I.R.S., U.S. Dep't of Treas., Pub. No. 334, Tax Guide for Small Business 4 (1991).

11. Id.

12. Id.

13. See, e.g., Dan L. Goldwasser, Structuring a New Business Enterprise, ALI-ABA Postgraduate Course in Fed. Sec. Law (1990).

14. I.R.S., U.S. Dep't of Treas., Pub. No. 334, Tax Guide for Small Business 4 (1991).

15. Id. at 96-97.

16. See, e.g., Richard E. Levine & Jeffrey A. Markowitz, Choosing the Proper Form of Legal Entity to Own Real Estate, ALI-ABA Course of Study, Creative Tax Planning for Real Estate Transactions: Strategies for the '90s (1990); William M. Ruddy, Combination Can Provide Flexibility of Partnership with S Corporation, 18 Tax'n for Law. 186 (1989).

17. Ruddy, supra note 15, at 187; Avi O. Liveson, Partnerships vs. S Corporations: A Comparative Analysis in Light of Legislative Developments, 5 J. Partnership Tax'n 142 (1988).

18. Goldwasser, supra note 13, at 730.

19. Id.

20. I.R.C. §§ 1371-79 (1991).

21. I.R.C. § 1361 (1991) (S Corporation Defined).

22. Id.

23. Tax Guide for Small Business, supra note 10, at 108.

24. Id. at 109.

25. Id. at 108.

26. I.R.C. §§ 1374 & 1375 (1988).

27. See, e.g., Tax Report: S Corporations are her to stay even if personal-tax rates rise, Wall St. J., Feb. 17, 1993, at A1.

28. Id.

29. 139 Cong. Rec. S16433-02, S16442 (daily ed. Nov. 19, 1993) (statement of Sen. Danforth).

30. Id.

31. I.R.C. § 535(c)(1) (1991).

32. I.R.C. §§ 531-37 (1991); see also Tax Guide for Small Business, supra note 10, at 105. The accumulated earnings tax is equal to the sum of 27½ percent of the accumulated taxable income not in excess of 100,000 plus 38½ percent of the accumulated taxable income in excess of $100,000. 26 I.R.C. § 531 (1991).

33. I.R.C. § 532(a).

34. Tax Guide for Small Business, supra note 10, at 105.

35. Treas. Reg. § 1.537-(1)(a) (1991).

36. Tax Guide for Small Business, supra note 10, at 105.

37. Id.

38. Id. Bona fide business uses would include specific and possible business plans for the accumulated funds or an amount that would be required to buy back the corporation's stock from a deceased shareholder's estate. Id.

39. Id.

40. 853 F.2d 1275 (5th Cir. 1988).

41. Id. at 1277-78.

42. Id. at 1294.

43. Id. at 1279.

44. Id. at 1292 (quoting Exempt Carriers, Inc. v. United States, 644 F.2d 1027, 1028 (5th Cir. 1981).

45. Id. at 1294.

46. See, e.g., Mary Rowland, Your Own Account: Perils of Small-Business Success, N.Y. Times, Jan. 10, 1993, § 3 (Business), at 17.

47. I.R.C. § 162(a) (1988) authorizes a deduction for all ordinary and necessary expenses in carrying on a business including a reasonable allowance for salaries for personal services actually rendered.

48. See, e.g., Klamath Med. Serv. Bureau v. Comm'r, 29 T.C. 339 (1957), aff'd, 261 F.2d 842 (9th Cir. 1958); Northlich, Stolley, Inc. v. U.S., 368 F.2d 272 (Ct. Cl. 1966); Irby Constr. Co. v. U.S., 290 F.2d 824 (Ct. Cl. 1961).

49. Botany Worsted Mills v. U.S., 278 U.S. 282, 292 (1928).

50. See generally, Graham, Unreasonable Compensation: What It Is, How to Avoid Disallowance, 10 Tax'n for Acct. 260 (1973).

51. Id. If the corporation pays the premiums, the benefits will be taxable, whereas if the individual pays the premiums, the benefits are not taxable. Id.

52. See Wayne M. Gazur & Neil M. Goff, Assessing the Limited Liability Company, 41 Case W. Res. L. Rev. 387 (1991).

53. Wyo. Stat. ch. 15 (1977).

54. Fall Meeting Program September 23-27, 1992 Williamsburg, Va.: Limited Liability Companies, Bus. L. Section Newsletter (N.Y.S.B.A.), Fall/Winter, 1992, at 5.

55. Id.

56. Id.

57. Rev. Rul. 88-76, 1988-2 C.B. 360.

58. Id. See also Rev. Rul. 93-6, 1993-3 I.R.B. 8 (holding that limited liability company organized pursuant to Colorado Limited Liability Act, Colo. Rev. Stat. §§ 7-80-101 through 7-80-913 (1990), was partnership for federal tax purposes by lacking free transferability of interests and continuity of life); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (holding that limited liability company organized pursuant to Virginia Limited Liability Company Act, Va. Code Ann. §§ 13.1-1000 through 13.1-1073 (Michie 1991), was partnership for federal tax purposes by lacking free transferability of interests and continuity of life).

59. Treas. Reg. § 301.7701-2(a)(1) (1983).

60. Larson v. Comm'r, 66 T.C. 159 (1976).

61. Rev. Rul 88-76, 1988-2 C.B. 360. The unanimous consent rule can be very burdensome on a business. The IRS has proposed a change in Treas. Reg. §301-7701-2(b)(1) so that only a majority of the remaining partners would have to vote to continue the business. See John Cederberg, Continuity of Life, 1 Limited Liability Company Rep. 93-101, 93-102 (1993).

62. Id.

63. Id.

64. Id.

65. Id.

66. Martin I. Lubaroff, Donald A. Bussard, Eric A, Mazie, C. Stephen Bigler & James G. Leyden Jr., Out in Front, Bus. L. Today, Jan./Feb., 1993, at 39.

67. Id. at 40.

68. Out in Front, supra note 66, at 39-40.

69. Ala. Code § 10-12-1 (1993); Ariz. Rev. Stat. Ann. tit. 29, ch. 4 (1992); Ark. Code Ann. § 4-32-103 (Michie 1993); Colo. Rev. Stat. tit. 7, art. 80 (1992); 1993 Ct. H.B. 6974 (signed by Governor Jun. 23, 1993); Del. Code Ann. tit. 6, subtit. II, ch. 18 (1992); Fla. Stat. tit. XXXVI, ch. 608; 1992 Ill. Legis. Serv. 87-1062 (West); 1992 Iowa Legis. Serv. 2369 (West); Ga. Code Ann. § 14-2-1109.1 (1993); Idaho Code § 53-61 (1993); Ill. Rev. Stat. ch. 305, para. 54-1 (1993); Ind. Code § 23-18-1-1 (1993); Iowa Code § 4.1 (1993); Kan. Stat. Ann. § 17-7601 (1992); La. Rev. Stat. Ann. § 9:3431 (West 1993); Md. Code Ann., [Corps. & Ass'ns], tit. 4A (1988); Mich. Comp. Laws § 450 (1993); Minn. Stat. ch. 322B (1992); 1992 N.J.S.B. 890, 205th Legis., 2d Sess. (signed by Governor Jul. 30, 1993); N.M. Stat. Ann. § 53-19-1 (Michie 1993); Nev. Rev. Stat. tit. 7, ch. 86 (1991); N.C. Gen. Stat. § 57C-1-01 (1993); N.D. Cent. Code § 10-32 (1993); Okla. Stat. tit. 18, ch.32 (1992); R.I. Gen. Laws § 7-16-1 (1992); S.D. Codified Laws Ann. § 47-34 (1993); Tex. Rev. Civ. Stat. Ann. art. 1528n (West 1992); Utah Code Ann. tit. 48, ch. 2b (1992); Va. Code Ann. tit. 13.1, ch 12 (Michie 1992); W. Va. Code ch. 31, art. 1A (1992); Wyo. Stat. § 17-15 (1993).

70. It is unclear, however, whether New York will be one of those even though bills authorizing limited liability companies are making their way through committees in both the Senate (S. 27, 215th G.A., 1st Sess. (N.Y. 1993)) and the House (A. 8676, 215th G.A., 1st Sess. (N.Y. 1993)) and the Governor's position is that if the bill is revenue neutral, it will be enacted. The problem arises because the New York bills have been amended to require that notice of the formation of a limited liability company must be published in two newspapers for six consecutive weeks. A. 8824, 215th G.A., 1st Sess. (N.Y. 1993). Such legal advertising is not

required in any other state and can cost a business up to $2000. This requirement has caused legal wrangling with much lobbying being done by newspaper publishers who stand to gain substantially if the law is enacted as amended. See John Riley, It's a Matter of Fine Print - Requirement of Legal Ads Stalls Business Bill in Albany, Newsday, May 29, 1992, at 45 (city ed.).

71. Pub. L. No. 103-66, 107 Stat. 312 (Aug. 10, 1993).

72. S. 1690, 103rd Cong., 1993-94 Reg. Sess.

73. The Act would, inter alia, (1) improve shareholder limitations by increasing the allowable number to fifty; permitting tax exempt organizations, financial institutions, nonresident aliens and more types of trusts to own S corporation stock; (2) permit more than one class of stock; (3) allow S corporation shareholders to have the same fringe benefits position as C corporations shareholders. 139 Cong. Rec. S16433-02, S16441 (daily ed. Nov. 19, 1993) (statement of Sen. Pryor).

WHAT EVERY PROFESSOR SHOULD KNOW ABOUT CHEATING IN THE CLASSROOM*

by

Peter M. Edelstein*

I

INTRODUCTION

Typically colleges and universities inform students and prospective students of the institution's standards of academic integrity. This is usually accomplished by a notice in the institution's catalogue or related materials.[1] The notice language should be broad enough to proscribe all forms of cheating. Students should be expected to understand that unethical conduct would include copying from any source without proper attribution, looking at another's answers during an exam, communicating with another during an exam, bringing information into the exam room (or placing it in the exam room prior to the exam), collusion with another on an assignment, or presenting another's work (including purchased papers) as one's own. Yet a recent survey of undergraduate students indicated that eighty five percent of those surveyed had cheated in one form or another while in college.[2]

All forms of unacceptable academic conduct, from plagiarism to the use of "cheat sheets" during an exam, are not only violations of the precepts set forth in the University catalogue but are an insult to the entire academic process and especially to those individuals who do adhere to the principles of academic integrity. At many institutions, the functions of policing adherence to the academic honesty standards and of administration of justice in the event of a violation or alleged violation thereof, have been bestowed primarily and initially upon the faculty.[3] This paper is intended to assist instructors in understanding and addressing their functions.

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II

FORMS OF CHEATING

All forms of academic dishonesty involve either the wrongful act of using another's knowledge as one's own or using one's own knowledge in a wrongful manner. Copying without attribution, using another student's work product, buying a commercially available term paper, are examples of the use of another's knowledge. Using "cheat sheets" or using other information surreptitiously during an exam are examples of the wrongful use of one's own knowledge. The list of methods of cheating is limited only by the imagination of the students.

In response to a request for methods of and devices for cheating, the following list was generated by students in the Spring of 1993.[4]

- During the semester and particularly shortly before the exam write information on the desk. Pencil works best because it can be rubbed off at the end of the exam.

- A chart or a page of text from a textbook can be photocopied and then repeatedly reduced by the copier to the size of a matchbook and brought into the exam room.

- If the instructor has informed the students in advance of the questions or gives the same exam to all sections, before the exam write the answers in a blank exam booklet, dispose of its colored cover, bring the pages into the exam room and at the opportune time remove the interior pages from the exam book distributed by the instructor, retain its colored cover and make a switch. Tell the instructor, the "staples came out".

- Bring a calculator into the exam room and insert answers between the device and its case.

- Bring a calculator or "spell check" device into the exam room which will accept words or symbols that cue the correct answers.

- Arrange a code system with another student to convey answers using body language; for example, hand opened or closed for true or false; count the fingers for multiple choice.

- Go to the restroom with concealed information.

- Install information in the barrel of a ball point pen.

- Use the same or a similar paper for assignments in several courses; it can be yours or that of another.

- Drop things on the floor (pencil, paper); look at concealed

information.

- Do not attend the regularly scheduled exam, then debrief a friend who took it; request a make-up due to illness.

- If in a large class, do not attend the exam; when the grades are given or the exam returned, tell the instructor that you didn't receive yours. Accept the instructor's apology and negotiate a method to replace the missing grade (after you have debriefed a friend).

- Arrange for one student to distract the instructor while another student looks at helpful information or the answers of another.

While no list of acts of academic dishonesty can ever be complete, an awareness of some of the means and variations of this type of behavior enhances the ability of an instructor to deter such conduct and to determine an appropriate response.

III

THE ROLE OF THE INSTRUCTOR

As instructors we embrace and endorse the concept of teaching ethics in our business courses. There is little debate on the merits of incorporating the subject into our curriculum, but we seem to pay only lipservice to the principles of academic honesty. Academic integrity appears to be a natural predicate of business ethics. If the two concepts are, in fact, related perhaps we should devote a relatively proportionate amount of attention to the requirements of academic ethics.

Demanding academic honesty of our students requires multiple missions of instructors: teaching, policing, preventing and enforcing. We are not expected to be experts in surveillance and detection, but it could be argued that we do have an obligation not to be enablers.

Consider the following practices:

- At the beginning of each course announce or give the students notice of your policy concerning academic integrity. Relate academic honesty to business ethics. Give examples of wrongful practices. Explain the sanctions attendant to the wrongful acts. Reinforce the message at appropriate intervals.

- Before an exam look at the writing on the desks.

- Before the exam announce that no pages are to be ripped from exam books and that no exam book covers are to be detached.

- Use different color exam books for each exam.

- Seat students randomly for an exam, not in their usual assigned seats.

- During the exam, walk the aisles frequently, look at what is on the floor and on the desks.

- If a student has a question during the exam, request that he or she comes to you with his or her exam and booklets. Do not go to the student's desk, hunch over and turn your back to the rest of the class.

- Inform the students that nothing is permitted on the desk during an exam; books and belongings go under their seats (not under the table part of the desk or in the aisles where they can be seen).

- While there is a difference of opinion as to whether the instructor should sit in the front or rear of the exam room, sit where you can observe the whole room.

- Use different exam for each section. Vary the exams from semester to semester.[5]

IV

THE SOURCES OF STUDENTS' RIGHTS

In the event an instructor believes a student has cheated, care must be taken, both procedurally and substantively in handling the resolution of the matter. If the instructor and the institution are not attentive to the rights of the student, the courts may be called upon by the student to intercede on his or her behalf. There are two basic sources of students rights upon which a court will rely when intervening in the student-university relationship: (i) the fourteenth amendment to the Constitution of the United States, and (ii) a theory of contract law.

The fourteenth amendment states in relevant part: "No state shall make or enforce any law which shall abridge the privileges or immunities of the citizens of the United States; nor shall any state deprive any person of life, liberty, of property, without due process of law..."[6] This language, commonly referred to as the "due process clause" has been held to be applicable to protect one only from state action[7] and, therefore, in the context of a student attending a college or university, the actual due process protections are only available to those attending a state or public university.[8] There have been many cases concerning the issue of whether a particular college or university is to be considered public or private for purposes of the application of the due process clause.[9] In many instances it is obvious that the institution is a state or public institution. In other cases private institutions may be deemed to be state or public due to

factors such as their tax exempt status, receipt of federal funds, receipt of state funds, exempt status under state and local law, or public function interest. If in doubt about the legal status of your institution consult with an appropriate member of the administration or the institution's counsel.

At public universities, the fourteenth amendment is applicable to the area of academic discipline because it has long been held that a student has a property interest in education[10] and any possible denigration of a student's good name, reputation, honor or integrity may involve a liberty interest.[11]

Private college students derive their rights primarily from a theory of contract law which holds that an implied contract is deemed to exist between a university and its students.[12] By the terms of this contract, the student is deemed to agree to pay the required tuition and to abide by the academic and disciplinary rules of the university and the university is deemed to agree to award the appropriate degree upon the successful completion of the required course of study. If the student does not pay the tuition or violates the rules, the student has breached the implied contract and as a result may not be entitled to receive the degree.[13] The details of the contract terms are to be found in the university catalogue and in its other publications.[14] By application of the contract theory, the school's standards would be considered binding by implication upon the students,[15] and the obligation to accommodate the students' reasonable expectations in awarding the degree would be deemed binding on the school.[16]

V

RIGHTS OF STUDENTS

Public university students, by relying on the due process clause, and private university students (unable to assert rights under the due process clause), by relying on the contract theory, have achieved similar protections when challenging university decisions that were allegedly "arbitrary" or "capricious" or "irrational" or "made in bad faith."[17]

The courts, in private school cases, while embracing the contract theory[18] on one hand make it known on the other that the student-university relationship is a special[19] one and, therefore, two results follow: (i) the courts do not rigidly apply the rules of commercial contract law,[20] and (ii) the courts are most reluctant to interfere in academic decisions; these being viewed as best made by the institution, without interference from the courts.[21] This combination of a rejection of a rigid application of commercial contract law and reluctance to intervene in academic decisions has resulted in an historical legal environment especially favorable to college and universities that allows substantial latitude in their decisions and in the process of administration of justice to students.[22]

The principal rights afforded students at a private institution are a function of the doctrine of "reasonable expectations." This doctrine is used to determine the meaning a college or university would reasonably expect a student to attribute to the terms of the contract.[23] Since there is little reason for private university students to perceive that they should be afforded lesser or different rights than public or state university students, they can reasonably expect to be afforded the same general rights and protections available to public or state college students.[24]

Thus, using public universities as a model, private school students can reasonably expect to benefit from the same rights as public school students: fair notice of their alleged misconduct and an opportunity to be heard in a process appropriate to the nature of the case[25] (procedural due process), and actions by the school free from bad faith, arbitrariness, or capriciousness[26] (substantive due process). While there is great judicial deference to all aspects of the academic process[27] based on a reluctance to intrude upon the discretion afforded institutions in matters of student affairs,[28] the University will be vulnerable to legal action if it does not offer its students certain legal accommodations.

VI

SUGGESTIONS FOR AFFORDING STUDENTS THEIR RIGHTS

The following suggestions are offered as a means of complying with the school's legal obligations when academic integrity is the issue:

- In the event of a perceived act of cheating during an exam, the faculty member may elect to take immediate action ranging from a whispered warning to the student, to moving his or her seat, to confiscation of the paper. In any event, do not overtly embarrass or humiliate the student or accuse him or her of wrongful conduct in front of the other students. Such acts may constitute defamation[29] (if the student was, in fact, not cheating) or the intentional infliction of emotional distress[30] (even if the student was cheating). Do not touch the student. Touching may be considered assault,[31] battery[32] or sexual harassment.[33]

- If you elect not to confront the student during the exam, make notes of the details of the incident: time of day; where the student was sitting; suspicious activity and other relevant facts. In the event the matter is not thereafter immediately resolved, this information will be important to refresh your memory of the incident in the event a hearing or litigation takes place weeks or months later.

- If you elect to address the situation after the exam or if the wrongful act took place out of the exam environment, speak to the student privately, promptly after your observation, and

inform the student of your conclusions and sanctions. If the student and you are willing and able to resolve the matter at the student-instructor level, do it. Expenditures of time, effort, emotions and cost increase in proportion to the duration of the process. Every effort should be made to resolve the matter between the instructor and the student. If the student contests your observation or objects to the nature or severity of the sanction or if you feel the matter cannot be resolved at the student-instructor level, then the administration of the university becomes involved.

- The university should have adopted written procedures for handling matters involving academic dishonesty and should in each case adhere to those procedures and apply them consistently.[34] If you do not believe that the matter can be handled at the student-instructor level, an appropriate representative of the university should inform the student in writing of the charges and the sanctions you imposed and advise the student that he or she has the right to a hearing and the procedures therefor. If the student initiates the process by informing the chairperson, the chairperson or other designated representative of the school should advise the student in writing of the details of the appeals procedure. By notifying the student of the details of his or her right to appeal the instructor's decision, the school is not only affording the student rights that may be required by law, but the availability of the appeal process may serve to prevent the matter from escalating from academic environment to a legal environment.

- The hearing should be held before an impartial panel which may consist of a mix of, or exclusively of, representatives of the faculty, administration and/or student body. The hearing should be conducted in an orderly fashion with the student, the instructor and others involved having a reasonable opportunity to be heard. There are no requirements that legal rules of evidence or the formality of courtroom procedures be followed.[35] The instructor should attend the hearing and be prepared to fully inform the student of the observations that led to the conclusion of wrongdoing and to justify the sanctions imposed. The student should be permitted to bring a representative if he or she so chooses, and the student and the representative should be allowed access to all available evidence. The student and his or her representative should be given the opportunity to question the instructor and any witnesses. If the student elects to have a lawyer serve as his or her representative, prudence would dictate that the University do the same. Minutes should be taken and retained. When the hearing is concluded, the decision-making panel should within a reasonable time inform the student in writing of its decision.

- All parts of the proceeding should be kept confidential. It is not necessary nor advisable to have a succession of appeals procedures to different or "higher" bodies or boards.[36]

- If in doubt about the nature or legality of an action to be taken in any particular case, consult with your chairperson who will have access to the institution's counsel.

- To the extent possible the school should treat cheating as an academic matter, rather than as a disciplinary matter, to preserve the historical reluctance of the courts to intervene in academic affairs.

VII

LEGAL AND ECONOMIC RISKS OF THE INSTRUCTOR

It is not difficult to imagine that, in some cases, issues of academic dishonesty will necessarily move from the classroom to the courtroom. Litigation, in any form, is expensive and aggravating regardless of your legal position. If you are required to defend your observations, sanctions, conduct or reputation, who will pay the costs?

Many institutions have a policy (or contract provision) providing for indemnification of faculty against the reasonable expenses, including attorneys' fees, actually and necessarily incurred in connection with the defense or appeal of certain law suits. Check with your school to assure that such protections are available to you.

VIII

CONCLUSION

Academic integrity will be an issue as long as there are students competing for grades, graduation and jobs. By being aware of the various forms of academic misconduct and doing our part to enlighten our students in matters of integrity and ethics, perhaps we will deter such misconduct while fulfilling an obligation to the ethos of our profession.

The process of policing adherence to the school's standards and of administering justice is initially in the hands of the instructor. We should be mindful of the rights of the students and take all steps to afford them the appropriate procedural and substantive protections to which they are entitled.

***

ENDNOTES

1. Four sentences in the Pace University Undergraduate Catalogue serve as a notice to students of the University's expectations concerning academic integrity: "Students must accept the

responsibility to be honest and to respect ethical standards in meeting their academic assignments and requirements. Integrity in the academic life requires that students demonstrate intellectual and academic achievement independent of all assistance except that authorized by the instructor. The use of an outside source in any paper, report or submission for academic credit without the appropriate acknowledgment is plagiarism. It is unethical to present as one's own work, the ideas, words or representations of another without the proper indication of the source. Therefore, it is the student's responsibility to give credit for any quotation, idea or date borrowed from an outside source." Pace University Undergraduate Catalogue, 1992-1993, p. 72.

2. Survey conducted in one section each of the author's Law 101, 212 and 213 classes on February 1, 1993, February 4, 1993 and February 2, 1993, respectively. The students responding in this anecdotal exercise have my gratitude for their candor. See Appendix "A" for sample questionnaire.

3. Some institutions of higher learning have adopted the "honor system" by which the students assume primary responsibility for their honesty and agree to report any violation of the honor code. Princeton, for example, gives jurisdiction over all written exams and tests to the Undergraduate Honors Committee which operates on the honor system. Jurisdiction over all other academic work, including essays, term papers, etc., resides with the Faculty-Student Committee on Discipline.

4. Some of the methods and devices were included in the responses to the survey referred to in note 2. above. Others were told to the author "off the record".

5. I have yet to learn of a meaningful deterrent to the student who "really has to go" to the restroom.

6. U.S. Const. amend. XIV, §1.

7. See Civil Rights Cases, 109 U.S. 3 (1883).

8. Dixon v. Alabama State Board of Education, 294 F. 2d 150 (5th Cir. 1961).

9. See, for example: Grafton v. Brooklyn Law School, 478 F. 2d 1137 (2d Cir. 1973), re tax exempt status; Weise v. Syracuse University, 522 F. 2d 397, 404 (2d Cir. 1975), Wahba v. New York University, 492 F. 2d 96, 103 (2d Cir. 1974), Berrios v. Inter American University, 535 F. 2d 1330, 1332 n.5. (1st Cir. 1976), Cannon v. University of Chicago, 559 F. 2d 1063 (7th Cir. 1977) (rev'd on other grounds), 45 U.S.L.W. 4549 (1979), Greenya v. George Washington University, 512 F. 2d 556, 562 (D.C. Cir.) cert. den. 423 U.S. 995 (1975), Blackburn v. Fisk University, 443 F. 2d 121, 123 (6th Cir. 1971), Browns v. Mitchell, 409 F. 2d 593, 595 (10th Cir. 1969), Grossner v. Trustees of Columbia University, 287 F. Supp. 535, 547 (S.D.N.Y. 1968), re receipt of Federal funds; Cannon v. University of Chicago, 559 F. 2d 1063 (7th Cir. 1977), Powe v. Miles, 407 F. 2d 73 (2d Cir. 1968), Grossner v. Trustees of Columbia University, 287 F. Supp. 535 (S.D.N.Y. 1968), Berrios v. Inter American University, 535 F. 2d 1330 (1st Cir. 1976), Lorentzen v. Boston College, 440 F. Supp. 464 (D. Mass. 1977), re receipt of state funds; Stewart v. New York University, 430 F. Supp. 1305, 1312 (S.D.N.Y. 1976), re tax exempt status under state and local law; Krohn v. Harvard Law School, 552 F. 2d 21, 24 (7th Cir. 1977), Grossner v. Trustees of Columbia University, 287 F. Supp. 535, 547 (S.D.N.Y. 1968), Cohen v. Illinois Institute of Technology, 524 F. 2d 818 (7th Cir. 1975), Weise v. Syracuse University, 522 F. 2d at p. 404, n.6., re public function interest.

10. Dixon v. Alabama State Bd. of Educ., 294 F. 2d 150 (5th Cir. 1959); cert. den., 368 U.S. 930 (1961).

11. Wisconsin v. Constantineau, 400 U.S. 433, 91 S. Ct. 507 (1971); Board of Regents v. Roth, 408 U.S. 564 (1972).

12. See Carr v. St. Johns, 17 A.D. 2d 632, 633, N.Y.S. 2d 410, 413 (1962), Slaughter v. Brigham Young Univ., 514 F. 2d 622, 423 U.S. 898 (1975).

13. See Anthony v. Syracuse Univ., 224 A.D. 487,231 N.Y.S. 435 (1928).

14. See Andersen v. Regents of Univ. of Cal., 22 Cal. App. 3d 763, 99 Cal. Reptr, 531 (1972), Johnson v. Lincoln Christian College, 150 Ill. App. 3d 733, 501 N.E. 2d 1380 (1986), Behrend v. State, 55 Ohio App. 2d 135, 379 N.E. 2d 617 (1977), Drucker v. New York University, 57 Misc. 2d 937, 293 N.Y.S. 2d 923 (Civ. Ct. 1968) rev'd. 59 Misc. 2d 789, 300 N.Y.S. 2d 749 term 1969) aff'd. 33 A.D. 2d 1106, 308 N.Y.S. 2d 644 (1970), Goldstein v.New York University, 76 App. Div. 80 (1902).

15. Students may be bound if they knew or should have known of the rules. See Slaughter v. Brigham, 514 F. 2d 662.

16. See Giles v. Howard Univ., 428 F. Supp. 603 (1977).

17. Connelly v. Univ. of Vermont, 244 F. Supp. 156 (D. Vt. 1965). See: "Contract Law and the Student-University Relationship", 48 Ind. L.J. 253 (1972-1973).

18. See: Latourette and King, "Judicial Intervention in the Student-University Relationship: Due Process and Contract Theories", (the seminal article in this area), 65 University of Detroit Law Review 199-258, (January, 1988).

19. Slaughter v. Brigham Young University, 514 F. 2d 622, at 626: "The student-university relationship is unique..."

20. Id.

21. Board of Curators v. Horowitz, 435 U.S. 78 (1978), Depperman v. Univ. of Ky., 371 F. Supp. 73 (E.D. Ky. 1974).

22. See "Judicial Intervention in Expulsions or Suspensions by Private Universities", 5 Williamette L.J. 277, 280 (1968-1969).

23. Giles v. Howard Univ. 428 F. Supp. 603 (D.D.C. 1977).

24. See "Contract Law and the Student-University Relationship", 48 Ind. L.J. 253, 266 (1972-1973).

25. Ross v. Pennsylvania State Univ., 445 F. Supp. 147, 153 (M.D. Pa. 1978), citing Goss v. Lopez, 419 U.S. 565, 95 S. Ct. 729 (1975).

26. See Gaspar v. Burton, 513 F. 2d 843 (10th Cir. 1975); Aubuchon v. Olsen, 467 F. Supp. 568 (E,D. Mo. 1979); Depperman v. Univ. of Ky., 371 F. Supp. 73 (E.D. Ky. 1974); Connelly v. Univ. of Vt., 244 F.Supp. 156 D. Vt. 1965); Mustell v. Rose, 282 Ala. 358, 211 So. 2d 489, cert. den.; 393 U.S. 939 (1968).

27. See Latourette, 200-201. See also Healy v. James, 408 U.S. 169, 92 S. Ct. 2338 (1972).

28. Id.

29. Defamation is an injury to the person and to one's reputation-- that is, to one's right to enjoy the good opinions of others. New York Jur, Defamation and Privacy, §1.

30. New York expressly recognizes the independent tort of intentional infliction of emotional distress. A person may be liable for conduct which is extreme and outrageous and causes severe emotional distress in another. New York Jur, Fright, Shock, and Mental Disturbance, §2.

31. An assault is an intentional attempt displayed by violence or threatening gesture to do injury to, or commit a battery upon, the person of another. New York Jur, Assault - Civil Aspects, §1.

32. Battery is the intentional and wrongful physical contact with the person of another without the other's consent. A touching can constitute a battery if done in a rude, angry or insolent manner. New York Jur, Assault - Civil Aspects, §1.

33. Sexual harassment is defined in the Pace University pamphlet as "...an attempt to coerce an unwilling sexual relationship, or to subject a person to unwanted sexual attention, or to punish a refusal to comply or to create a sexually intimidating, hostile, or offensive working or educational environment. Sexual behavior includes a wide range of behaviors, from the actual coercing of sexual relations to the unwelcome emphasizing of sexual activity, verbal harassment or abuse, unwelcome sexual advances, and unnecessary touching. This definition will be applied consistent with accepted standards of mature behavior, academic freedom, and freedom of expression". p.1.

34. Tedeschi v. Wagner College, 49 N.Y. 2d 652, 1980.

35. See Board of Curators of the Univ. of Missouri v. Horowitz, 435 U.S. 78 and Goss v. Lopez, 419 U.S. 565 (1975).

36. See Board of Curators v. Horowitz, 435 U.S. 78 (1978), Gaspar v. Burton, 513 F. 2d 843 (1975).

QUESTIONNAIRE
ACADEMIC INTEGRITY

All questions pertain to your University experience.

1. Have you ever cheated?

a) On an assignment?	Yes_____	No_____
b) On a paper?	Yes_____	No_____
c) On an exam?	Yes_____	No_____
d) On any other school work:	Yes_____	No_____

2. Have you ever seen anyone cheat? Yes_____ No_____

3. Would you cheat:

a) If you believed you would not get caught?	Yes_____	No_____
b) If you knew you would not get caught?	Yes_____	No_____

4. If you have ever cheated, describe how you did it. (On the back of this page).

5. If you believed you would not be caught, describe methods of cheating you could or would use. (On the back of this page).

6. If you saw someone cheating or knew that someone had cheated, would you feel it was your duty to report them to the University? Yes_____ No_____

7. If you felt it was your duty to report them, would you report them to the University? Yes_____ No_____

8. Which statement is most accurate:

a) I know of no one that has ever cheated.
b) I know of a few people that have cheated.
c) I know many people that have cheated.
d) Most people I know have cheated.

a) _____ b) _____ c) _____ d) _____

9. If you knew someone had cheated, would it affect your friendship?

a) Not at all.
b) Could no longer be friends.
c) Would think less of that person.
d) Would think more of that person.

a) _____ b) _____ c) _____ d) _____

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Exhibit "A"

INFORMATION TECHNOLOGY: THE CONFLICT BETWEEN FREEDOM OF INFORMATION LAWS AND THE RIGHT TO PRIVACY

by

Diana D. Juettner* and Anthony F. Libertella**

Count not him among your
friends who will retail
your privacies to the world.
Publius Syrus, 1st Century B.C.

INTRODUCTION

Consider the following scenarios:

1. An unwanted suitor sent several unsavory letters to a 17 year old "pop" singer. He was able to obtain her home address from the California Department of Motor Vehicles database for a fee. She was forced to go to court to obtain an order of protection to prevent him from harassing her.[1]

2. A school district in Texas released the contents of a teacher's personnel file that included her college transcript. The file was released against her wishes pursuant to the state's freedom of information laws in response to requests made by two citizens.[2]

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3. The United States Department of Education badgered a man to repay a college loan he claimed he never applied for or received. He contended that it was a computer matching error that confused him with another person with the same name. In spite of his contention, agents for the Department reported the loan as unpaid to the credit reporting bureau causing him to be denied a car loan.[3]

4. The California State Bureau of Criminal Identification supplied information from their database to private employers, licensing agencies and other state agencies about arrests of potential employees that did not result in convictions. A class action suit was brought on behalf of the affected individuals and the court barred the state agency from releasing arrest information that did not result in a disposition.[4]

The above cases illustrate the ongoing conflict between freedom of information laws and the right to privacy. The Freedom of Information Act(FOIA)[5] was enacted by Congress in 1966 to ensure greater public access to government information in order to facilitate public scrutiny of agency action. Subsequently, Congress passed the Privacy Act of 1974[6] because it was concerned about the rapid growth of computer technology and the amount of personally identifiable data that was being collected, stored, disseminated and accessed electronically. This act tried to strike a delicate balance between government's need to gather, disseminate and use personal information while maintaining the individual's right to privacy.

By the 1990's, the upsurge in technological advancements, involving computers, computer systems, data, data storage and retrieval and other related areas has caused the federal and state governments to reexamine the requirements of freedom of information laws in the light of the privacy rights of those individuals whose computerized records are maintained by governmental agencies. Has the computerization of information stolen the right to privacy from Americans? Should there be consistent procedures developed that set forth policies and procedures regarding the collection, processing, use or shaping of personally identifiable data utilized by all levels of government and by those who acquire the information from government?

Americans are highly concerned about their privacy. They feel it slipping away from them in this highly technical era. Public pressures and concerns have arisen regarding the safeguard of the collection and retention of personally identifiable computer information. There is a desire to curtail privacy abuses that arise primarily in the collection and retention of unnecessary or inaccurate information.

An Equifax poll conducted in 1990 using a cross section of people in this country revealed that 79% of those polled were highly concerned about the confidentiality of their personal records.[7] A Time/CNN poll showed that people felt that companies selling personal information should be required to ask permission from individuals before making information about them available.[8] Congress's Office of Technology Assessment has revealed that it is impossible to know where files about you exist, making it almost impossible to seek redress for misuse of the information.[9] Today all levels of government which are the custodians of public information are faced with the dilemma

of meeting the requirements of freedom of information laws while protecting the privacy rights of their citizens.

PURPOSE OF THE PAPER

The escalation of the computer age has revolutionized the way government on all levels accumulates, uses and disseminates personal information. This escalation in information technology has put freedom of information laws into conflict with the privacy rights of individuals. This paper first examines the Freedom of Information Act and the Privacy Act of 1974 whereby Congress attempted to strike a balance between government's need to collect personal information with the individual's right to privacy. Next, the paper will review New York's Freedom of Information Law and its Personal Privacy Protection Law, both modeled after the FOIA and the federal Privacy Act. The paper then highlights the concerns of legislators about the public's use of personal information that is obtained from Motor Vehicle Bureaus and discusses some enacted and proposed legislation introduced by various state legislative bodies to restrict access to some of this data. Lastly, the newly emerging trends in information technology will be discussed with a brief commentary on various approaches offered by legislative bodies, freedom of information specialists and privacy experts to reconcile the conflict between freedom of information laws and the privacy rights of individuals.

FREEDOM OF INFORMATION ACT

The Freedom of Information Act(FOIA) was enacted in 1966 to facilitate public scrutiny of agency action to keep government officials from operating under a veil of secrecy.[10] The FOIA amended Section 3 of the Administrative Procedure Act(APA)[11] which was the original government information disclosure statute. Section 3 of the APA was generally looked upon as poorly drafted and falling short of its disclosure goals because it was more of a withholding statute than a disclosure statute.

The FOIA is an access mechanism into the activities of the executive branch of the federal government. Each agency of the executive branch is required: to publish statements of general policy, procedure and a description of their central and field organizations; to index and make available final opinions, unpublished statements of policy and staff directives that affect members of the public; to make such documents promptly available; and to release on written request all records not covered by the nine exemptions to disclosure.[12]

Information subject to the disclosure exemptions are as follows: (1) matters that are authorized and classified by executive order to be kept secret in the interests of national defense or foreign policy; (2) internal regulations and personnel practices of governmental agencies;(3) information specifically protected by other statutes provided such statutes mandate that the material be withheld from the public in such a way that there is no discretion on the issue or requires special criteria for withholding or indicates

the particular types of material withheld; (4) trade secrets, privileged or confidential financial information received from an individual; (5) inter or intra-agency memoranda that would be privileged from discovery in litigation; (6) personnel, medical or other similar files that would clearly establish an unwarranted invasion of privacy, if revealed; (7) investigative records used for law enforcement purposes subject to specific criteria;[13] (8) reports made, utilized or on behalf of an agency accountable for the regulation or supervision of financial institutions; and (9) geological and geophysical information relating to wells.[14]

Following the passage of the FOIA, Congress attempted to strike a balance between the government's need to gather, use and disseminate personal information and the individual's right to privacy regarding personally identifiable information by enacting the Privacy Act of 1974.

The Privacy Act sets forth the following requirements that every agency must follow regarding disclosure of personally identifiable information. These requirements function as safeguards to assist in the protection of personal information.

The first requirement or safeguard prohibits any federal agency from disclosing information from a record within a system of records without the written consent of the individual to whom the record pertains.[15] However, this requirement is subject to many exceptions that are quite expansive in scope.[16]

The second safeguard permits an individual to gain access to his or her record for review. The individual may also request that his or her record be amended and further permits an individual to request a review of an agency's refusal to amend the record.[17]

The third requirement empowers an agency to adopt rules and regulations for limiting the collection, maintenance, use and dissemination of personal information by the agency.[18] It also establishes procedures for an individual to: identify the system of records that exists pertaining to himself or herself; make the records available; and identify the individual who wants to see the record.[19]

The fourth and final safeguard enables an individual to bring suit against an agency for failing to meet the requirements of the Privacy Act. The court may impose civil penalties[20] and criminal penalties for willful disclosure of records without complying with the notice requirement.[21]

The FOIA and the Federal Privacy Act have been used by many states as a standard to create their own freedom of information and privacy statutes. New York was one of the first states to enact statutes patterned upon FOIA and the Privacy Act.

NEW YORK'S FREEDOM OF INFORMATION LAW

On September 1, 1974 New York enacted a "freedom of information" statute modeled upon the FOIA.[22] The enactment of the Freedom of Information Law (FOIL)[23] was a bipartisan effort to increase the accountability of government to its citizens. The underlying policy of the FOIL is the citizens' rigbt to know. The essential purpose of the law is to make available to the public all documents generated by and in the possession of government unless a compelling reason requires their confidentiality. This was to make agency officials more responsive to the citizens of the state who have developed distrust and alienation toward government officials.[24]

The New York courts have consistently held that any request to examine government documents should be afforded liberal statutory construction to maximize legitimate access to government records. When examining sections of the FOIL, the New York courts have considered and relied on the constructions made by the Federal courts regarding the parallel sections of the FOIA.[25]

The FOIL provides for the creation of a Committee on Public Access to Records to consider exclusively questions and problems that arise concerning the nature or application of any FOIL provision.[26] Although the Committee's principal function is advisory, it issues model regulations for agency procedures under the FOIL and it is required to issue annual reports to the governor and the state legislature. The reports must describe the committee's activities, findings, and recommended changes in the law.[27] The courts have relied on the expertise of the Committee thereby giving the Committee latitude in determining legislative intent and in suggesting principles of disclosure that will most effectively serve the public interest.[28]

In 1977, the FOIL was amended to provide easier access to government documents by changing the method of disclosure from an enumerated list of records to be disclosed to requiring complete disclosure of all government records unless the information sought falls under one of eight enumerated exemptions.[29]

The FOIL's right to privacy exemptions recognize the tension between the public's interest for open government and each individual's right to privacy. The amendment also sought to significantly broaden the statute's reach by creating a rebuttable presumption in favor of disclosure.[30]

The drafters of the FOIL recognized that disclosure resulting in limited invasions of privacy is in the best interests of the public and is therefore permissible. Hence, the courts have ordered disclosure of information when the public interest outweighs the interest of privacy of the individual being affected by the disclosure.[31]

NEW YORK'S PERSONAL PRIVACY PROTECTION LAW

The Personal Privacy Protection Law (PPPL)[32] was enacted in 1983 to protect against the increasing invasion into personal privacy posed by modern computerized data, collection and retrieval systems. The New York legislators were primarily concerned with the potential misuse of personally identifiable information stored in computers. Modeled after the federal Privacy Act, the New York law was designed to restrict public access to those records that state agencies could retrieve from their computer systems with personal identifiers. While the law primarily focuses on the restriction of public access to computerized personal data about others, it may have benefitted individuals by enhancing their right to acquire computerized data about themselves.[33] Access to local government information is not covered by the PPPL unless that information has been transferred to the local government from a state agency that is subject to the provisions.[34]

SAFEGUARDING THE SYSTEM

In spite of freedom of information exemptions and privacy laws, questions and concerns arise regarding the utilization of personal information that is obtained from government by the private sector. The Department of Motor Vehicles(DMV) is a well-known government agency that collects personally identifiable information about millions of people and is exempt from coverage under the PPPL.[35] The DMV serves as a representative example of potential unwarranted invasion of personal privacy by government because applicants for drivers licenses are required to provide personal information to the state that is subsequently made available to individuals as an open public record.

Although statutes such as the New York Vehicle and Traffic Law clearly reflect an intent that certain records be disclosed,[36] nevertheless it probably was not envisioned that these records could be obtained by the touch of finger on a home computer at the cost of $4.00 per search[37]. The applicant merely has to write a letter to the Department of Motor Vehicles stating an intention to become a member of the computer network and enclose a minimum of $200.00 to setup an account to access information contained on vehicle registration forms and operator licenses.[38]

Concerns over the improper use of the data collected by Motor Vehicle Bureaus have caused legislators in some states to adopt legislation restricting access to some of the data collected by the DMV.

California enacted a more restrictive disclosure law in light of the tragic death of the actress Rebecca Schaeffer whose aggressor stalked her after obtaining her home address from the California motor vehicle records.[39] California amended its Civil Code to require its Department of Motor Vehicles (DMV) to establish procedures that require the person requesting information to identify himself or herself and "state the reason for the request". In addition the statute requires the DMV to establish the following

procedures regarding requested information: (1) to verify the name and address of the requester; (2) to notify the person to whom the information primarily relates; and (3) to provide the name and address of the requester.[40] Moreover, legislation was enacted by California making a person's residential address confidential in DMV records "and shall not be disclosed to any person, except a court, law enforcement agency or other government agency, or as authorized in Section 1808.22."[41]

The death of Rebecca Schaeffer caused other states to enact legislation to curtail the misuse of personally identifiable information. The Virginia legislature addressed the problem by enacting a statute that requires the Commissioner of Motor Vehicles to "consider all driving records in the Department as privileged public records".[42] The Commissioner is authorized to release such records upon request only under specific conditions to specific classes of requesters such as: (1) any adult, parent or legal guardian of a minor or their authorized agent requesting any records pertaining to such persons except medical records;[43] (2) any insurance carrier or surety or representative of either, requesting an abstract of the operating record of any person subject to the provisions of this title;[44] and (3) any business official who upon written request provides an individual's driver's license number, may be provided with the name and address of the individual as shown on that driver's license record.[45] If a violation occurs, the requestor can be found guilty of a class 4 misdemeanor carrying a penalty of not more than $250.00.[46]

Delaware amended its statute by restricting access to DMV data by requiring individuals who want to use DMV information for purposes other than those stated in the statute to "... personally appear and present evidence of identification satisfactory to the Division and shall state the purpose for which the information is being sought[47]. The statote sets no criteria as to the sufficiency of the purpose by the requester. The statute clearly indicates that telephone requests will not be honored unless approved by the Director or his designee. Furthermore, a request by an individual to identify a vehicle owner from their registration plate shall be specifically noted by keeping a record of the request for a period not to exceed six months.[48] In addition, a vehicle owner or driver may submit a request to the Division of Motor Vehicles to have his or her name and address "excluded from any list compiled and sold or otherwise supplied by the Division for direct mail advertising purposes"[49].

Following the lead of California, Virginia and Delaware, some New York legislators have proposed bills to amend the vehicle and traffic law by requiring that personally identifiable information contained on motor vehicle registrations and licenses be made confidential.

New York State Senator Norman Levy introduced a bill that passed the Senate requiring the DMV to carry out the following provisions: (1) to keep the residence address confidential if requested by the registrant unless the address is needed for a legitimate business purpose; and (2) to educate the public that the residence address may be kept confidential through the media and DMV notices. Those who violate the provisions of confidentiality shall be guilty of a Class A misdemeanor.[50] Senator Levy

believes that the criminal penalty is an important provision that should be included in the legislation to give it some "clout".[51]

Similar concerns regarding the use of personally identifiable information contained in motor vehicle records prompted action in the New York State Assembly as well. Assemblyman Thomas Di Napoli has been concerned about this issue for a number of years. He introduced Assembly Bill A.896, modeled after the Delaware statute, that required the driver's license holder to be notified whenever a request for personally identifiable information was made.[52] This bill did not have the support of the Commissioner of Motor Vehicles because the application of the notification provision was seen as administratively cumbersome.[53] In response to the DiNapoli bill, the DMV proposed its own bill that gave discretion to the Commissioner to establish guidelines for accessing personally identifiable information. The DMV bill was later introduced by Assemblyman DiNapoli as A.7177.[54]

Thereafter, Assemblyman DiNapoli modified A.7177 (designated as A.7177A) making it mandatory rather than discretionary for the Commissioner of Motor Vehicles to establish guidelines relating to the use of personal information contained in motor vehicle records disclosed to the public. In addition, A.7177A permits the Commissioner to deny disclosure of information which if made public would result in an unwarranted invasion of privacy. Furthermore, A.7177A makes it "...a misdemeanor to knowingly use any information obtained pursuant to section 202 of this article for any purpose other than a motor vehicle related purpose, or to violate any regulations established for the receipt and subsequent use of such information or to knowingly provide any information to any person in violation of the regulations for disclosure of such information."[55]

The legislation proposed by Senator Levy and Assemblyman DiNapoli has raised concerns because of the potential loss of revenue that such legislation has for the New York State treasury. Currently the Department of Motor Vehicles generates 40 million dollars in revenue from fees collected from those who access the data. In spite of these monetary concerns, legislative aides believe that passage of some compromise legislation is forthcoming due to the concerns of citizens that have been raised regarding an unwarranted invasion of their personal privacy.[56]

Some other states have proposed legislation to restrict access to some Motor Vehicle information. For example, the State of Washington proposed an amendment to allow the secretary of state to permit those in danger of domestic violence to provide a substitute mailing address in place of one's residence address to fulfill all state and local agencies' filing requirements. This amendment would allow any person the right, upon request, to keep their address relating to motor vehicle registration confidential to avoid harassment or domestic violence.[57] Similar legislation is also pending in Colorado.[58]

CONCLUSION

During the 1990's, government will continue to utilize technological advances for the accumulation, use and dissemination of personal information. One notable example of government usage of new technology is the implementation of Geographic Information Systems(GIS). GIS are computer systems that are able to store an infinite amount of information that can be retrieved in significantly less time than the standard systems that are currently in use.

While GIS are being used predominantly at the local government level, over 20 agencies within the Department of the Interior use information stored in GIS.[59] Presently, GIS primarily utilizes land information data; however, it has the potential to incorporate all types of data that can be related to a vast number of uses by government and the private sector. Future plans call for the expansion of GIS to integrate data from all government departments. Some experts feel that as more government departments become integrated into a GIS system and more information is contained within the data base, that protection of an individual's personal privacy will become most important.[60]

The FOIA and state freedom of information laws create a clear right of public access to government stored information with very few statutory exemptions. However, the current privacy laws do no provide sufficient protection for the personal data contained within the vastly expanding body of computerized government records. Consequently, several suggestions are being offered as pssible solutions to the growing concern over the immediate access to personal information that has been made available through the advances of technology that invade our privacy. Some privacy rights' experts have indicated that federal and state legislators should amend freedom of information laws and personal privacy protection laws so that they can be "in step" with the new technology.

Robert Freeman, New York State's Executive Director of the Committee on Open Government, has a different approach to protect personal information. He believes that it is more important to provide better security over the computerized data that is collected and to provide appropriate penalties for violations, than to pass more stringent privacy laws that further restrict access to government records.[61]

Another suggestion is to create a federal data protection board[62] that will develop guidelines and issue opinions about new government and private sector data banks. Furthermore, the data protection board will have the authority to investigate privacy act complaints and to champion research into the social implications of new computer technologies[63].

To cover issues arising in the computer era, various privacy experts have recommended that state governments develop a concept of fair information practices to provide guidance to government agencies gathering personal information.[64] For example, the State of Wisconsin has recently adopted a Code of Fair Use of Information Practices that: prohibits secret personal data record-keeping systems; establishes an

individual's right to know the type of information stored about such individual and how it is utilized; assures that the data created, maintained, used or disseminated must be reliable for the intended use; permits an individual with the opportunity to correct or amend personally identifiable information in a stored record; and takes precautions to prevent misuse of the data.[65]

The technology of the 1990's requires that the federal and state governments reexamine the purpose of the freedom of information laws in the light of the privacy rights of those individuals whose records are maintained by governmental agencies. For those states that have not addressed the complexities of this issue, their legislators must enact legislation to address the growing concern over the access to personal information that has been made available through the advances of technology that invade our privacy.

ENDNOTES

[1] Robert Ellis Smith & Eric Siegal, War Stories: Accounts of Persons Victimized by Invasions of Privacy 69 (1990).

[2] Klein Ind. School District v. Mattox, 830 F.2nd 576 (5th Cir. 1987).

[3] See Smith & Siegal, supra note 1, at 16.

[4] Id. at 37.

[5] 5 USC Sec. 552 (1993).

[6] 5 USC Sec. 552a (1993).

[7] Jeffrey Rothfeder, Privacy For Sale 25 (1992).

[8] Id. at 92. Some companies such as American Express have addressed this concern by giving their customers the opportunity to choose whether or not they wish to have their names and addresses included on mailing lists that will be sold to other vendors.

[9] Id. at 17.

[10] See supra note 5.

[11] 60 Stat. 237, repealed September 6, 1966; replaced with Pub.L.89-554 (5 USC Sec. 551 (1993)).

[12] 5 USC Secs. 552(a)(1-4) (1993).

[13] 5 USC Sec. 552(b)(7)(1993). The criteria subject to privacy protections are as follows: a) deprive an individual of a fair trial, b) constitute an unwarranted invasion of personal privacy, c) disclose the identity of a confidential source d) disclose techniques and procedures for law enforcement investigations e) disclose guidelines for such investigations or prosecutions if such disclosures could reasonably be expected to circumvent the law; and f) endanger the life or physical safety of any person.

[14] 5 USC Secs. 552(b)(1-9)(1993).

[15] 5 USC Sec. 552a(b)(7)(1993).

[16] Some notable exceptions are to make information available: to a recipient who has provided an agency with written assurance that the record will be used solely for statistical purposes and will not be used in any identifiable form; to a person who shows compelling circumstances that affect the health and safety of any individual; to Congress and its committees; and to requesters who satisfy the disclosure requirements set forth under FOIA. See 5 USC Secs. 552a(b)(1-12)(1993) for the complete list of exceptions.

[17] 5 USC Sec. 552a(d)(1993).

[18] 5 USC Sec. 552a(e)(1993).

[19] 5 USC Sec. 552a(f)(1993).

[20] 5 USC Sec. 552a(g)(1993).

[21] 5 USC Sec. 552a(i)(1993). See 5 USC Sec. 552a(e)(4) (1993) for a full description of the notice requirement.

[22] Ralph Marino, "The New Freedom of Information Law", 43 FORDHAM L. REV.83 (1974). It should be noted that Sen. Ralph Marino was the author of the Freedom of Information Law.

[23] N. Y. Pub. Off. Law Sections 84 et seq.(McKinney 1993).

[24] See Marino, supra note 22, at 83,84.

[25] "New York's Freedom of Information Law, disclosure under the CPLR, and the common-law privilege for official information: conflict and confusion over 'the people's right to know'". 33 SYRACUSE LAW REVIEW 615, 615-617 (1982).

[26] N. Y. Pub. Off. Law Section 89 (McKinney 1993).

[27] Id., at Section 89(1)(b).

[28] Miracle Mile Assocs. v. Yudelson, 68 AD2d 176,181, 417 N.Y.S.2d 142 (1979); Sheehan v. City of Binghamton, 59 AD2d 808,809, 398 N.Y.S.2d 905(1977).

[29] N. Y. Pub. Off. Law Section 87(2)(a-j) (McKinney 1993). It should be noted that there are now ten exemptions to the FOIL. The exemptions permit a government agency to deny access: a) to records that are specifically exempted from disclosure by state and federal statute; b) to records the disclosure of which would constitute an unwarranted invasion of personal privacy; c) to records if disclosed would impair present or imminent contract awards or collective bargaining negotiations; d) to trade secrets or records maintained for the regulation of commercial enterprise the disclosure of which would substantially injure the competitive position of the said enterprise; e) to records compiled for law enforcement purposes; f) to records the disclosure of which would endanger the life and safety of any person; g) to certain types of inter or intr-agency records; h) to certain types of examination questions or answers which are requested prior to the final administration of such questions; i) to any computer access codes; and j) to certain photographs, videotapes or other recorded images prepared under authority of section eleven hundred eleven-a of the vehicle and traffic law.

[30] N. Y. Pub. Off. Law Section 84 (McKinney 1993).

[31] MacHacek v. Harris, 106 Misc.2d 388,431 N.Y.S.2d 927 (1980); HMG Marketing Associates v. Freeman, 523 F. Supp. 11, S.D.N.Y.(1980); Wine Hobby USA, Inc. v. United States Internal Revenue Service Appeal of United States Bureau of Alcohol, Tobacco and Firearms, 502 F.2d 133, 3rd Cir. (1974).

[32] N. Y. Pub. Off. Law Section 91 (McKinney 1993).

[33] FOIL AO-4602 para. 5 (6/2/87).

[34] N. Y. Pub. Off. Law Section 92(1) (McKinney 1993).

[35] Id.

[36] N. Y. Veh. & Traf. Law Section 508(3) (McKinney 1993).

[37] Id. at Section 202(b).

[38] Id. at Section 202(d).

[39] See Rothfeder, supra note 7, at 13-15.

[40] Cal. Civ. Code Sec. 1798.26(Deering,1993).

[41] Cal. Veh. Code Sec. 1808.21(a)(Deering,1993).

[42] Va. Code Ann. Sec. 46.2-208(B)(Michie,1992).

[43] Va. Code Ann. Sec. 46.2-208(B)(1)(Michie,1992).

[44] Va. Code Ann. Sec. 46.2-208(B)(2)(Michie,1992).

[45] Va. Code Ann. Sec. 46-2-208(B)(3)(Michie,1992). For the remaining list of those classes of requesters, see Va. Code Ann. Sec. 46.2-208(B)(4-10)(Michie,1992).

[46] Va. Code Ann. Secs. 46.2-203,46.2-208 and 46.2-113(Michie,1992) to carry out the provisions of Va. Code Ann. Sec. 2.1-380 paragraphs 3 and 5 of the Privacy Protection Act of 1976 as it relates to maintaining and disseminating the personal data located within the Department of Motor Vehicles. See Va. Code Ann. Sec.18.2-11 (Michie,1992) for punishment for Class 4 misdemeanors.

[47] 21 Del. Code Ann. Sec. 305(b)(1992).

[48] Id.

[49] 21 Del. Code Ann. Sec.305(c)(1992).

[50] 1993-1994 Regular Session New York State Senate S.190. This bill passed the New York State Senate on March 2, 1993 and was sent to the Assembly Committee on Transportation. Currently, no action has been taken on this bill by the Assembly Committee.

[51] Interview with Senator Levy's legislative aide, Rebecca DeGati on June 15, 1993.

[52] 1993-1994 Regular Session New York State Assembly A.896. Assembly bill 896 introduced by Assemblyman DiNapoli in the 1993 session is the same bill introduced by him in the 1991- 1992 Session as A.9451-B. These bills have been superseded by A.7177B described in endnotes 54 and 55.

[53] Interview with Assemblyman DiNapoli's aide, Gary Henning, on June 15, 1993.

[54] 1993 Motor Vehicle bill No.8R. This bill was introduced in the Assembly by Assemblyman DiNapoli as A.7177.

[55] 1993-1994 Regular Sessions New York State Assembly A.7177A. This bill was approved by the Assembly Transportation Committee, the Committee on Codes, Ways and Means Committee and is currently in the Rules Committee. It was modified in Committee and as of November 1993 is now known as A.7177B.

[56] Interviews with legislative aides, Rebecca De Gati and Gary Henning in Albany on June 15, 1993.

[57] Wash. Rev. Code Ann. Secs. 26.04, 29.0155, 42.17.310, 42.17.311 (West 1991).

[58] Colo. Rev. Stat. Ann. Sec. 24-72-204(West 1991).

[59] U.S. Department of the Interior, A Study of Land Information(1990).

[60] Ron J. Aschenbach, "Geographic Information Systems as a Decision Making Tool", 52 OHIO ST. L.J. 351 (Winter 1991).

[61] State of New York Committee on Open Government, 1992 Report to the Governor and the Legislature 45 (1992).

[62] 102nd Congress, 1st. Session 1991, H.R.685. Hearings were held before the Government Information, Justice and Agriculture Subcommittee of the Committee on Government Operations, but the bill died in Committee. This bill has not been reintroduced in the 1993 session and apparently there are no current plans to do so.

[63] See Rothfeder, supra note 7, at 25,26,148-152.

[64] Robert Ellis Smith, The Law of Privacy in a Nutshell 50 (1993).

[65] Wisconsin Legislative Council, Information Memorandum 92-13 6 (1992).

CURRENT LEGAL DEVELOPMENTS IN CHINA

by

ROY J. GIRASA*

PREFACE

In January, 1993, after decades of following the significant events in China, from the overthrow of Chiang Kai-shek to the present development of a market economy, I visited the People's Republic of China (PRC). During the three week stay, I met numerous officials, diplomats, consulate and trade personnel, company executives, officials of the American Embassy, professors and, also, students during the time of the Tiananmen Square massacre. I purchased all the translated books and materials available to me. This paper reflects some of the developments of US-PRC legal and trade relations to the present date.

HISTORICAL BACKGROUND

China, historically, has always been an enigmatic, far away place which has intrigued Europeans and others for the past millennium. Confined to the Asiatic region, it made few or no forays abroad beyond the region.[1] China was the focus of invasions, visits and other periodic attempts to open its ports to the outside world. It has the longest recorded history, predating the Roman Empire by two thousand years. All schoolchildren know of the 13th Century voyage of Marco Polo who found an incredibly advanced civilization in the East. In 1601, Matteo Ricci, a Jesuit priest, was permitted to establish his religion within Beijing and environs due mainly to his knowledge and teaching of Renaissance advances in science, technology and other intellectual pursuits to the Qing emperor. Prior to Ricci, Arab traders had developed a spice trade, particularly with Mongols along the Silk Road.

In the 1600s, the East India Company developed an extensive trade with China in tea, silk, porcelain (china is named after the country) and other imports. The city of Canton was the port through which trade took place. In the late 1700s, the British began exporting opium to China from India. When the Daoguang Emperor sought to cease its import, British gunboats, in the Opium War of 1839-1842, were sent to China to continue the trade. In the Peace Treaty of 1842, Hong Kong was given to the British by the reluctant Emperor.

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Numerous additional ports were open to international trade. The Chinese were compelled to purchase opium in exchange for their silk and other commodities.

The Taiping revolt of 1848-1864 by a Christian leader, Hong Xiuguan, who alleged he was a brother of Jesus Christ, led to further British and French interference and resulted in the grant of concessions to them, particularly in Shanghai and Beijing. After a losing war with Japan (1894-1895), secret groups formed within China which aimed at expelling foreigners. The brief Boxer Rebellion, which was suppressed by Western powers, eventually led to the demise of the Qing dynasty in 1911.

The rebellion of Sun Yatsen and his followers led to the formation of a republican government. His government lasted briefly. China disintegrated into a state led by warlords seeking control of the country. After World War I, revolutionary movements arose, including the Chinese Communist Party in 1921. Communists collaborated with Sun Yatsen's organization (the Kuomintang). Chiang Kai-shek became the head of the Kuomintang, expelling and executing communist members. His rule lasted until 1949 when the Communists took over under the leadership Mao Tze-Tung, whose country became known as the People's Republic of China.

China under Mao was a closed society. Considering the historical maledictions of foreigners, including the Korean War (1950-1953) it is not surprising that China sought to go it alone. Ultimately, famines and China's arguments and brief conflict with the Soviet Union in 1960s led it to seek an opening to the Western World. It became obvious that the industrial world was greatly surpassing China's economy. Japan's industrialization to the East and the Soviet border threat caused it to open its ports anew to the West. President Nixon's visit in 1972 provided the opportunity to expand China's horizons. The ascent of Dong Xiaoping after Mao's death in 1976 led to the modernization program. With old-line Communist leadership dying, the ideological underpinnings of the Communist Party became loosened. In 1989, however, the incipient democracy movement was suppressed. The Party today is still in control, but it is more akin to a Central American dictatorship rather than a totalitarian society. At a Party Congress in October, 1992, the Party declared that ideology and economics were to be separated. Removing economics from the Party is akin to removing Christ from Christianity. Today, one can see that the free-market economy is quickly replacing China's planned economy.

THE LEGAL SYSTEM

Historically, the legal system and codes of law of China derived from the Emperor. It was an ethics based law which

blended dynastic codes with Confucian ethical principles.[2] Each dynasty promulgated codes of law, some of which pre-dated the Christian era. With the ascendancy of the Communist movement in China, there were attempts commencing in 1931 to introduce a variety of laws in anticipation of its seizure of power. World War II interrupted the Communist takeover of the government.

As in the Soviet Union, law became subservient to the state. Marxist theory and practice relegated all governmental institutions to the service of the state, including the judicial system. From 1949 to 1957, after abolishing all laws enacted by the previous government, a few laws were passed dealing with law reform, marriage and trade unions. Judges had to decide cases in accordance with governmental policy. Between 1958 to 1966, no laws were passed; rather 420 decrees were enacted.[3] Anarchy reigned during the Cultural Revolution in the late 1960s and early 1970s. The death of Mao in 1976 led to significant reforms. The People's Congress, which previously merely approved pre-ordained mandates, became invigorated. Legislation was drafted and enacted which lent some credibility to the rule of law within China. The Ministry of Justice, which had ceased to exist in 1959, was re-established in 1979.[4] The laws, which are discussed below, are a few of the significant legislative enactments which have been promulgated. They reflect China's renewed entry in the global marketplace and a reaffirmation that modernization entails a much greater understanding and cooperation with global and local market forces.

The underlying philosophy which formulates much of the precepts of China, as well as most of Asia, is Confucianism. The rule of law is based, not upon conflict resolution, i.e., a neutral observer (judge) who determines a result after combatants for the parties (attorneys) have presented their evidence, but rather upon a system of conciliation and compromise. Confucianism is an ethical system the basis of which is li (reason) rather than fa (law).[5]

The threat to sue, so familiar to Western thought, is utterly abhorrent in Asia. Dispute resolution is a multi-step process commencing with friendly discussion followed in successive order by conciliation, mediation and arbitration. Litigation is left to those who lack virtue and modesty. Reason reigns supreme over law.

It is important to recognize the immense cultural differences between Western democracies and Eastern political developments. China has not had a Western style Lockian/Jeffersonian historical evolution. Its history, though profound, is one of autocracy. Its legal system was developed over a period in excess of four millennia (from the 21st century B.C.). From an early slave owning society, China's history is marked by a succession of dynasties.

FORMS OF DOING BUSINESS IN CHINA

There are primarily six ways of doing business in China: (1) representative offices; (2) processing and assembling operations; (3) technology transfer; (4) equity joint ventures; (5) cooperative joint ventures; and (6) wholly formed enterprises. The first four methods are not legal persons, while the last two are legal persons within the PRC.

Representative Offices

These offices represent other offices of a multi-national company. They may engage in sales and purchases, bargain with local and state governments and enterprises, engage in market studies and collect information. They should exhibit a commitment to the Chinese market. They may, however, not engage in direct business activities, i.e., they cannot execute contracts or bind their home offices. They may negotiate without making final decisions. In reality, much decision-making does take place by them. They are primarily liaison offices. The PRC in 1980 wanted technology with a heavy emphasis on manufacturing and the acquisition of management skills. It did not want foreign companies to provide service facilities inasmuch as they were to be reserved to China companies, such as Chinese import-export companies.

It is anticipated that representative office will be replaced by a true branch office. These offices will have some greater leeway but may not engage in direct business activities.

Processing and Assembling Operations

This method of doing business is most favored by Hong Kong. Companies therein ship raw materials and parts to China where they are assembled and exported. It may take the form of compensation trade wherein the foreign enterprise supplies the equipment and is repaid by the product produced within China. Regulations promulgated in 1987 govern them. These regulations do not attempt to limit such activities but rather are informational to the government. The Ministry of Foreign Economic Relations with Trade of the PRC (MOFERT) in Beijing, approves the enterprises. Local commissions in the locality have direct authority over them. Similar regulatory provisions apply to joint ventures and other forms of doing business. If the enterprise is in excess of $100 Million, the State Council above MOFERT must approve. Provincial approval authority governs contracts of $30 million and local authorities have approval authority of up to $10 million.

The latest incentive granted by authorities permit new material and equipment to be "bonded goods" which escape import and export taxation.

Technology Transfer

The foreign party licenses its technology which is protected by intellectual property statutes and regulations.[6] Technology import regulations (patents, trademarks, copyrights, property technology (know-how) and computer software come within the purview of the statutes and regulations.

China joined the Berne Convention of 1886 for Protection of Copyrights. Technology transfer contracts must be approved by MOFERT. Regulations provide that the technology must be advanced or allow China to conserve resources or stimulate exports. In practice, the restrictions are not onerous. Contracts may <u>not</u> have the following provisions: (1) tying of technology with output; (2) price-fixing; if foreign party supplies parts, it cannot limit production; (3) restrictions on exports using the technology, except where the foreign company already gave exclusive territories to other companies. The regulations specify a ten year limit to royalties at the end of which the recipient party may utilize the technology. The contract can restrict re-licensing. It is therefore important to have majority control of the Board of Directors of the joint venture so as to prevent the venture from exceeding the limitations desired by the foreign partner.

A company providing the technology can apply to the Government for special approval for exceptions to the above. Although the law says a company is under the above constraints, the Government in practice is fairly liberal in granting exceptions. The applicant must give guarantees that the technology is complete and accurate. The licensor must agree to defend the licensee against claims respecting the technology. New regulations being adopted allow the parties to decide how to allow parties to decide licensing arrangements. Royalties are subject to a withholding tax of 20%, reduced to 10% by tax treaty and in special economic zones.

Equity Joint Ventures

The most popular form of doing business in the PRC is the equity joint venture. The legal basis is derived from the 1979 enactment of the "Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures"[7] and its 1983 regulations implementing the legislation. Inasmuch as there is no joint company law (Business Corporation Law) in the PRC which defines the rights and obligations of the parties, one must look to the individual statutes and regulations to determine one's rights and obligations.

The statute is rather brief, containing 15 articles which provide the framework for the enterprise. Considering the previous xenophobic governmental attitude towards investments,

the law was an extraordinary opening to the outside world. Article I states the purpose of the legislation which is to expand international economic cooperation and technological exchange.

The regulations elaborate the statute's overall purpose. Article 3 of the regulations provide that the joint ventures are to raise the scientific and technological standards of China by establishing business in six primary areas, to wit: (1) energy resources development, construction materials, chemical and metallurgical industries; (2) machine-building instruments, meter industries, and off-shore oil-mining facilities; (3) electronics, computers and communications equipment manufacturing; (4) light industries, textiles, food, pharmaceutical, medical and packaging industries; (5) agriculture; and (6) tourism.

The joint venture must satisfy at least one of the following requirements: (1) adopt advanced technology, equipment and scientific techniques; increase variety and quality of output of products and conserve energy and materials; (2) benefit technical renovation of the venture and achieve quick results and large profit with small investment; (3) expand exports and increase foreign exchange earnings; and (4) train technical or managerial personnel.[8]

Establishment

The joint venture with the Chinese enterprise must take place within the PRC.[9] The agreement must be in writing, which agreement, together with the articles of association and other relevant documents, are to be examined and approved by MOFERT.[10] Once it approves the joint venture, it then authorizes the local or regional authorities under the State Council to examine and approve the joint venture.

Application, in Chinese, for permission to establish a joint venture commences with its submission by the Chinese party to the department of government in charge. The application consists of: (1) an application for establishing the joint venture; (2) a preliminary feasibility study report; (3) the joint venture agreement; (4) contract and articles of association; (5) the names of the chairman, vice-chairman and the other members of the Board of Directors; and (6) the signed opinions about the joint venture of the departments of government in charge of the Chinese ventures of the local governmental authorities.[11] Approval or disapproval of the authorities is rendered within three months unless revisions of the documents are requested.[12] Within one month after approval, the applicants are to register with local authorities in charge of industry and commerce.[13] The joint venture comes into effect upon approval of the registration.[14]

As stated previously, there are three basic documents required for submission. The joint venture agreement is the document in which the parties consent to the establishment of a joint venture and state the basic principles for its establishment.[15] The joint venture contract states the rights and obligations of the parties. The document shall include: (1) the names, countries of registration, legal addresses of the parties as well as the names, position and nationalities of their legal representatives; (2) the name, legal address and purpose of the venture as well as the scope and scale of its operation; (3) the total amount of investment, its registered capital, amount to be invested by each party, the ratio types of their contribution; and the time limits for further contributions; (4) the ratio of sharing profits and losses; (5) the composition of the Board of Directors as well as their respective responsibilities; (6) the equipment, technology and sources of supply for same; (7) the manner in which raw and processed materials are to be purchased and products sold as well as the ratio of internal sales to export sales; (8) receipt and expenditures of foreign exchange funds; (9) labor management, wages and fringe benefits for employees; (10) finance, accounting and auditing principles; (11) term of joint venture and procedures for dissolution and liquidation; (12) liabilities for breach of contract; (13) methods of dispute resolution; and (14) language(s) to be used.[16] NOTE: Chinese law is to govern with respect to all aspects of the joint venture contract.[17]

The joint ventures articles of association follow the contract very closely. They are to include the names, addresses and purpose of the joint venture, its scope and term, the names of all parties and representatives, the amount of investment registered capital, ratio of contributions as well as profit and loss allocation; composition of Board of Directors, management structure together with the responsibilities of the principal officers as well as the procedures for their appointment or dismissal; principles of financial, accounting and auditing systems; and dissolution and liquidation and method for amendment of the article.[18] There may be other ancillary agreements such as distribution, licensing, land-grant and/or purchase agreements.

What if a party desired to enter into a joint venture in the PRC but lacked a corresponding Chinese party? The regultions provide that it should submit a preliminary joint venture proposal to the national China International Trust and Investment Corporation or a local similar agency with authority to introduce it to a partner.[19]

Status

The equity joint venture is a "limited liability company."[20] Its precise definition is not found either in the statute and regulations or in other legislation. It is thus necessary to explain what it means in the joint venture contract. The statute and regulations do state that the liabilities of the parties are limited to the amount of

investment each has undertaken in the joint venture. The 1979 statute mandated that the foreign party must invest not less than 25% of the registered capital of the joint venture. Most foreign joint ventures invest 51% or more of the capital. Profits or losses are to be divided in proportion to their contribution to the "registered capital."[21] The registered capital (similar to "stated capital" in the U.S.) is the total amount registered with the government agency when the joint venture was established and is the sum of the investment by all parties.[22] The joint venture may not diminish the registered capital but may increase or assign it provided the Board of Directors and governmental authorities approve.[23] If a party wishes to assign its interest, governmental approval will be necessary and is subject to the right of first refusal by the other party to the joint venture.[24]

The difficulty of the joint venture having a strictly Chinese personam is its lack of ability to branch out beyond the national boundaries. It appears, however, that MOFERT may approve a branch office of the joint venture outside of China.[25]

Capitalization

The investment in a joint venture may be in cash, buildings, plant equipment, machinery, international property rights, technology, or right to use a site. The parties to the joint venture are to fix the value of the investment in a fair and reasonable manner.[26] Foreign currency must be converted to renminbi at the foreign exchange rate set by the State Administration of Exchange Control. The rate tends to be considerably lower than black market exchange rates although the currency may be exchanged into foreign currency at the same governmental rate.[27]

The right to use a site must be compensated for either as a credit to the Chinese party as a part of its investment or to the government.[28] The regulations are obviously tipped greatly in favor of the Chinese party. For example, if machinery, equipment or other materials are contributed by the foreign party, they must be: (1) indispensable to the joint venture; and (2) made in China or the price, quality or delivery time would not satisfy the joint ventures requirements; and (3) their fixed value may not exceed their current international market price for the equipment. The Chinese party is not bound by the provisions.[29]

Industrial property rights or technology contributed by a foreign party must be capable of producing new products urgently needed in China or are suitable for export, or significantly conserves raw or processed materials, fuel or power.[30] If the foreign party contributes industrial property rights or technology, it must furnish proof of its registration abroad as well as the basis for the value affixed thereto. Machinery, equipment or other investment property by the foreign party shall be examined and agreed to by government agent for approval. Note again the above only applies to the foreign party.[31]

The investment is to be examined by an accountant registered in China who verifies the contribution made by each party. Thereafter investment certificates are issued to the parties.

Management

The Board of Directors of the joint venture determines all major questions of the joint venture.[32] It consists of at least three members. The number of directors is determined by the parties who are to take into account the ratio of the investment by each party. The chairman must be the Chinese venturer and the vice-chairman (vice-chairmen) will be the foreign investors. The term of office is 4 years and is renewable.[33] At least one annual meeting is mandatory, which meeting is convened and presided over by the chairman, or vice-chairman, if (s)he is not present. At least two-thirds of the Board must be present although a board member may give a proxy to another person to act on his/her behalf. Interim board meetings must be called upon request of one-third of the board members. The meeting is held at the official address of the joint venture.[34]

Although resolutions may be adopted by the percentage vote authorized in the articles of association, certain resolutions require unanimous approval, to wit: amendment of the articles of the joint venture; termination or dissolution of the joint venture; increase or assignment of the registered capital of the joint venture; or merger of the joint venture with another economic organization.[35]

The day-to-day operation of the joint venture is conducted by the officers named by the board of directors. It shall have a president whose duties include the promulgation of all resolutions of the board, representation of the joint venture, appointment and dismissal of personnel and other daily activities. The officers may be Chinese or foreign persons. Board members may be officers.[36] The president and vice-president may not hold similar offices or participate in another economic organization.[37] These officers may be dismissed at any time for dereliction of duty or for corruption.[38]

Taxation

The joint venture is taxed at the basic rate of 30%; 24% in coastal economic zones (Tianjin, Shanghai, Guangdong), and 15% in special economic zones (e.g. Hunan). Tax holidays are typically 2 years, 50% reduction for an additional 2 to 3 years plus investment incentives if reinvested.

The joint venture regulations merely recite the necessity of paying taxes in accordance with applicable laws. Imports by a joint venture are exempt from customs duty and from the industrial and commercial consolidated tax with respect to machinery and equipment needed for construction of the factory site or are part of the investment or are used in production of goods for exports and are manufactured within China. Exports may be exempted from industrial and commercial consolidated tax by MOFERT. Exemption from taxation may be granted in the early phase of a joint venture.[39]

Foreign Exchange Control

The joint venture must use the Bank of China or other designated bank which supervises all receipts and payments. All receipts and deposits must be made through the account. Foreign accounts may be permitted provided the State Administration of Exchange Control allows them. In such circumstances, they are subject to full disclosure of receipts, payments and bank account statements.[40] Loans for foreign exchange and for local currency may be applied for at the Bank of China in accordance with regulations of the Bank of China.[41] Foreign exchange funds may be borrowed from abroad but a report must be made to the State Administration of Exchange Control.[42] A remission of the net profit after payment of taxes and expenses may take place upon receipt of permission from the Bank of China.[43]

Finance and Accounting

The fiscal year is the calendar year. A treasurer must be appointed to manage the finance and accounting work of the joint venture. An auditor shall also be appointed for larger joint ventures who is responsible for examining all financial records pertaining to the enterprise and for submission of reports to the Board of Directors.[44] Internationally used accrual basis and debit and credit accounting systems are to be used. All books and records must be in Chinese.

After-tax profits are to be distributed to a reserve fund, bonus and welfare funds for staff and workers, and to the venture expansion fund as determined by the Board of Directors. The reserve fund is to be used to make up losses of the joint venture as well as for expansion of production. Net profits shall be divided in accordance with the ratio of the investments made by the parties. No profits may be distributed until all prior losses have been paid up.[45]

Quarterly and annual accounting statements are to be submitted to local tax authorities as well as to the parties and local governmental departments. Investments certificates, annual accounting statements and accounting statements upon liquidation of the enterprise must be examined and certified by an accountant registered in China.[46]

Term, Dissolution and Liquidation

The term of a joint venture is dependent upon the nature of the enterprise. Ordinarily, it is 10-30 years. A joint venture involving a large investment, a long construction period and a low profit ratio or one in which advanced technology is given or is internationally competitive may extend to 50 or more years.[47]

The term of the joint venture should be stated in the joint venture agreement as well as in the contract and articles of association. At least six months before proposed extension of the term, the parties must apply to the appropriate governmental agency for renewal.[48]

A joint venture may be dissolved: (1) upon expiration of the term of the joint venture; (2) due to major losses in the enterprise; (3) by failure by one of the parties to fulfill its obligations; (4) due to major losses due to war, natural disaster or other force majeure; (5) by failure to achieve business objective without possibility for future development; or (6) the occurance of a stipulated event in the joint venture contract or articles of association.[49] Except for expiration of the term, the Board of Directors must submit an application for dissolution for approval to the examining and approving agency. If a party caused the losses sustained by the enterprise by breaching the agreement, it shall be liable to the joint venture for the losses.[50]

Once the dissolution is announced, the Board of Directors is mandated to propose liquidation procedures and submit its proposal and nominations to the government department in charge of the venture for approval and supervision of the liquidation.[51] The liquidation committee is normally composed of members of the Board of Directors but the joint venture may invite registered attorneys or accountants to act in such capacity. The liquidation committee's obligations are to investigate the finances of the joint venture in debt, collect assets and liabilities, as well as compile an inventory, and propose a liquidation plan for approval by the Board of Directors. The committee shall initiate and defend lawsuits where appropriate.[52]

The assets remaining are to be applied to the payment of existing indebtedness and then distributed to the parties pro-rata to their investments or as provided in the joint venture agreement. The net difference between remaining property and stated capital shall be deemed a taxable profit. Once the liquidation is completed, a liquidation report, approved by the Board of Directors, is submitted to the original examining and approving agency. Procedures are then undertaken to cancel the joint venture registration at the original agency for registration and cancellation and to turn in the business license for cancellation.[53] The original Chinese joint

venture retains all account books and documents after dissolution.[54]

Dispute Resolution

Disputes between the parties to a joint venture are to be resolved, when possible, by friendly consultation or mediation and, ultimately, through arbitration or by use of the courts. Arbitration may be applied for if stipulated in the joint venture agreement. It is conducted by the Foreign Economic and Trade Arbitration Commission of the China Council for the Promotion of International Trade in accordance with its rules and procedures. The parties may agree for arbitration outside of China. If no arbitration procedures are provided for in the joint venture agreement, the matter may be determined by the People's Courts of the PRC The parties are to continue their joint venture business while the dispute is being resolved.[55]

Miscellaneous Provisions

Staff and Workers: The joint venture must employ, recruit, discipline, dismiss and provide salary and benefits for staff and workers in accordance with the provision of the PRC for Labor Management in China - Foreign Joint Ventures.[56] It is responsible for the professional and technical training of staff and workers. The theory is that the joint venture shall create a cadre of skilled workers whose remuneration is based upon skill and degree of work performed.[57] The salaries and benefits of officers are determined by the joint venture.

Trade Unions: The staff and workers are permitted to establish trade unions and conduct union activities in accordance with the Trade Union Law of the PRC and the Constitution of China's Trade Union. The union is empowered to represent the staff and workers with respect to signing labor contracts and the implementation of the contracts.[58] The union's duties are to protect workers; assist the joint venture in planning of use of welfare and bonus funds; organize staff and workers in political, professional, scientific and technical studies; organize cultural and sports activities; educate staff and workers, and to observe labor discipline in order to fulfill the task of the joint venture.[59]

The union is permitted to attend, without voting, meetings of the Board of Directors with respect to the joint venture's expansion plans, worker related issues, and other important activities.[60] The joint venture is responsible for providing facilities for the trade union for office work, meetings, cultural and sports activities and to allow 2% of total wages monthly of staff and workers to the union.

Importation of Technology: Technology imported from abroad must be appropriate and advanced so as to enable the joint venture to produce goods for export and for advancement of domestic needs. The appropriate governmental authorities must examine technology transfer agreements for submission and approval by the examining and approving agency. All fees paid for the technology must be fair and reasonable.

If royalties are paid, they must be at the standard international rate. The term may not generally exceed 10 years. The agreement may not place territorial, volume or price limitations on export products. After the term, the importing party may continue to use the technology. The transfer agreements cannot violate Chinese law and the importing party shall have the right to purchase spare parts and raw materials from whom it desires.[61]

Right to Use Site and Site Use Fees: A joint venture needing a site for its operation must apply to the local land administration for permission to use it (the Chinese venturer normally contributes it to the venture). The agreement with the government shall specify the area, location and use of site, fee to be paid, the rights and obligations of the parties and the penalties for breach of same.[62] If the Chinese venturer contributes the site, a monetary value equivalent to the site use fee is credited to it. The fee rate is based upon obvious factors of location, expenses for demolishing existing structures, if any, and environmental conditions. MOFERT is to be advised of the site use fee assessed. Fees may vary greatly; for example, the rate may be considerable lower in special economic zones. The rate charged is fixed for the first five years and is adjusted in intervals of 3 or more years.[63]

Planning, Purchasing, and Selling: The capital construction plan of the joint venture is based upon the feasibility study and includes details of utilities needed and construction materials. The construction funds are managed by the bank having the account of the joint venture. The production and operating plan is determined by the Board of Directors. It alone decides what machinery, materials, equipment and means of transport to purchase and utilize. The regulations emphasize strongly that priority of purchases of materials should be within China. Goods produced should be directed to export trade unless they are urgently needed within China. A joint venture has the right to export its products without interference, except in limited circumstances, either on its own or through Chinese foreign trade corporations.[64]

Goods imported from abroad require import licenses and are to be based upon an annual plan setting forth the materials required. Similarly, goods sold within China also require a distribution plan filed with appropriate governmental departments.[65] Materials and services purchased within China are to be priced in accordance with international market prices for certain raw materials and existing price control sums for other materials.[66]

Cooperative Joint Ventures

The fastest growing form of foreign investment is the cooperative joint venture. As of 1985, there were 2300 joint ventures, 3700 cooperative ventures and 120 wholly foreign-owned enterprises. Foreign hotel chains operating within China almost always use cooperative joint ventures to conduct business therein.

A cooperative joint venture is similar to equity-joint ventures with a number of exceptions. For example, it can vary the profit-distribution ratio. Thus, if there is a 60-40% capital ratio with the Chinese joint venture, it can negotiate a 70-30% profit distribution. It can contract out its management to a third party management company (very common in hotels which tend to be operated by Philippine managers). Such delegation is very difficult to accomplish in equity joint ventures. Another advantage is that the foreign party can retrieve its capital before the end of the joint venture, whereas the Chinese party receives all fixed assets at the end of the equity joint venture. For example, the foreign party can agree with the Chinese venturer that the latter buy-out the foreign venturer at or near the end of the term. The tax incentives, management and other aspects of the cooperative joint venture are the same as the equity joint venture.

Wholly Foreign-Owned Enterprises

A foreign company may establish a wholly-owned limited liability (to capital investment) subsidiary within the PRC.[67] Generally, it must use advanced technology or export more than 50% of its product.[68] The latter percentage appears to be changing downward at present or in the near future. Generally, the hi-tech requirement poses few problems in negotiating such an enterprise. The requirements of the Chinese joint venture are similar with respect to a feasibility study, taxation, etc. The advantage of such an enterprise is that there is no Chinese party but the disadvantage is the lack of contacts, assets and experience a Chinese partner may provide. The term is 20-30 years which may extend to 70 years for large properties or businesses.

The statute specifically provides that such enterprises "are protected by Chinese law."[69] Unlike its philosophical and legal position of the past wherein the PRC, like other states and most third-world states, held that a state may nationalize property within its territory without "prompt, effective compensation," the statute states:

> "Article 5. The state will not nationalize or requisition any enterprise with foreign capital. Under special circumstances, when public interest requires, enterprises with foreign capital may be requisitioned by legal procedures and appropriate compensation shall be made."

The procedure for setting up such an enterprise is similar to joint ventures. Application is made to the appropriate department under the State Council, which has 90 days to examine and decide whether or not to permit the enterprise. The foreign investor has to apply for a business license from the industry and commerce administration authorities for registration.[70]

Upon registration, the enterprise becomes a Chinese legal person. Investments within China must be made as previously stated in the application and approval. Major changes must be reported to the appropriate governmental agency.[71]

The requirements concerning operation, labor agreements, unions, account and reporting taxes, banking, purchase of materials, and remission of profits abroad, termination and liquidation are like that of joint ventures. Insurance coverage is to be applied for with Chinese insurance companies.[72]

CONCLUSION

The above discussion is designed to afford an understanding of the present legal developments affecting business within China. The door is open to a massive influx of Western technology and to an opening of the potentially largest market for foods and services. The PRC is a new frontier in the global market.

Many American entrepeneurs presently doing business within China are astonished at the incredible demands for foreign goods. Consumerism is now prevalent throughtout the country, especially in the major cities. On any given day, there are three million shoppers in a 1-2 mile commercial area in Shanghai. Contrary to most reports that the average salary of a worker is $75 per month, a representative of the American Embassy advised a group of professors, including this writer, that the per capita annual income is $6,000 when housing, medical and other expenditures are calculated within the equation.

American companies have a vast market of 1.2 billion people, many of whom can afford significant consumer purchases. Industries are commencing and expanding rapidly. The senior representative of Mitsui, in a speech to these professors in January 1993, expressed his bewilderment and delight that the U.S. has demurred in expanding its trade with China because of human rights violations. Japan, according the the representative, was happy to fill the gap of opportunity left by the Americans.

It is incumbent upon U.S. companies to play a major role within China. In so doing, both China and the U.S. will prosper. As China becomes increasingly reliant upon U.S. trade, it will more readily attend to demands for humane treatment for all its inhabitants.

ENDNOTES

1. Exception was an Admiral Zheng He in 1405-1433. Many of the historical aspects of the paper were taken from Frank Gibney, The Pacific Century: America and Asia in a Changing World (New York: Charles Scribner's Sons, 1992); Roderick Mae Farquhar and John K. Fairbank, The Cambridge History of China (Cambridge: the Cambridge University Press) and John King Fairbank, China: A New History (Cambridge: The Belknap Press, 1992).

2. Laszlo Dadany, Law and Legality in China: The Testament of a China-Observer, ed. Marie-Luise Nath (London: Hurot & Company), 1992, pp. 34-35.

3. Ibid., Ch.3.

4. Du Xichuan and Zhang Lin Gyuan, China's Legal System: A General Survey, (Beijing: New World Press, 1990), p. 22.

5. Eric Lee, Commercial Disputes Settlement in China, (London: Lloyd's of London Press LTD., 1985), ch. 1.

6. Trademark Law of The People's Republic of China, eff. 3/5/83; Patent Law of The People's Republic of China, eff. 4/1/85; Rules for the Implementation of the Trademark Law of The People's Republic of China, promulgated on 3/10/83. Rules for the Implementation of the Patent Law of the People's Republic of China, promulgated on January 19, 1985; Copyright Laws of the People's Republic of China, eff. June 1, 1991; and Regulations for the Protection of Computer Software, eff. October 1, 1991.

7. Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 7 of the Chairman of the Standing Committee of the National People's Congress effective on July 8, 1979. The text and translation thereof was taken from The Law of the People's Republic of China, 1979-1982, (Beijing: Foreign Languages Press, 1987), pp. 150-153. The regulations may be found in "Regulations for the Implementation of the Law of the People's Republic of China or Chinese-Foreign Joint Ventures," issued by the State Council on September 20, 1983, China's Foreign Economic Legislation, Vol III (Beijing: Foreign Languages Press, 1987).

8. Article 4 of Law of The People's Republic of China on Chinese-Foreign Equity Joint Ventures.

9. Ibid., Article 1.

10. Ibid., Article 3, and Regulations, supra, Article 8.

11. Regulations, supra, Article 8.

12. Ibid., Article 10.

13. Ibid., Article 11.

14. Ibid., Article 17.

15. Ibid., Article 13.

16. Ibid., Article 14.

17. Ibid., Article 15.

18. Ibid., Article 16.

19. Ibid., Article 12.

20. Law, supra, Article 14 and Regulations, supra, Article 19.

21. Law, supra, Article 4.

22. Regulations, supra, Article 21.

23. Ibid., Articles 22, 24.

24. Ibid., Article 23.

25. Ibid, Article 42.

26. Ibid, Article 25 and Law, supra, Article 5.

27. Regulations, supra, Article 26.

28. Law, supra, Article 5.

29. Regulations, supra, Article 27.

30. Ibid., Article 28.

31. Ibid., Articles 29-30.

32. Ibid., Article 33.

33. Ibid., Article 34 and Law, supra, Article 6.

34. Regulations, _supra_, Article 35.

35. _Ibid_., Article 36.

36. _Ibid_., Articles 38-40.

37. _Ibid_., Article 40.

38. _Ibid_., Article 41.

39. _Ibid_., Articles 69-72.

40. _Ibid_., Articles 73-76.

41. _Ibid_., Article 78 and _Interim Procedures for the Handling of Lonas by the Bank of China to Chinese-Foreign Joint Ventures_, promulgated by the State Council, eff. 7/26/80.

42. Regulations, _supra_, Article 78.

43. _Ibid_., Article 79 and Law, _supra_, Article 10.

44. Regulations, _ibid_., Articles 80-83.

45. _Ibid_., Articles 87-89.

46. _Ibid_., Article 90.

47. _Ibid_., Article 100 as revised by the State Council on January 15, 1989.

48. _Ibid_., Articles 100-101.

49. _Ibid_., Article 102 and Law, _supra_, Articles 12-13.

50. Regulations, Article 102.

51. _Ibid_., Article 103.

52. _Ibid_., Articles 100-105.

53. _Ibid_., Articles 106-108.

54. _Ibid_.

55. _Ibid_., Articles 109-112 and Law, _supra_, Article 14.

56. Regulations, Articles 91-93.

57. _Ibid_.

58. _Ibid_., Articles 95-96.

59. _Ibid_., Article 97.

60. _Ibid_., Articles 97-98.

61. _Ibid_., Articles 43-46.

62. _Ibid_., Article 47.

63. _Ibid_., Articles 48-51.

64. _Ibid_., Articles 58-62.

65. _Ibid_., Articles 63-64.

66. _Ibid_., Articles 65-66.

67. Law of The People's Republic of China on Foreign-Capital Enterprises, adopted at the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 39 of the President of The People's Republic of China, eff. April 12, 1986. "Foreign" enterprises are established within China by foreign investors using their capital exclusively. Hong Kong and Macao are considered "foreign" for purposes of this statute.

68. Regulations, Article 3.

69. _Ibid_., Article 4.

70. _Ibid_., Articles 6-7.

71. _Ibid_., Articles 8-19.

72. _Ibid_., Articles 11-23.

MINIMIZING EMPLOYER LIABILITY IN FEDERAL SEXUAL HARASSMENT CLAIMS AFTER THE CIVIL RIGHTS ACT OF 1991

by

Bruce L. Haller* and Richard C. Aitken**

Part I Introduction

The seriousness of sexual harassment was firmly established by the Anita Hill-Clarence Thomas hearings held by the Senate Judiciary Committee in October, 1991.[1] The hearings directed the country's attention to the shortcomings of Title VII of the Civil Rights Act of 1964 which prohibits discrimination on the basis of race, color, religion, sex or natural origin.[2] According to the 1981 U.S. Merit System Protection Board Report, forty-two percent of the women who were questioned had answered that they had been subjected to some form of sexual harassment.[3] Unfortunately, in 1988 when the Board conducted the same survey, the results were identical[4]; moreover, the percentage was even greater in male dominated workplaces.[5]

The victims of sexual harassment[6] not only become less efficient employees, but also suffer depression, loss of confidence as well as, physical effects.[7] In addition to the toll it takes on the employee, sexual harassment costs the federal government over a hundred million dollars a year.[8] The money represents the cost of absenteeism, reduced productivity, job turnover, medical costs, and litigation.[9] Finally, sexual harassment creates an offensive working condition that alienates its victims and decreases job morale.

It is therefore in the best interests of employers, employees and society to prevent all forms of sexual harassment. Short of this employers can take steps to minimize their liability in Title VII sexual harassment claims.

Part II of this article will review the evolution of sexual harassment claims under Title VII of the Civil Rights Act of 1964. Part III outlines how the 1964 Act was changed by the Civil Rights Act of 1991. Part IV outlines the procedures an employer may implement to minimize their liability.

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Part II Evolution of Sexual Harassment Claims

A. Background

Although sexual harassment[10] is currently actionable under Title VII, claims of sexual harassment had fallen on deaf ears until 1976.[11] Prior to this, the courts had held that victims of sexual harassment had no recourse under Title VII.[12] For example, the United States District Court for the District of Columbia in Barnes v. Train denied a plaintiff relief under Title VII because she had not been discriminated against on the basis of her sex, but rather on the basis of her refusal to submit to the sexual advances.[13] Thus, in order to recover a plaintiff had to use the traditional tort theories of assault, battery, defamation, or intentional infliction of emotional distress.[14]

It should be noted that, even though Title VII was proposed to eliminate all barriers to employment for all, the provision regarding sex discrimination was only added as a last-minute attempt to defeat the act.[15] Presently Title VII not only prohibits sex discrimination in all of its forms, section 704 of Title VII prohibits employers from retaliating against employees who initiate complaints.[16]

In 1976 the District Court of the District of Columbia became the first district court to recognize a sexual harassment claim under Title VII.[17] The plaintiff, Diane Williams, who was an employee of the Justice Department refused to submit to sexual advances of her supervisor. In response, her supervisor retaliated with unfavorable reviews and unwarranted reprimands. The district court determined that the supervisor's retaliatory measures discriminated against Ms. Williams on the basis of her sex and was therefore a violation of Title VII.[18]

In the aftermath of Williams, courts started to recognize sexual harassment as actionable action under Title VII. However, a majority of the courts required that the plaintiff show a loss of a tangible job benefit.[19] This type of harassment has been referred to as quid pro quo harassment or "this for that" harassment. Quid pro quo sexual harassment involves conduct of a sexual nature when submission to such conduct is made explicitly or implicitly a term or condition of employment or when submission or rejection of such conduct is used as a basis for employment decisions affecting the employee.[20] Therefore when a supervisory employee conditions concrete employment benefits on sexual favors, he imposes an additional burden on subordinate employees that they need not suffer. As a result, an employer may be sued for the action of the supervisor.[21]

The Equal Employment Opportunity Commission drafted a set of guidelines regarding the problem of sexual harassment in

the workplace.[22] The guidelines reinforced the various court rulings regarding quid pro quo harassment and then went a step further, defining sexual harassment as:

> [R]equests for sexual favors, and other verbal or physical conduct of a sexual nature constitute sexual harassment when (1) submission to such conduct is made either explicitly or implicitly a term or condition of an individual's employment, (2) submission to or rejection of such conduct by an individual is used as the basis for employment decisions affecting such individual, or (3) *such conduct has the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile, or offensive work environment*[23]

According to the EEOC's guideline,[24] a plaintiff does not have to show that she suffered from a loss of tangible job benefit but rather that she was subjected to unwelcome sexual advances, jokes, suggestive remarks or comments, physical touching, or the displaying of objectional material in the workplace rising to the level of creating an offensive or hostile working environment.[25] The hostile work environment claim differs from the quid pro quo claim, because it is not limited to harassment by one with authority to make substantive employment decisions.

To promote hostile work environment as a valid claim for sexual harassment, the EEOC's guidelines call for the strict liability for employers regardless of whether they knew or should have known of the discriminatory acts of its agents or supervisors. The guidelines state:

> Applying general Title VII principles, an employer,... is responsible for its acts and those of its agents and supervisory employees with respect to sexual harassment *regardless of whether the specific acts complained of were authorized or even forbidden by the employer and regardless of whether the employer knew or should have known of their occurrence*. The Commission will examine the circumstances of the particular employment relationship and the job function performed by the individual in determining whether an individual acts in either a supervisory or agency capacity.[26] After the release of the Guidelines, the courts agreed that hostile environment sexual harassment claims are actionable under Title VII[27]. In Bundy v. Jackson[28] the Circuit Court for the District of Columbia announced that hostile work environment sexual harassment violates Title VII of the 1964 Civil Rights Act. The court based its decision on Title VII race discrimination cases.[29] The court stated:

> Indirect discrimination is illegal because it may constitute a subtle scheme designed to create a working environment imbued with discrimination and directed ultimately at minority group employees. As potentially discriminated practices become outlawed, those employers bent on pursuing a general policy declared illegal by congressional mandate will undoubtedly devise more sophisticated methods to perpetrate discrimination among employees.[30]

The circuit court in Bundy recognized both quid pro quo and hostile environment sexual harassment. The court stated that by only allowing quid pro quo actions the courts are condoning the actions of employers who sexually harass their workers but stop before dismissing or depriving an employee of a tangible job benefit.[31]

In similar fashion, the Eleventh Circuit held that hostile environment sexual harassment violates Title VII in Henson v. City of Dundee.[32] Barbara Henson was a dispatcher for the city of Dundee's police department. She claimed that during the two years she had worked for the department she and her female co-workers were subject to "numerous harangues of demeaning sexual inquiries and vulgarities."[33] In addition, she alleged that her supervisor had repeatedly asked her to have sexual relations with him. In reversing the lower Courts decision, which denied her claim because she had not lost a tangible job benefit, the court set forth a five point analytical frame work for hostile environment claim.

According to Henson, the elements for a prima facie case of hostile environment sexual harassment are (1) the employee belongs to a protected group; (2) the employee was subjected to unwelcome sexual harassment; (3) the harassment complained of was based on sex; (4) the harassment complained of affected a "term, condition or privilege" of employment; (5) employer knew or should have known of the harassment in question and failed to take prompt remedial action.[34]

B. Meritor Savings Bank FSB v Vinson[35]

In 1986, the issue of sexual harassment reached the United States Supreme Court.[36] In 1974, Michelle Vinson, respondent, met Sidney Taylor of Capital City Federal Savings and Loan Association (now Meritor Savings Bank) and discussed the possibility of employment. Vinson was eventually hired with Taylor as her supervisor and started as a teller-trainer. Thereafter she was promoted to teller, head teller, and assistant Branch Manager. She worked at the same branch for four years and it is undisputed that all of her promotions were based on merit.[37] In September of 1978 Vinson notified Taylor that she was taking sick leave for an indefinite period and on November 1, 1978, she was discharged from the bank for excessive use of that leave.

Pursuant to this Vinson brought a Title VII action against Taylor and the bank alleging that "she had been constantly subjected to sexual harassment" by Taylor.[38]

At trial, Vinson testified that shortly after her probationary period was concluded Taylor had asked her out to dinner and while at dinner he suggested that they go to a motel and have sexual relations. Out of what she described as fear of losing her job, Vinson agreed. Vinson further testified that Taylor had made repeated sexual demands upon her and that during the course of her employment she had intercourse with him 40-50 times: In addition, she testified that Taylor had fondled her in front of other employees, followed her into the ladies room, exposed himself to her, and forcibly raped her several times.[39]

The District Court held for Taylor and the Bank. The court concluded that:

> [if] Vinson and Taylor did engage in an intimate sexual relationship, during the time of her employment with the bank, the relationship was a voluntary one having nothing to do with her continued employment with the bank or her advancement for promotions at the institution.[40]

The court also concluded that the bank was not in violation of Title VII because "the bank was without notice and cannot be held liable for the alleged actions of Taylor".[41]

The District Court's holding was reversed by the Court of Appeals for the District of Columbia.[42]Drawing support from its decision in Bundy v. Jackson[43] and the EEOC Guidelines the court announced that a violation of Title VII may be based upon either quid pro quo sexual harassment or hostile environment sexual harassment. Therefore since the Appellate Court believed that Vinson's allegations were clearly of the hostile environment type,[44] and concluded the District Court had not addressed the issue, the court remanded the case.

In regard to the bank's liability the Court of Appeals held that an employer is absolutely liable for the sexually harassing conduct of its supervisory personnel, regardless of whether the employee knew or should have known about the misconduct. The Court concluded that Title VII's definition of "employer" includes "any agent of such person".[45] Therefore, the court held that a supervisor is an agent of his employer for Title VII purposes.[46]

The Court of Appeals' decision was affirmed by the Supreme Court, but on other grounds. The court determined that "the language of Title VII is not limited to "economic" or "tangible" discrimination. The phrase "terms, conditions, or privileges of employment" evidences a legislative intent "to strike at this entire spectrum of disparate treatment of

men and women."[47] The court also relied on the EEOC Guidelines[48] in determining that sexual harassment, regardless of whether or not there is any loss of a tangible job benefit is actionable under Title VII. The court did however, caution that:

> Not all workplace conduct that may be described as "harassment" affects a "term, condition, or privilege" or employment within the meaning of Title VII. For sexual harassment to be actionable, it must be sufficiently severe or pervasive "to alter the conditions of [the actions] employment and create an abrasive working environment."[49]

In regard to employer liability the Court disagreed with the Court of Appeals' decision that employers should be held absolutely liable for the conduct of its supervisors.[50] Although the court refused to give a definitive answer on employer liability, it did agree with the amicus curiae brief by the EEOC which stated "that Congress wanted courts to look to agency principles for guidance in this area.[51]

Finally, the court rejected the bank's view that the existence of a grievance procedure and policy against discrimination, insulates the bank from liability. The reasons the court gave are two-fold. First, the bank's policy did not address sexual harassment in particular. Secondly, the bank's procedure required an employee to report any discrimination to her supervisor. Therefore, since Taylor was Vinson's supervisor it is quite evident why she did not choose to implement the grievance procedure.[52]

C. Burdens of Proof in Sexual Harassment Cases

Quid Pro Quo Sexual Harassment

Quid pro quo sexual harassment claims are similar to the traditional discrimination claims under Title VII. Therefore, in order to establish a guid pro quo claim[53] a plaintiff must use the tripartite framework for proving a Title VII claim of disparate treatment established by the Supreme Court in McDonnell Douglas Corp. v. Green.[54] The plaintiff must first establish by a pre-ponderance of the evidence she was denied a tangible job benefit because she refused to submit to the sexual advances of her supervisor. Upon doing so the burden of proof shifts back to the employer to demonstrate by clear and convincing evidence that it had a legitimate, non discriminatory reason for denying the plaintiff of this benefit. Finally, if the employer is able to meet this burden of proof, the plaintiff has the opportunity to show that the employer's stated "legitimate" reason is pretextual and unworthy of credence.[55]

Evidence of sexual advances made to other employees may be admitted on this issue of motive, intent, or plan in making the sexual advances toward the plaintiff.[56] In regards to imputing liability for quid pro quo sexual harassment, the federal courts have held employers strictly liable, based on agency principles.[57] For example, in the Sixth Circuit case of Shrout v. The Black Clawson Co.[58] the District Court for the Southern District of Ohio found the employer strictly liable for the acts of a supervisor who attempted to force the plaintiff "to submit to his sexual advances by withholding performance evaluations and salary reviews."[59] The court stated:

> Respondeat superior liability exists because in a quid pro quo action "an employer is held strictly liable for the conduct of supervisory employees having plenary authority over hiring, advancement, dismissal and discipline..."[60]

Similarly, in Sowers v. Kemira[61] the District Court for the Southern District of Georgia held an employer strictly liable for quid pro quo sexual harassment by its supervisor, Mr. Skinner. The court records show that Mr. Skinner made numerous sexual advances to the plaintiff, many of which occurred during discussion regarding the possibility of her promotion. Citing Henson v. City of Dundee, the district court held the employer liable on the basis of agency because the supervisor was using "his apparent or actual authority to extort sexual consideration from an employee...[T]he supervisor uses the means furnished to him by the employer to accomplish the prohibited purpose."[62]

Opponents to implying strict liability on employers argue that supervisors who practice quid pro quo sexual harassment are acting outside of their scope of employment. Therefore, their argument continues, an employer should not be held liable for the consequences of these acts.[63] Although at first this appears to be a valid defense, upon closer examination this theory is flawed.

While it is correct that a master is not liable for the torts of his servants committed while acting outside their scope of employment, the Restatement (second) of Agency lists four exceptions to the general rule. The two exceptions which are applicable to quid pro quo sexual harassment claims are that the:

> (b) "master was negligent or reckless, or...
>
> (d) The servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.[64]

The first exception cited is exemplified in the Eighth Circuit case of Hall v. Gus Construction Co..[65] In Hall, the plaintiffs were a group of women who work on one of the company's crews and were subject to various sorts of sexual harassment by their co-workers.[66] Although the court acknowledges that the harassment was not within the scope of employment it still imposed liability on the employer stating:

> [A]n employer is directly liable...for those torts committed against one employee by another, whether or not committed in furtherance of the employer's business, that the employer could have prevented by reasonable care in hiring, supervising, or if necessary firing the tort feasor.[67]

Therefore, although an act of sexual harassment may be outside the scope of employment, the employer may still be held liable if the plaintiff can prove that the employer was negligent in hiring, or supervising the supervisor.

Strict liability may be imposed by the second aforementioned exception when the supervisor uses the existence of the agency relation to accomplish his tort. This exception is the very basis upon which quid pro quo sexual harassment claims are based. By simply being in the position to hire, make recommendations, promote, supervise, and fire an employee, a supervisor has the capability and power by the existence of his agency relationship with the employer, to carry out all forms of sexual harassment. It would, therefore, be grossly inequitable to refuse to impose direct liability on an employer when one of its supervisors uses his relationship with his employer to sexually harass employees under him.

Hostile Environment Harassment

The primary procedure to proving a hostile environment sexual harassment was set forth by the eleventh circuit in Henson v. City of Dundee.[68] The court made it demonstrably clear that an employee's psychological well being is a term and condition of employment. The court further declared that the issue of sexual harassment must be viewed under the totality of circumstances. Finally, once the plaintiff establishes the five elements outlined in Henson the second and third step of the McDonnell Douglas test are triggered.

The Henson test has not been used without criticism. The element concerning the unwelcomeness of the harassment, as well as, the element regarding employer liability has [69] come under fire. The sixth circuit case of Rabidue v. Osceola Refining Co.,[70] provides an excellent illustration of the shortcomings of the unwelcomeness requirement.

Vivienne Rabidue was the only female administrative assistant at the Osceola Refining Company. After her discharge in 1977, she filed a sexual harassment claim against her employer. She charged that her employer's refusal to stop the display of pornographic posters in private offices and common work areas at the company plant, as well as anti-female obscenities directed at her and other women by a co-worker in another department, constituted sexual discrimination in violation of Title VII.[71] Furthermore, she introduced evidence that she had been denied various managerial privileges accorded to male employees and in other ways had been given secondary status in the company.[72]

The conduct which Rabidue complained of was not mild and ambiguous. Pictures of nude and scantily clad women abounded at the company, including one that had hung on the wall for eight years. This poster depicted a prone women with a golf ball on her breasts, straddled by a man holding a golf club and yelling, "Fore".[73] The language of co-workers was equally offensive. They engaged in generally uncooperative behavior that impaired Rabidue's ability to perform her job effectively.[74]

In writing for the majority, and applying the "reasonable man" standard in deciding whether or not the conduct complained of was unwelcome, Judge Krupansky held that the conduct complained of was not sufficiently severe or pervasive to alter the conditions of their employment. The court characterized the conduct as a legitimate expression of the cultural norms of the workers at the employer's plant and stated:

> [I]t cannot be disputed that in some work environments humor and language are rough hewn and vulgar. Sexual jokes, sexual conversations and girlee magazines may abound. Title VII was not meant to or can change this. It must never be forgotten that Title VII is the federal court's mainstay in the struggle for equal employment opportunity for the female workers of America. But it is quite different to claim that Title VII was designed to bring about a magical transformation in the social mores of American workers.[75]

The court further argued that Rabidue had voluntarily and knowingly entered the Osceola workplace and therefore could not complain about the conditions she encountered there.[76]Hence, Rabidue was denied any relief under Title VII.

Despite the fact that the court attempted to make a proper assignment regarding the alleged sexual harassment at Osceola, the opinion in Rabidue reflected patriarchal attitudes about women. In the court's assertion that a proper assessment of a hostile environment claim includes evidence about the personality of the plaintiff,[77] the court minimized the conduct engaged in at Osceola and reflected the common male attitude that the victim of harassment is to blame for her mistreatment.[78] Many men believe that women can avoid harassment if they behave properly and that the tactful registering of a complaint is usually an effective way of dealing with harassment when it occurs.[79]Clearly the court's focus on the character of the victim[80] echoes these male attitudes and thus undermines the "neutrality" of its analysis.

It has, therefore, been argued that by employing the reasonable man standard the courts cannot provide a neutral basis for the definition of discrimination because the courts neutral analysis contains a hidden male perspective. In lieu of this the dissent in Rabidue advocated the use of the reasonable victim standard.[81]

Although the sixth circuit has not expressly overturned its own decision in Rabidue, it has called Rabidue into question in at least two subsequent opinions. In Yates v. Avco[82], the court stated, "We acknowledge that men and women are vulnerable in different ways and offended by different behavior."[83] In lieu of this, the court adopted the "reasonable victim" standard which was one of the main arguments in the Rabidue dissent.

In Davis v. Monsanto Chemical Co.[84], the sixth circuit criticized Rabidue's limited reading of Title VII. Specifically, the court qualified its statement in Rabidue that read "Title VII [was] not designed to being about a magical tranformation in the social mores of American workers."[85] The court, in Davis, emphasized:

> In reading this passage, however, one should place the emphasis on the word "magical" not the word "transformation."Title VII was not intended to eliminate immediately all private prejudice and biases. That law, however, did alter the dynamics of the workplace because it operates to prevent bigots from harassing their co-workers.[86]

In addition to the sixth circuit questioning its decision in Rabidue, other courts have rejected it in its entirety. For instance, in 1991, the ninth circuit in Ellison v. Brady[87] adopted the reasonable woman standard as opposed to the reasonable man standard. Kerry Ellison worked as a revenue agent for the Internal Revenue Service in San Mateo, California.[88] After turning down several requests for dates from a co-worker, she began to receive "love letters."[89] The court explicitly rejected the reasoning in Rabidue and employed the reasonable woman standard because men and women have different opinions of what type of conduct is objectionable.[90] In fact, the court stated that "If we only

examined whether a reasonable person would engage in allegedly harassing conduct, we would run the risk of reinforcing the prevailing level of discrimination."[91] Therefore, a plaintiff can prove a prima facie case for hostile environment sexual harassment by showing "conduct which a reasonable woman would consider sufficiently severe or pervasive to alter the conditions of employment and create an abusive working environment."[92]

A few district courts across the country have also adopted the reasonable woman standard. In Spencer v. General Electric Co.[93], the District Court for the Eastern District of Virginia employed the reasonable woman standard and found "[t]hat the conduct complained of would have interfered with the work performance and would have seriously affected the psychological well-being of a reasonable female employee."[94] Similarly, the District Court for the Middle District of Florida in Robinson v. Jacksonville Shipyard, Inc.[95] used the reasonable woman standard to determine that pervasive pornographic pictures, sexual comments, verbal harassment, abusive graffiti, and unwelcome touching of some of the plaintiff's female co-workers created a hostile environment.[96] Finally, as recently as October, 1992, the District Court of Nevada in Canada v. The Boyd Group, Inc.[97] used the reasonable woman standard in denying the defendant's motion for summary judgement.[98]

Notwithstanding this seeming emergence of the reasonable woman standard, the reasonable person standard can not be so easily discarded. In the recent unanimous Supreme Court decision regarding Harris, the court discarded the reasonable woman standard in favor of the reasonable person standard removing gender from the harassment issue.[99]

The facts of the case reveal that Teresa Harris, a former rental manager of Forklift Systems, was allegedly subjected to unwanted sexual comments by the owner. Harris accused the owner of making derogatory comments such as, "[l]et's go to the Holiday Inn to negotiate your raise;" forcing Harris and other female employees to retrieve coins from his front pocket; and throwing things on the floor, then asking women to pick them up while he commented suggestively on their clothes.[100] Although the trial judge acknowledged that the owner's behavior was crude, vulgar, and offensive, he ruled against Harris because he found that she had not suffered serious psychological injury.[101] The Supreme Court, Harris v Forklift Systems, Inc., struck down the narrow interpretation of the federal sexual harassment law, instead taking a middle of the road approach stating, "a discriminatory abusive work environment, even one that does not seriously affect the employee's psychological well-being, can and often will detract from the employee's job performance, discourage employees from remaining on the job or keep them from advancing their careers."[102]

Notwithstanding which standard is used, once a plaintiff proves that the sexual harassment has in fact occurred, he or she is burdened with the additional task of proving employer liability.[103] The fourth circuit in Katz v. Dole[104] further refined the analytical framework of Henson and opined that:

> the plaintiff must demonstrate that the employer had actual or constructive knowledge of the existence of a sexually hostile working environment and took no prompt and adequate remedial action. The plaintiff may do this by proving that complaints were lodged with the employee or that the harassment was so pervasive that the employer's awareness may be inferred. Thus, we posit a two step analysis. First the plaintiff must make a prima facie showing that sexually harassing actions took place and if this is done, the employer may rebut the showing either directly, by proving the events did not take place, or indirectly by showing that they were isolated or trivial. Second, the plaintiff must show that the employer knew or should have known of the harassment, and took no effectual action to correct the situation. This showing can also be rebutted by the employer directly, or by pointing to prompt remedial action reasonably calculated to end the harassment.[105]

Applying its own rule, the court in Katz imposed liability on the employee even though the agency did have an anti-harassment policy in place because it was not effective and was known to be not effective by the employer's supervisors.[106]

Not all plaintiffs have been as fortunate as Ms. Katz. The seventh circuit has held that a female factory worker failed to establish a Title VII claim when her claim was based on a single incident in which a co-worker made crude physical jokes in the guise of a sexual advance and the employees promptly disciplined the co-worker and the behavior was not repeated.[107] Similarly, a discharged engineering technician failed to establish a claim of hostile environment sexual harassment at a glass factory where sexually suggestive nude photos were circulated at the plant. The use of gender-hased references to personnel, and whistles from male co-workers were met with prompt, remedial management attention.[108]

Part III - The Civil Rights Act of 1991

Legal liability for unlawful acts of sexual harassment is now accompanied by significant monetary liability as a result of the Civil Rights Act of 1991.[109] Signed by President Bush on November 21, 1991, the Act has implemented a series of sweeping changes to federal anti-discrimination laws that expands the scope and amount of monetary relief available to prevailing plaintiffs, and also expands the types of conduct that may be deemed discriminatory under the law.[110] The Act went into effect on the date of enactment and is not retroactive.[111]

With passage of the amended law, a sexually harassed employee can now sue for more than the remedies available under Title VII which are injunctive relief and/or reinstatement, back pay, front pay and attorney's fees. Section 102 of the Civil Rights Act of 1991 provides for the possibility of recovery of compensatory punitive damages for victims of intentional employment discrimination on the basis of sex, religion, and disability.[112] A sexually harassed employee may therefore, sue for the pain and suffering caused by the discrimination (compensatory damages) and for an additional amount that serves to punish the employer (punitive damages).[113] Punitive damages are available when the employer deliberately planned to discriminate against an employee or acted without caring whether or not the employee would suffer when it was obvious that the employee would suffer.[114]

The damage awards granted under the new act are capped at $50,000 for companies of 100 or fewer workers, $100,000 for companies with 101 to 200 employees, $200,000 for employers with 201 to 500 employees and $300,000 for employees of over 500 employees.[115]

In addition, jury trials are now available in Title VII claims by any party to a discrimination action if the complaining party seeks compensatory or punitive damages.[116] Furthermore, since experts play an important role in sexual harassment cases,[117] the 1991 Act provides that expert witness fees are available in Title VII cases.[118]

Part IV Steps Employers Can Take to Avoid Liability

In addition to refuting the elements to a sexual harassment claim[119] an employer may improve the possibility of avoiding liability by implementing a strong viable anti-harassment policy. A strong policy promotes an understanding of harassment throughout an organization and makes everyone aware of the legal consequences of violating the policy. Having a written policy can reduce the risk of liability because harassment is least likely to occur when employees are aware of the rules.[120] As one commenter has said "Once a company has a corporate policy, men are much more careful. Policies make employees more aware.[121] It is therefore imperative that all companies devise a policy that:

- states that sexual harassment will not be tolerated
- defines both quid pro quo and hostile environment harassment
- outlines a procedure for employees to make complaints about sexual harassment to a person with authority to resolve the complaint.
- guarantees that all complaints will be treated confidentially.
- guarantees that employees who complain about sexual harassment will not suffer adverse job consequences as a result of the complaint, and
- states that an employee who engages in sexual harassment is subject to discipline up to and including discharge.[122]

The company's policy should be outlined in a memo and distributed to all employees "using whatever the usual trusted mechanisms of the company are..."[123] The anti-harassment policy should also be contained, in its entirety, in any employee handbook that the company may furnish.

The procedure for filing of complaints should encourage employees to come forward and report the incidents of sexual harassment. It is important that there are at least two employees of the company in high level positions who will investigate the allegations and make the appropriate recommendations. It would be prudent to make sure that these two employees are from different departments in case the alleged harassment claim is against one of these individuals.

All complaints should be handled in a serious matter and investigated confidentially by trained personnel. The investigator should not only investigate the act complained of but should also find out if the employer was aware of any other instances of harassment.[124] Once the investigation is complete, the investigator should meet with management and recommend the possible remedial actions that should be taken.

The employer's remedial action should be reasonably calculated to end the harassment, make the action whole and prevent any future misconduct. By taking immediate remedial action, an employer has utilized his best defense to Title VII claims. [125] Normally if the EEOC finds that the harassment has been eliminated, the victim made whole, and the preventive measures instituted, it will normally drop the charge.

In addition to the implementation of a strong anti-harassment policy, employers must educate their employees as

to what conduct the law considers to be sexual harassment. The education program must stress that any type of unwelcome sexual conduct is strictly prohibited. Furthermore, the program should stress that an employee who voluntarily partakes in such conduct may still consider it unwelcome but feel as if she has no choice but to submit to such conduct.

Finally, educating the employees about the existence of and the matter in which an anti-harassment complaint procedure operates is as important as the details of the procedure itself. This may be accomplished through training seminars, that should be ongoing and presented on company time.

Moreover, whatever policy a given company asserts as a defense will have little effect if the court deems that such policy was neither known or readily acceptable to the employees.[126]

Part V Conclusion

In light of the popularity and political correctness of sexual harassment claims since the Thomas hearing, it is imperative that an employer takes the appropriate steps to limit his or her liability. Therefore, since the standard for liability has not yet been clearly expressed by the Supreme Court, the best way for an employer to escape liability is through prevention. The employer should not only implement a sexual harassment policy, but should also educate their employees as to what constitutes sexual harassment, develop appropriate sanctions, and inform employees of their right to raise the issue under Title VII. Once an employer has done this, a court will be reluctant to find liability if the implemented policy had been adhered to.

ENDNOTES

1.Gross, Jane, "Suffering in Silence No more, Women Fight Back in Sexual Harassment," New York Times Monday 13 July 1992 2P. A1, col.2.

2.42 U.S.C. §2000 e-2 (a)(1) (1988) Title VII of the Civil Rights Act of 1964 makes it "an unlawful employment practice for an employer...to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions or privileges of employment because of such an individuals race, color, religion, sex or national origin..." Id.

The goal of eliminating employment discrimination has also been a goal on the state level. i.e., New York has enacted the "New York Human Rights Law," New York Executive Law §§290-301 (McKinney 1982 and Supp 1993) The statute covers employers who

employ four or more people, licensing agencies employment agencies as well as labor organizations.

3.U.S. Merit Systems Protection Board, "Sexual Harassment in the Federal Workplace: Is it a Problem?" 36 (1981).

4.U.S. Merit Systems Protection Board, "Sexual Harassment in the Federal Government: An Update" (1988) (hereinafter Merit Board Survey).

5.Kantrowitz, Barbara "Striking a Nerve" Newsweek October 21, 1991. In a 1990 Defense Department study, 64% of military women said they had endured such abuse.

6.Although men may also be victims of sexual harassment, this article focuses on female victims because the percentage of women who are sexually harassed far outnumber the number of men. The percentage of males experiencing sexual harassment was 14% in 1988. This represented a one percent drop from the Merit Board survey of 1981 Merit Board Survey. See note 3 supra.

7.Krista S. Schoenheider. "A theory of tort Liability for Sexual Harassment in the Workplace", 134 U. Pa. L Rev. 1461, 1464-65 (1986).

8.Merit Board Survey at note 4 supra.

9.Id.

10.The EEOC Guidelines define sexual harassment as follows:

> Unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature constitute sexual harassment when (1) submission to such conduct is made either explicitly or implicitly a term or condition or an individuals" employment, (2) submission to or rejection of such conduct by an individual is used as the basis for employment decisions affecting such individual,or (3) such conduct has the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile, or offensive work environment.

29 CFR §1604.11(a)

11.In William v. Saxbe, 413 F. Supp. 654 (D.D.C. 1976) a district court held for the first time that sexual harassment fell within the meaning of sex discrimination in Title VII of the Civil Rights Act of 1964.

12.See, e.g., Jane Corne v. Bausch & Lomb, 390 F. Supp. 161, 163 (D. Ariz. 1975) (sexual harassment not actionable because acts complained of were not sufficiently tied to the workplace, not "based on sex," and the "conduct appears to be nothing more than a personal proclivity, peculiarity, or mannerism...; [the offender]

was satisfying a personal urge"), vacated and remanded, 562 F.2d 55 (9th Cir. 1977); Paulette Barnes v. Russell Train, 13 Fair Empl. Prac. Cas. (BNA) 123, 124 (D.D.C. 1974) (alleged discrimination attributed not to plaintiff's sex, but to her refusal to have sexual relations with her supervisor, which resulted in an "inharmonious personal relationship," no evidence of a gender-based barrier to employment found), rev'd sub nom. Paulette Barnes v. Douglas Costle, 561 F.2d 983 (D.DC. Cir. 1977).

13.13 Fair Empl Prac. Cas. (BNA) 123, 124 (D.D.C. 1974).

14.See Skousen v. Nidy, 90 Ariz. 215, 367 P 2d 248 (1961) (punitive damages and award for mental suffering, including "shame," appropriate for 65-year-old woman harassed by employee assault and battery proven); Mitra v. Williamson, 21 Misc 2d 106, 197 N.Y.S. 2d 689 (1960) (damages allowed for public disgrace, humiliation, mental and physical distress from obscene phone calls and letter): Edmisten v. Dousette, 334 S. W.2d 746 (Mo. App. 1960) (damages for worsened nervous condition resulting from physical advance). Similarly, in criminal actions, the taking of "indecent liberties or familiarities" with a female, or the purposeful infliction of shame or disrepute, were aggravating circumstances in many state assault and battery laws during this period. See, for example, Maine v. Towers, 304 A.2d 75 (Me. 1973); South Carolina v. Hollman, 245 S.C. 362, 140 S.E. 2d 597 (1965).

For a discussion of tort claims in sexual harassment cases see, comment, "A Theory of Tort Liability for Sexual Harassment in the Workplace," 134 U.Pa.L.Rev. 1461 (1986).

15.110 Cong. Rec 2577-82, 2851 (1964) (The word "sex" was added by Rep. Smith on Feb 8, 1964 in an attempt to defeat Title VII's passage.)

16.Title VII of the 1964 Civil Rights Act, §704, 42 USC §2000e-3(a) 1991.

17.Williams, 413 F. Supp. at 654.

18.Id. at 662.

19.First circuit: Fisher v. Flynn, 598 F.2d. 663, 665 (1st Cir. 1979).
Third circuit: Tomkins v. Public Serv. Elec. & Gas Co., 422 F. Supp. 553 (D.N.J. 1976). rev'd, 568 F2d 1044, 1048-49 (edd Cir. 1977).
Fourth circuit: Garber v. Saxon Business Prods., 14 Empl. Prac. Dec. (CCH) ¶7586 (E.D. Va. 1976), rev'd, 552 F2d 1032 (4th Cir. 1977).
Sixth circuit: Munform v. James T. Barnes & Co.. 441 F. Supp. 459 (E.D. Mich. 1977).
Ninth circuit: Miller v. Bank of Amer., 418 F. Supp. 233 (N.D. Cal. 1976), rev'd 600 F.2d 211 (9th Cir. 1979).

Tenth circuit: Heelan v. Johns-Manville Corp., 451 F. Supp. 1382, 1388 (D. Colo. 1978).
District of Columbia Circuit: Barnes v. Costle, 561 F. 2d 983, 992 (D.C. Cir. 1977); Williams v. Saxbe, 413 F. Supp. 654, 657 (D.D.C. 1976), rev'd on other grounds sub nom. Williams v. Bell, 587 F 2d 1240 (D.C. Cir. 1978), remanded for trial de novo sub nom. Williams v. Civiletti, 487 F. Supp. 1387 (D.D.C. 1980).

20.29 CFR§ 1604.11(a) (1991).

21."Defining Sexual Harassment" excerpt from Sexual Harassment: Walking the Corporate Fine Line, Training Program Workbook, (New York: National Organization of Women Legal Defense and Education Fund (NOWLDEF) 1988), p.1.

22.29 CFR §1604.11 (a-g) (1980).

23.29 CFR § 1604.11 (A) (1991) (emphasis added).

24.The EEOC guidelines are only inter-agency regulations and are therefore not binding on the Courts. However, courts have adopted the guidelines or portions thereof. See e.g., Meritor Savings Bank. v. Vinson, 77 US 57, 57 (1986); such regulations constitute a body of experience and informed judgement to which courts and litigants may properly resort for guidance. Id. at 65 quoting General Electric v. Gilbert, 429 US 125,141-142 (1976).

25.See Waltman v. International Paper, Co., 875 F.2d 468, 477 (5th Cir. 1989).

26.29 CFR §1604.11 (C,) (D) (1991) (emphasis added). Furthermore the Guidelines provide for employer liability for sexual harassment by fellow employees when the employer knew or should have known of the harassing conduct.

27.See Jones v. Flagship Int'l., 793 F.2d 714, 720 (5th Cir. 1986); Moylan v. Maries County, 792 F.2d 746, 750 (8th Cir. 1986); Downes v. Federal Aviation Admin., 775 F.2d 288, 292-93 (Fed. Cir. 1985); Katz v. Dole, 709 F.2d 251, 254-56 (4th Cir. 1983); Henson v. City of Dundee, 682 F.2d 897, 902 (11th Cir. 1982); Loftin-Boggs v. City of Meridian, 633 F. Supp. 1323, 1326-27 (S.D. Miss. 1986); Mitchell v. OsAir, Inc., 629 F. Supp. 636, 643 (N.D. Ohio 1986); Arnold v. City of Seminole, 614 F. Supp. 853, 868 (D.C. Okla. 1985); Harrison v. Reed Rubber Co., 603 F. Supp. 1457, 1461 (E.D. Mo. 1985); Ambrose v. United States Steel Corp., 38 Empl. Prac. Dec. (CCH) 35,641 (N.D. Cal. 1985); Zabkowicz v. West Bend Co., 589 F. Supp. 780 , 783 (E. D. Wis 1984); Hayden v. Atlanta Newspapers, 534 F. Supp. 1166, 1178 (N.D. Ga. 1982); Coley v. Consol. Rail Corp., 561 F. Supp 645, 649 (E.D. Mich, 1982); Morgan v. Hertz Corp., 542 F. Supp. 123,128 (W.D. Tenn, 1981); Caldwell v. Hodgeman, EEOC Dec 81-18, 25 Fair Empl. Prac. Cas. (BNA) 1647, 1649 (Mass. Dist. Ct. 1981); EEOC Dec 81-17 27 Fair Empl. Prac. Cas. (BNA) 1791, 1793 (1981).

28.Bundy v. Jackson, 641 F.2d 934 (DC Cir 1981).

29.See Rogers v. EEOC, 454 F.2d 234, (5Cu 1972), cert. denied, 406 US 957(1972) employee liable for creating an hostile work environment for Hispanic employees in violation of there Title VII rights) Id. at 238.

30.Bundy at 940 quoting Rogers v EEOC, 454 F.2d 234, 239 (5th Cir. 1971).

31.Id. at 945 The Bundy court explained that: "conditions of employment include the psychological and emotional work environment that the sexually stereotyped insults and demeaning propositions to which she was indisputably subjected and which caused her anxiety debilitation,... illegally poisoned the environment. Id. at 944.

32.Henson v. City of Dundee, 682 F.2d 897 (11 Cir. 1982).

33.Id. at 899.

34.Id. at 903-905.

35.Meritor Savings Bank FSB v. Vinson, 477 US 57 (1986).

36.For a detailed analysis on the effects of the Supreme Court's decision in Meritor, see., Ecabeert, Gayle, "An employer's Guide to Understanding Liability for Sexual Harassment Under Title VII: Meritor Savings Bank v. Vinson." 55 U. Cin. L. Rev. 1181 (1987); Anderson, Katherine, "Employer Liability Under Title VII for sexual harassment after Meritor Savings Bank v. Vinson." 87 Colum L. Rev. 1258 (1987); Turner, Ronald, "Employer Liability Under Title VII for Hostile Environment Sexual Harassment by Supervisory Personnel: The Impact and Aftermath of Meritor Savings Bank, FSB v. Vinson." 33 How. L. Rev. 51 (1990); Barton, Christopher, "Between the Boss and a Hard Place: A consideration of Meritor Savings Bank FSB v. Vinson and the law of Sexual Harassment" 67 B.U. L. Rev. 445 (1987); Phillips, Michael "Employer Sexual Harassment Liability Under Agency Principles: A second look at Meritor Savings Bank, FSBV Vinson." 44 Vand L. Rev 1229 (1991), Vinciguerra, Marlisa. "The Aftermath of Meritor: A search for standards in the Law of Sexual Harassment 99" Yale LS 1177 (1990).

37.Meritor, at 59.

38.Id. at 60. At the time Vinson sought injunctive relief, compensatory and punitive damages against Taylor and the bank, as well as attorney's fees.

39.Id. Vinson also testified that Taylor touched and fondled other women employees but the district court did not allow her "to present wholesale evidence of a pattern or practice relating to sexual advances to other female employees in her case in chief..." Id. at 61.

40.Id. at 61, quoting Vinson v. Taylor 23. For Empl Prac Cas (BNA) 37,39 (D.D.C. 1980).

41.Vinson at 42.

42.243 U.S. App. D.C. 323., 753 F.2d 141 (1985).

43.See Notes 28-31 and accompanying text.

44.243 U.S. App. D.C. at 327, 753 F.2d at 15.

45.243 U.S. App. D.C., at 332, 753 F.2d at 150.

46.243 U.S. App. D.C. at 330, 753 F.2d at 147.

47.Meritor, 477 U.S. at 64. Therefore the court concluded that an employee does not have to suffer from a tangible job benefit in order to recover under Title VII. See, Los Angeles Department of Water v. Manhart, 435 U.S. 702, 707 N. 13 (1978), quoting Sprogis v. United Air Lines, Inc. 444 F.2d 1194, 1198 (1971).

48.See notes 23-26 and accompanying text.

49.Meritor, 477 US at 67 (citations omitted).

50.Id. at 72.

51.Id. The court continued, "while such common-law principles may not be transferable in all their particulars to Title VII, Congress' decision to define "employer" to include any agent of an employer... surely evidences an attempt to place some limits on the acts of employees for which employers under Title VII are to be held responsible."

52.Id. at 72-73.

53.Generally the plaintiff must show that tangible job benefits are conditioned on an employee's submission to conduct of a sexual nature and that adverse job consequences result from employee's refusal to submit to the conduct." Hicks v. Gates Rubber Co., 833 F.2d 1406, 1414 (10th Cir 1987). See also notes 18-21 and accompanying text.

54.McDonnell Douglas v. Green, 411 U.S. 792 (1973).

55.Bundy, 641 F24 at 953. It should be noted a women may also recover via a quid pro quo sexual harassment claim based on a hostile environment created by supervisors who preferentially treat female employees who did submit to their sexual advance.

> [S]uch conduct created a hostile or offensive work environment which affected the motivation and work performance of those who found such conduct repugnant and offensive... [P]laintiff and other women... found the sexual conduct and

its accompanying manifestations which [the] managers engaged in over a protracted period of time to be offensive.

Juliano, Ann, "Did She Ask for it?: The "Unwelcome" Requirement in Sexual Harassment Cases." 77 Cornell L. Rev. 1558, 1566 N. 53 (1992) (quoting Broderick v. Ruder, 685 F. Supp 1269 (D.D.C. 1988). (hereafter the Unwelcome Requirement).

56.Sowers v. Kemira, Inc. 46 Fair Empl Prac Cas (BNA) 1825 (SD GA 1988). However, evidence of the alleged victim's dress and conduct is also admitted Meritor 477 US at 69.

57.See generally Restatement (second) of Agency @ 219-237 (1958).

58.Shrout v. The Black Clawson Co., 689 F. Supp 774 (S D Ohio 1988).

59.Id. at 779.

60.Id. at 780 (quoting Highlander v. KFC National Management Co., 805 F.2d 644, 648 (6th Cir 1986).

61.Sowers v. Kemira, 701 F. Supp 809 (S D Georgia 1988).

62.Id. at 824 (quoting Henson 682 F.2d at 910).

63.This agreement is analoguous to the agency principle that "a master is not subject to liability for the torts of his servant while acting outside the scope of his employment..." Restatement (Second) Agency 219(2) (1958).

64.Restatement (second) Agency 219 (2) (b) and (d).

65.Hall v. Gus Construction Co., 842 F.2d 1010 (8th Cir. 1988). Although this case was primarily a hostile environment sexual harassment case the reasoning of the court provides an excellent example of how an employer may be found liable due to his own negligence.

66.The harassment included having nicknames such as "Herpe," "Blond Bitch" and "Cavern Cunt;" being asked if they "wanted to fuck;" and physical touching. Id. at 1012.

67.Id. at 1016.

68.See notes 32, 33 supra and accompanying text for description of Henson and the eleventh circuit five point test of hostile environment sexual harassment claims.

69.In contrast to Henson the third circuit, in Drinkwater v. Union Carbide Corp., 904 F.2d 853 (3rd Cir 1990) did not require that the harassment be unwelcome. Instead the court relied on the objective and subjective effect the discrimination has on the plaintiff. The most recent tenth circuit decisions also do not require the element of "unwelcomeness" see "The Unwelcome Requirement" 77 Cornell L. Rev 1558, 1571 N. 90 (1992).

70.Rabidue v. Osceola Refining Co., 805 F.2d 611 (6th Cir. 1986) cert. denied 1107 S. Ct. 1983 (1987).

71.Rabidue, at 615.

72.Id. at 624 (Keith J. dissenting).

73.Id.

74.Id.

75.Id. at 620 (quoting Rabidue v. Osceole Ref. Co., 584 F. Supp. 419, 430 (ED Mich. 1984).

76.Id.

77.The majority of the court presented the plaintiff as an excessively sensitive obnoxious women who was incapable of getting along with others. The court also trivialized the conduct to which she was subjected. Rabidue at 622.

78.Collins and Blodgett "Sexual Harassment...Some See It, Some Won't". Vol. 68 Harvard Business Review (March-April) 76, 90 (many victims of harassment feel guilty and somehow to blame for what happened because of prevailing male attitudes.)

79.Id.

80.The court in Rabidue used the following factors in deciding the case:

> the nature of the alleged harassment, the background and experience of the plaintiff, her coworkers, and supervisors, the totality of the physical environment of the plaintiff's work area, the lexicon of obscenity that pervaded the environment of the workplace both before and after the plaintiff's introduction into its environments coupled with the reasonable expectation of the plaintiff upon voluntarily entering that environment.

Rabidue, 805 F.2d at 620.

81.Rabidue, 805 F2d, at 626 (Keith dissenting) the dissent noted that the relevant inquiry is what would be offensive to the reasonable women, not to society, "which at one point also condoned slavery". Id. at 627 (Keith J. dissenting).

82.Yates v. Avco Corp., 819 F.2d 630, (6th Cir. 1987).

83.Id. at 637 (quoting Rabidue 805 F.2d 611, 626 (Keith, dissenting).

84.Davis v. Monsanto Chemical Co., 858 F2d 345, (6th Cir 1988) Cert denied, 490 US 1110 (1989).

85.Rabidue, 584 F. Supp at 430. See also notes 62-64 and accompanying text.

86.Davis, 858 F.2d at 350. The court went on to state: "...while Title VII does not require an employer to file all "Archie Bunkers" in its employ, the law does require that an employer take prompt action to prevent such bigots from expressing their opinions in a way that abuses or offends their co-workers." Id.

87.Ellison v. Brady, 924 F.2d 872 (9th Cir. 1991).

88.Id. at 873.

89.Id. at 874. The letters included letters such as "I cried over you last night and I'm totally drained today." and "I have enjoyed you so much over the past few months. Watching you." Id.

90.Id. at 878. The court stated, "[W]e believe that in evaluating the severity and pervasiveness of sexual harassment, we should focus on the perspective of the victim." Id.

91.Id.

92.Id. at 879.

93.Spencer v. General Electric Co., 697 F. Supp 204. (E.D. Va. 1988), affd 894 F.2d 651 (4th Cir. 1990).

94.Id. at 218. The alleged harassing conduct included sexual comments and suggestive behavior of plaintiff's superior such as sitting on female worker's laps and talking about the length of his penis.

95.Robinson v. Jacksonville Shipyard, Inc., 760 F. Supp 1486, (M.D. Fla. 1991).

96.Id. at 1524.

97.Canada v. The Boyd Group, Inc., 809 F.Supp 771 (D.C. Nev. 1992).

98.Id. at 776. The court stated: A prima facie case of hostile environment sexual harassment exists when a female employee alleges conduct that "a reasonable woman would consider sufficiently severe or pervasive to alter the conditions of employment and create an abusive working environment." Id. (quoting Ellison v. Brady 924 F.2d 872, 879 (9th Cir 1991).

99.Harris v. Forklift Systems, Inc., 114 U.S. 367 (1993).

100.Harris, 60 Empl. Prac. Dec (CCH) at 42075.

101.Id.

102.Harris, at 370.

103.See note 33 and accompanying text. The fifth point of the Henson test is that the employer knew or should have known of the harassment in question and failed to take prompt remedial action.

104.Katz v. Dole, 709 F.2d 251 (4th Cir. 1983).

105.Id. at 254-56 (footnotes omitted).

106.Id. at 256.

107.Guess v. Bethlehem Steel Corp., 913 F.2d 463 (7th Cir. 1990).

108.Tunes v. Corning Glass Works, 747 F. Supp 951 (S.D. NY 1990).

109.Pub L No. 102-166. 105 STAT. 701 (1991).

110.Furfaro, John and Josephson, Maury. "The Civil Rights Act of 1991," New York Law Journal (New York Law Publishing Co. 1992) Friday 3, April 1992, Volume 207, No. 64.

111.Whether or not the Act applies to cases pending at the time of enactment is still under dispute. See eg. Mojica v. Gannett Co., 57 Fair Empl Prac Cas (BNA) 537 (ND Ill 1991) (presumption of retroactivity) but see James v. American International Recovery, No. 1:j9-CV-321 (ND Ga. 1991).

112.Under the prior law, damage awards were only available to victims of intentional or ethnic discrimination. See Conte, Alba Sexual Harassment in the Workplace: Law and Practice, Wiley Law Publications, See 2.21 (1990 and 1992 Supp.).

113.Furfara supra note 75 at ed.

114.Overview of Federal Sexual Harassment Law. (New York: NOW LDEF 1991) p. 9.

115.See Conte, supra note 77.

116.Pub L. No 102-166 See 102, 1977A(c).

117.See eg. Robinson v. Jacksonville Shipyards, Inc., 760 F. Supp 1486 (MD. Fla. 1991) (The court relied on expert testimony to conclude that pin ups of nude and partially nude women and demeaning sexual remarks, created a hostile work environment).

118.Pub L. No 102-166, Sec 113 105 Stutat 1079.

119.Conte, note 77 supra 7.1-7.17 eg. Conduct was not discriminatory. Conduct was welcome. Conditions and terms of employment not affected. Employer had no notice and employee took

prompt and appropriate remedial action.

120.Burns, Sarah. "Grounds of Action for Sexual Harassment," Sexual Harassment in the Workplace Litigation, (New York: NOW LDEF 1990) p. 2.

121.Moskal, Brian. "Sexual Harassment: An Update." Industry Week. November 18, 1991.

122."Sexual Harassment Manual for Managers and Supervisors," CCH Business Law Editors, Commercial Cleaning House Inc. (1992) (hereinafter "Sexual Harassment Manual")

123.Bravo, Ellen and Cassidy, Ellen. The 9 to 5 Guide to Combating Sexual Harassment. (New York) John Wiley and Son, Inc. (1992) p. 101.

124."Guidelines to Advocates: Effective Complaint and Investigation Procedures for Workplace ." Sexual Harassment. (New York: NOW LDEF) p. 4.

125.Although the Supreme Court decision in Meritor rejected the employer's contention that the mere existence of a grievance procedure and a policy against discrimination, coupled with [the plaintiff's] failure to invoke that procedure, must insulate [the employer] from liability. (Meritor, 477 U.S. at 72). Courts have denied such claims on that basis. See eg. Monroe-Lord v. Hytche, 668 F. Supp 979 (D. Md. 1987), aff'd. 854 F 2d 1317 (4 Cn 1988).

126.For samples of sexual harassment policies see Approaches to Affirmative Action The Bureau of National Affairs (1992) p. 47-48, "Sexual Harassment Manual" supra note 87 p. 46.

COMMERCIAL PAPER FORGERIES: A COMPLETE ONE-HOUR LESSON

by

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The members of the Academy of Legal Studies in Business have increasingly turned their attention and emphasis to the pedagogical aspect of our profession. This increased interest in the actual teaching of our material has given rise to many initiatives, for example, the publication of the Journal of Legal Studies Education and a teaching symposium at the annual convention of the Academy. In that collegial spirit of sharing teaching ideas which have been effectively used in the classroom, the following material is submitted as a lesson which students have found to be worthwhile. No suggestion is made that it is a model lesson. It is a lesson, however, which develops in a concise manner a number of principles concerning commercial paper forgeries. The lesson also develops a number of learning aids for students.

Implicit in the writing of this paper is the strongly held belief of the author that it is valuable for teachers of business law/legal environment courses to make available to colleagues approaches that have been found pedagogically effective. The lesson includes some mild attempts at levity, but they are not essential to the structure of the lesson. An outline of the lesson is provided in Appendix A.

The lesson on forgeries begins with the instructor asking the students a rather simple question: "What does the bank contract to do, in general terms, when a depositor opens a checking account?" After eliciting a number of responses, the instructor leads the students to the conclusion that the bank agrees to pay properly drawn checks on the account to the holders of the checks up to the balance in the account. The instructor may write the terms "properly drawn" and "holders" on the chalkboard for emphasis.

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Forgery of Drawer's Signature

The instructor then suggests that, while they are speaking, a thief breaks into the instructor's home and is greatly disappointed because there appears to be nothing worth stealing. As the thief dejectedly begins to leave, the thief sees the instructor's checkbook. The thief decides that perhaps the instructor may keep all his/her money in the bank because there is certainly no evidence of anything else valuable in the home. The thief then takes several checks from the bottom of the checkbook, steals a handwriting sample, and leaves the same way the thief came in so that the crime will be undetected. The thief proceeds to forge a check signing the instructor's name to the check. The forgery is masterfully done and clears the drawee bank, which pays the item in good faith following normal check verification procedures.

The students are asked the following questions. Answers are provided in parentheses.

a. What type of forgery is this? (Forgery of drawer's signature.)

b. How will I, the depositor, learn of this? (Upon receipt of bank statement and preparation of a bank reconciliation.)

c. Upon notification, is the bank liable to recredit the drawer's account? (Yes; not a properly drawn check.)

d. How long does the depositor have to notify the bank? (One year, if there is only one forgery in question.)

e. Is the quality of the forgery a factor, e.g., a very good forgery which is extremely difficult to detect? (No, a forgery is a forgery.)

The instructor writes "UCC Sec. 4-406(2)(b)" on the chalkboard to indicate the source of the rule.

The instructor then asks how many of the students promptly balance their checking accounts upon receipt of the statement. The students are asked to visualize a situation, continuing the previous example, where the instructor does not detect the forgery of the instructor's name as drawer when the statement bearing the forgery is received in August. Another forged check arrives in the September statement and that also goes undetected. Likewise, forged checks are received in the October and November statements, but the instructor/depositor does not notice these either. Finally, it is New Year's Eve. The instructor decides he/she does not want to go out and eat and drink too much, wear party hats, go to wild parties, and have fun. No, the instructor decides that new Year's Eve is a perfect time to set financial affairs in order and to balance the checking account. All of the aforementioned statements are reviewed and the horrified instructor now finds the forgeries and immediately notifies the drawee bank.

The students are asked the following questions:

a. Has the bank lived up to its responsibilities? (No, the bank paid on checks that were not properly drawn.)

b. Has the instructor/depositor acted responsibly? (No, the account should have been promptly reconciled, thus precluding the possibility of the bank paying on all forgeries after those contained in the first statement.)

c. How much, if anything, is the bank liable to the instructor/depositor for? (The amount of the first check only.)

As a reference, the instructor may refer to "UCC Sec. 4-406(2)(b)" previously written on the chalkboard. This alerts the students to the 14-day rule from receipt of the statement for subsequent checks.

The students are asked to consider another aspect of forged checks. They are told to suppose that another forger steals the instructor's checks and issues one of those checks to the Pope in exchange for a book. The students are advised that the Pope has been selected as standing for any honest person and that the example might have used Arnold Atheist or Agnostic, the Archbishop of Canterbury, the principal rabbi of Jerusalem, etc. In our example, the Pope in good faith deposits the check in his bank for collection and the forged check is cleared by the drawee bank. This time, however, the instructor promptly discovers the forgery upon receipt of the statement, informs the bank, and demands reimbursement from the bank. The students are aware that the instructor/depositor is entitled to reimbursement.

The question for the students is, "Must the Pope return the money if sued by the drawee bank, i.e., is an honest person who cashed a check bearing a forgery of the drawer's signature liable to the drawee bank for the amount of the check?" The answer which the students generally find interesting is that the bank alone bears the loss when an honest person cashes a check bearing a forgery of the drawer's signature. When one presents a check to the drawee bank for payment, the presenter warrants all indorsements are genuine but does not warrant the authenticity of the drawer's signature to the drawee bank. The bank has the depositor's

signature on file and it is its responsibility to determine authenticity. As between the two honest parties, the person who presented the check for payment and the bank which paid the check, the loss is borne by the bank as one of the risks of doing business.

This prompts the instructor to write on the chalkboard, "The worst thing that can happen to a bank is to pay on a forgery of the drawer's signature." UCC Sec. 4-207(1)(b)(ii) is given as the reference.

Forged Indorsements

The students are then asked to change gears and consider properly issued checks where there is a forgery of an indorsement, e.g., the payee's signature is forged. The following scenario is constructed. An uncle mails a check payable to the order of his niece, Sara Student, as a college graduation gift. The uncle encloses a note asking his niece to tell him what she buys for herself with the money from the check. The check never reaches Sara Student because a thief steals it from the mailbox, forges the indorsement of Sara, and transfers it to Honest Al in purchase of a suit of clothes. Honest Al deposits the check in Al's account at Al's bank which proceeds to collect the check from the drawee. The drawee bank verifies the drawer's signature, which is genuine, and not knowing the student's signature has been forged, pays the check. The check is then returned to the uncle along with the monthly statement. More than a year later, the uncle asks his niece what she bought for herself with his graduation gift. To the uncle's surprise, he learns the facts as indicated above. Finally, the uncle notifies the bank that it has paid a check on which the holder's (payee's) indorsement has been forged and demands reimbursement for the amount. The bank protests that it had no way of knowing the genuineness of the payee's signature and should not be held liable in this instance.

The students are asked their opinion of the matter. Some questions for the students:

a. Should the bank be held liable when the forgery is that of an indorser? (Yes, reference is made to the opening determination of the bank's responsibility to pay holders of properly issued checks.)

b. How much time does the drawer/depositor have to notify the drawee bank of its error? (Three years; "UCC Sec. 4-406(4)" is written on the chalkboard.)

c. Why does the law grant the drawer/depositor so much time for notification? (As in our example, it may be difficult for the drawer to learn of the forgery.)

Whether the bank can recover from the honest person who cashed the check is the next logical question. Reminded of the Pope's earlier adventures, Honest Al notes that he has acted as honestly as the Pope. Once again, we have two parties who have acted honestly and in good faith, i.e., the bank that cashed the check and the party who presented it for payment. The students are referred to the prior discussion concerning the warranties made by those who present checks for payment.

Unfortunately for Honest Al, UCC Sec. 4-207(1)(a) makes the party who presented a check for payment with a forged indorsement liable for return of the money. One who presents a check for payment does not warrant the authenticity of the drawer's signature to the drawee bank, but the presenter does warrant that all other necessary indorsements on the instrument are genuine and authorized. By way of explanation, it may be suggested that here there is no reason to protect the presenter inasmuch as the presenter was not entitled to the money. The presenter is not the holder of the instrument since it bears the forged indorsement. Moreover, we are not dealing in the forged indorsement case with a situation where the bank has the better opportunity to determine the forgery. The latter situation would apply where there is a forgery of the drawer's signature because the bank has the sample on file. Here, the presenter would seem to have the better opportunity to determine authenticity by establishing the identity of all indorsers before accepting the instrument.

The above discussion prompts the instructor to mention the First Fool Rule, i.e., in the case of a forged indorsement there is no fool like the first fool who took the instrument after the forgery. The so-called first fool should ultimately bear the loss no matter how many times the instrument has been passed on after leaving the first innocent victim's hands. The instructor may conclude this portion of the discussion by simply writing "first fool" and "UCC Sec. 4-207(1)(a)" on the chalkboard.

The Fictitious Payee Rule

The students are asked to speculate as to the reaction of a person on the street to the following situation. The student has received a transfer of an instrument on which the payee's signature has been forged and the student wonders if he/she will be recognized as the holder or owner of the instrument entitled to receive payment. The student stops and asks a person on the street for advice. The point that is being developed is that even those without training will probably recognize that as a general rule one who claims ownership of an instrument through a forgery will not be entitled to enforce payment of the instrument. A forged indorsement in effect is no indorsement. The instructor suggests that this rule is certainly reasonable but there are

several exceptions to the rule that the students need to consider. These exceptions are loosely called the "Fictitious Payee Rule."

The students are told that an individual presents him/herself at the home of the student and claims to be a cousin from the "old country." It is suggested that virtually all of us have an old country. The student and the student's family do not know this cousin, but the cousin is convincing and the student's family is generous. They open their home to their relative. Later, the cousin asks for a loan and they generously issue a check to the cousin in the name that he/she has been using.

Some months later and long after the check has been cashed, the family learns that it has been duped because this person was not a relative but a fraud. Realizing they have been victimized, searching for a way to recoup the loss, and being unable to locate the "cousin," a claim is made against the drawee bank for paying a check on the basis of the forged indorsement of the payee.

Some questions for the students:

a. Is this a criminal matter for which the alleged cousin could be prosecuted? (Yes, clearly.)

b. Should the bank be held liable for paying on the basis of a forged indorsement? (No, UCC Sec. 3-405(1)(a) places the loss on the drawer when the drawer is duped into issuing an instrument to an impostor or impersonator.)

The second version of the Fictitious Payee Rule, sometimes called the "dishonest employee" rule, may be illustrated by the following hypothetical. A student in the class retains the instructor to represent the student in the purchase of a home. At the closing of title, the student is told to issue various checks for expenses of the closing. Months later, the student is reading the newspaper and sees a headline, "Professor Indicted." Below the headline is a somewhat blurry picture of the instructor. A quick reading of the article reveals that the instructor's favorite scam was to have clients issue checks to the order of persons not entitled to any payment. The student then goes back to verify all payments made in connection with his/her closing only to find that a check written to New York Abstract ostensibly for a survey was unnecessary. In fact, no survey was made and New York Abstract did not cash the check. Instead, it was cashed by the instructor in an account which was maintained for this criminal purpose. The account is now empty, and the instructor is either destitute or judgment-proof.

After the students have heard both hypotheticals, they will readily agree that both matters are criminal in nature and the perpetrators subject to arrest. The students are reminded that in both of these situations, however, the law must decide which honest person must absorb the loss. Should the drawer who was duped into issuing the check by the impersonator or dishonest agent or employee suffer the loss, or must the honest person who took it from the fraudulent party, e.g., the bank, suffer the loss? The students are advised that as between these two honest parties, the drawer, the party who most contributed to the loss by issuing the check, sustains the loss. Under the Fictitious Payee Rule, the one who was first duped into issuing the check loses. What about the forgery of the fraudulent party? For criminal law purposes it is treated as a forgery, but for commercial paper purposes the signing of the payee's name in the aforementioned situations is treated as an effective indorsement. Therefore, all honest persons who take the instrument after the fraudulent party signs are protected as holders of the instrument. To give a reference for the second situation, the instructor may write "UCC Sec. 3-405(1)(c)" on the chalkboard.

Finally, the students are advised to be careful to distinguish the case where a drawer issues a check to a party to whom a debt is actually owed. In such a case, if an employee of the drawer steals the check, forges the indorsement of the payee, and cashes the check, the Fictitious Payee Rule does not apply and the bank is not protected. The essence of the rule is that the drawer/employer is liable under the dishonest employee exception when it allows itself to be fraudulently induced into writing checks to parties who are not owed debts. But if the drawer/employer has properly issued a check to a party to whom an obligation is owed, there is no reason for holding the drawer/employer liable. In the case of a check to an actual creditor, the party (usually the bank) which takes the check from the thief who forged the indorsement suffers the loss.

As a final note on the chalkboard, the instructor may add, "Beware check to actual creditor."

Cautionary Note

Slight modifications in the above material may be necessary for those who wish to alert the students to the 1990 revisions of the UCC which have been passed in a number of states. The above lesson focuses on the general rules.

APPENDIX A

OUTLINE FOR COMMERCIAL PAPER FORGERIES: A COMPLETE ONE-HOUR LESSON

I. What does bank contract to do when you open a checking account?

   A. Pay properly drawn checks to holders of the checks.

II. While we speak, a thief breaks into my home and steals my checkbook.

   A. Forges one of my checks.

      1. What type of forgery?
      2. How will I learn of this?
      3. If I notify bank, must bank recredit?
      4. How long to notify bank? (UCC Sec. 4-406(4)).
      5. Quality of forgery a factor?

   B. Fail to balance account and detect forgery, crook forges checks in each of next 3 months.

      1. Notify bank on New Year's Eve.
      2. Must bank recredit? (UCC Sec. 4-406(2)(b)).

   C. Same thief issues check to the Pope.

      1. Suppose bank cashes check for Pope, must Pope return money to bank? (UCC Sec. 4-207(1)(b)(ii)).
      2. Worst thing that can happen to bank is to pay on forgery of drawer's name.

   D. Drawer issues check to you, stolen from you and your signature forged.

      1. How will depositor learn of this?
      2. Must bank recredit?
      3. How long to notify bank? (UCC Sec. 4-406(4)).
      4. May bank recover if honest person cashed check? (UCC Sec. 4-207(1)(a)).

   E. Impostor or impersonator induces drawer to issue check in name of assumed identity.

      1. Bank cashes check.

      2. May drawer recover from bank? (UCC Sec. 3-405(1)(a)).

   F. Agent or employee induces drawer to issue check to one not a creditor.

      1. Bank cashes check.
      2. May drawer recover from bank? (UCC Sec. 3-405(1)(c)).
      3. Beware check to actual creditor stolen and cashed by employee. Fictitious Payee Rule does not apply.

BABES IN BRIEFS:
IS THE EDUCATION OF INFANTS A NECESSARY?

by

Robert S. Wiener*

INTRODUCTION

This paper examines the legal and equitable ramifications[1] and sociological implications[2] of education as a necessary for infants. What determines an infant's contractual liability? How does the law reflect and affect the societal role of infants? What is its view of the education of infants and social classes, parental power, and gender? How has it or should it have changed?

Even if an infant disaffirms a common law contract, the court of equity may recognize a quasi-contract if the subject matter is a necessary. Can education be a necessary so that an infant is liable for its procurement? As a matter of law, the answer depends on whether the education is common school, arts, religious, college, professional, such as apprenticeships, pharmacy, stenography, aviation, and correspondence courses, or from books. If the type of education can be a necessary, the trier of fact considers parental approval, job training, cheaper alternatives, and the social status, special suitability, and educational background of the infant to determine whether it is a necessary for the particular infant.

I. COMMON LAW CONTRACTS

An infant (also called a minor) is a person who lacks the capacity to contract due to youth. The age of contractual capacity, twenty-one at common law,[3] has been statutorily reduced to eighteen by most states.[4] A common law contract

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formed by an infant is voidable at best, that is, valid but able to be avoided by the infant.[5] The public policy rationale for this rule is that infants, as a matter of law, do not have the capacity to fully appreciate the obligations of a contract and "the law still guards the interests of minors against their own assumed improvidence and want of sound judgment"[6] and from others who might take advantage of them.

An infant can disaffirm and thereby avoid contracts for lack of contractual capacity before achieving majority and for a reasonable time thereafter.[7] To disaffirm, the infant must be in privity of contract. An adult who forms a contract for an infant intended third party beneficiary cannot assert the infant's right of disaffirmance. In keeping with the rule that legal rights are one's own, if an adult permits an infant to contract or creates a suretyship contract to obtain a contract for an infant, the infant's right to disaffirm is not barred.[8] Age misrepresentation by an infant, innocent or fraudulent, generally will not prevent disaffirmance of the contract.[9]

An infant who disaffirms a contract must give back any consideration received, but need not place the other party in status quo and that is not possible if the property received during infancy has been spent, consumed, or destroyed. Regarding intellectual benefit derived from education, an infant "is not precluded from disaffirming the contract and recovering the consideration that he paid, by the fact that he cannot return the instruction received."[10] However, materials, such as books received for a correspondence course, must be returned.[11]

A voidable contract formed by an infant may be expressly or impliedly ratified when the infant gains contractual capacity at the age of majority. Implied ratification results from failure to disaffirm within a reasonable time of becoming a major.[12] A reasonable time period may be as long as thirteen months.[13]

Infants who act like adults by marrying, conceiving children, or enlisting for war, may be held to have made valid common law contracts under case or statutory law.[14] Some states have reduced the age of contractual capacity for educational loans to sixteen by statute.[15] The theory may be that infants wise enough to appreciate the value of higher education should have contractual capacity. This paper focuses on contracts made by infants who lack contractual capacity.

II. QUASI-CONTRACTS

A. Creation

Infants can avoid all common law contractual liability. This principle standing alone would make parties reluctant to form any contracts with infants, including those for necessaries. Therefore, the court of equity has the power to create a fictional quasi-contract when the disaffirmed common law contract was for necessaries for the infant. "And the reason anciently assigned was, that without this power he might be exposed to perish of want."[16] The equitable remedy for non-performance of a quasi-contract is quantum meruit or reasonable value. Contracts and quasi-contracts should be distinguished. "[A]n unexecuted contract for necessaries may be disaffirmed unless it be otherwise provided by statute."[17] Even executed contracts for necessaries can be disaffirmed. A common law contract, once disaffirmed, is not binding. Only an equitable quasi-contract created in the case of necessaries is unavoidable. Application of these principles can be confusing and, therefore, warrants further analysis. In the Rhode Island case of *Pardey v. American Ship-Windlass Co.*,[18] Frank B. Pardey contracted with the American Ship-Windlass Company on 17 April 1893 "to work for the [Company] in the pattern-making business for the term of three years and a half ...."[19] Pardey was to be compensated with a salary and "reasonable and proper instruction as a pattern maker. The contract further provided that the sum of $1 per week from the wages earned should be retained by the [Company] till the end of the term, and should then be paid to [Pardey], with interest from the end of each year, but that if [Pardey] should leave the employment before the end of the term, or be discharged for cause, the money retained should be forfeited. At the time of entering the employment [Pardey] was a minor [eighteen years old] .... [Pardey] attained his majority in July, 1895, and left the defendant's employment of his own accord September 7, 1895. The amount of wages retained under the contract ... is $124."[20]

Frank B. Pardey disaffirmed the contract. The court decided that "[Pardey] is mistaken in his supposition that the contract was voidable; for, though it is true generally that a minor cannot bind himself by his contracts, for want of legal capacity, it is equally well settled that he may bind himself by a contract for necessaries, if reasonable, or by a contract beneficial to him."[21] A modern court would decide that Pardey could avoid a common law contract created when he was an infant.

The court found that the contract was for necessaries and "As the contract was binding on [Pardey], and he has violated it by leaving the employment, he must be considered to have forfeited the wages retained as provided by the contract ...."[22] A modern court would find that a disaffirmed common law contract is not binding and cannot be breached. A liquidated damages clause, such as the forfeiture clause here, is avoided with the contract. If the instruction received by Pardey was a necessary, he is "bound" only to a quasi-contract and owes the company quantum meruit, the reasonable value of consideration received and not returned. The court would find that the "wages retained" were "wages earned" and award them to Pardey as quantum meruit or, perhaps, on a theory of constructive bailment.

As with common law contracts, an infant, to be liable on a theory of quasi-contract, must be in privity of contract for the necessaries. If an obligation is assumed by a relative or friend to benefit an infant, the infant is an intended third party beneficiary of the contract formed and not personally liable. "It is essential to recovery that necessaries shall have been furnished on the credit of the infant. If furnished on the credit of his parent or guardian, he is not liable."[23] Therefore, the New York Court of Appeals held that "since the primary duty of support of an infant is on his father, the action for necessaries could not be maintained against the infant [because] the complaint does not allege that the services were rendered in reliance on the infant's credit [nor] that the services were performed at the request of the infant ...."[24]

A few cases relieve an infant of liability for necessaries even in quasi contract if an adult with legal responsibility for the infant is ready and willing to provide them. Even if a contract was formed by the infant, "an infant living with his father or guardian who is able and willing to furnish him with every thing suitable and necessary to his position in life cannot make a binding promise to pay even for necessaries."[25]

In general, an infant who disaffirms a contract for legally necessary education is liable in quasi-contract. If the education is not a necessary, a disaffirming infant is free of both legal and equitable liability. Whether education can be a necessary is determined as a matter of law by its type. Whether possibly necessary education is a necessary for a particular infant is a matter of fact.

B. Can This Type of Education Be a Necessary?

What is a necessary? "[T]he law has never limited its definition of the term *necessaries* to those things which are strictly essential to the support of life,--as food, clothing, and medicine in sickness."[26]

Can education be a necessary? According to Blackstone, an infant may be obligated for "necessary meat, drink, apparel, physic and such other necessaries; and likewise for his good teaching and instruction, whereby he may profit

himself afterwards."[27] If "profit" is the test of good teaching and instruction, is it limited to money or does it include non-monetary rewards? Most courts ask if the minor "would be better enabled to earn a livelihood"[28] as a result of the education. However, one court decided that piano playing was a necessary despite no short-term financial benefits.[29]

Necessaries are distinguished from non-necessaries or luxuries. To be a necessary, education "must be actually necessary, in the particular case, for use, not mere ornament, for substantial good, not mere pleasure; and must belong to the class which the law generally pronounces necessary for infants."[30] If the education is in fact necessary,[31] things essential to its proper study are also necessaries.

What class of education may be a necessary? Under English case law, "I have no doubt that the proper education of an infant stands in the same position under English law as food and clothing supplied to him."[32] American case law is in accord. "The authorities are agreed that a proper education is a necessary."[33] What is a proper education?

1. Common School Education

In 1844, the Vermont Supreme Court in *Middlebury College v. Chandler*[34] stated that "a good common school education, at the least, is now fully recognized as one of the necessaries for an infant. Without it he would lack an acquisition which would be common among his associates, he would suffer in his subsequent influence and usefulness in society, and would ever be liable to suffer in his transactions of business. Such an education is moreover essential to the intelligent discharge of civil, political, and religious duties."[35] This view of common school education is accepted as a matter of law.[36]

What is a good common school education? The supreme court in Virginia, in 1884, found "that it is a reasonable inference" that an infant who "was studying English, Latin, Greek and mathematics" from age ten to thirteen "had acquired a fair education."[37] Additional education was not considered necessary.

What is today's equivalent of a good common school education? The answer probably is a "public school and high school" education.[38]

2. Arts Education

Can education in the arts be a necessary? In *Sisson v. Schultz*,[39] Burt Sisson, "a piano turner [sic]" sued Herman Schultz for $5 for tuning a piano at the request of Schultz's wife and daughter.[40] "The father had provided piano lessons for [his 12 year old daughter] and at the time she was taking

one lesson a week. The piano was out of tune, no question of that and there is testimony, undisputed, that for the daughter to pursue her studies and become proficient in music, the piano had to be kept in tune.... [T]here is evidence that it had not been tuned for two or three years."[41] Although the only precedent was that instruction in music and painting was not a necessary,[42] the trial court judge apparently found that piano tuning could be a necessary and submitted the question to the jury which decided that it was. The Supreme Court of Michigan affirmed stating that the question of whether a piano tuning was a necessary was "a close one" and the trial court had not reversibly erred.

3. Religious education

"No cases can be found either in England or in any of the United States where the definition of instruction [of infants] has been carried so far as to include religious instruction."[43] "[T]he rent of a pew in a church where divine worship is held and religious instruction given is [not] included in the list of articles known to the common law as necessaries."[44] In this 1873 Connecticut case, the pew was rented for the wife and a daughter of the defendant without his authority or assent.[45] The judgment of the court seems, at least in part, to result from reluctance to classify the teaching of all religions as a necessary. "And indeed in this country, where there is no established church and every one is permitted to worship God according to the dictates of his own conscience, no distinction could be made among the thousand different tenets and precepts that are taught upon the Sabbath under the name of religious instruction."[46] Perhaps, if such a distinction could constitutionally be made, this court would have found some religious instruction necessary.

4. College education

Can college education be a necessary?[47] The 1844 *Middlebury College case* distinguished between a good common school education and collegiate study. The court found that a college education could not be a necessary for "it is obvious that the more extensive attainments in literature and science must be viewed in a light somewhat different. Though they tend greatly to elevate and adorn personal character, are a source of much private enjoyment, and may justly be expected to prove of public utility, yet in reference to men in general they are far from being necessary in a legal sense. The mass of our citizens pass through life without them .... I speak only of the regular and full course of collegiate study."[48]

More recent cases have been more open to finding that a college education could be a necessary. The 1912 New York Court of Appeals observed that "circumstances ... may exist where even [a classical or professional] education might properly be found a necessary as matter of fact."[49] In 1930,

the Supreme Judicial Court of Massachusetts stated in dictum that "under present day conditions, as in the past [citing *Middlebury College*], a college education is not, as matter of law, a necessary" but "very likely circumstances could be shown which would warrant that conclusion as matter of fact."[50] The Supreme Court of Michigan noted in 1930 that "[w]hile it has been held in several cases that a higher or classical or professional education is not a necessary, the holding is usually qualified by the statement that circumstances may exist where such an education may be a necessary as a matter of fact."[51]

In modern society, does a college education come within the legal definition of a necessary? The *Middlebury College* court's observation that a common school education "is now" fully recognized as a necessary implies that it was not always so and that other education might be so recognized in the future. That case's tests of what is common among associates, the lack thereof resulting in suffering in subsequent influence and usefulness in society, and being ever liable to suffer in business transactions may apply today to a college education.[52]

In fact, an increasing number of jobs on all levels now require college education.[53] Society has sufficiently changed since 1844 and 1930 to find a college education a legal necessary.[54]

5. Professional education

The *Middlebury College* ruling that college education cannot be a necessary did not apply to all education outside the common school. As the court said, "I would not be understood as making any allusion to professional studies, or to the education and training which is requisite to the knowledge and practice of mechanic arts. These partake of the nature of apprenticeships, and stand on peculiar grounds of reason and policy."[55]

a. Apprenticeships: Apprenticeships can be necessary. Under the apprenticeship contract in *Pardey*, he "was to work for the [Company] in the pattern-making business" for a salary and "reasonable and proper instruction as a pattern maker."[56] The court, referring to *Middlebury College*, decided that "[i]t is a contract for necessaries, and is beneficial to the plaintiff, since it stipulates for his instruction in the useful art of pattern making, by which he would be better enabled to earn a livelihood."[57]

b. Pharmacy: As the *Supreme Court of Iowa said*, "it is conceded that a course in pharmacy may come within the definition of necessaries for which a minor may be bound by contract."[58] In this case, the male infant "entered the pharmacy department of Highland Park College ... for a course

of 12 weeks' instruction" and "quit the school soon thereafter" suing only "to recover the unearned portion of the sum so paid."[59] Therefore, the issue of whether the course was indeed a necessary was not raised.

c. Stenography: A course in "the science or art of stenography" can be a necessary.[60]

d. Aviation: The Brooklyn Municipal Court of New York decided in 1934, as a matter of law, that "aviation instruction to prepare an infant to be a mechanic is a contract for necessaries."[61] On the other hand, the Supreme Judicial Court of Massachusetts correctly decided in 1938 that education in elementary aviation, as a limited commercial pilot and as a transport pilot was not a necessary as a matter of law, but possibly as a matter of fact.[62]

e. Correspondence Courses: What of mail-order education correspondence courses?[63] In 1909, a Maine trial court judge instructed the jury that "a course of correspondence instruction in the electrical engineering course ... seems to stand on intermediate ground, being between that of a trade and a learned profession."[64] The jury decided that here such education was a necessary and the appellate court affirmed the decision.

6. Books

Education can also be gained directly from books. The Michigan Court of Appeals decided as a matter of law that reference books can be necessaries.[65]

B. Is This Education a Necessary for This Minor?

Whether a type of education that can be a necessary is a necessary in a specific case is a question of fact. "What is a proper education in a given case depends on the circumstances of the case."[66] Some factors considered may stay in the jury room, but "The practical meaning of the term [necessaries] has always been in some measure relative, having reference as well to what may be called the conventional necessities of others in the same walks of life with the infant, as to his own pecuniary condition and other circumstances."[67]

1. Parental Approval

Parental approval is a criterion for determining if education is a necessary. In 1912, New York's Court of Appeals said of unapproved engineering education, "the [infant] resided with a parent or guardian able and anxious to give him any kind of an education that he desired, and that in defiance of parental authority he perversely took his own course to his injury and the overthrow of family discipline."[68]

Therefore, if the infant and the parent or guardian disagree on the infant's education, the parent or guardian can prevent the infant from forming quasi-contracts for education. The infant is thereby given additional protection -- able to avoid quasi-contractual as well as common law contractual liability. The practical effect is that a party contracting with an infant to provide otherwise necessary education to that infant must first get parental or guardian approval or risk not only disaffirmance of the contract, but loss of a quantum meruit claim for the education's reasonable value. The rationale seems to be that what is necessary to an infant is best determined by parents and guardians: "Honor your father and your mother"[69] and "Father knows best." Surely, parents should decide what education for their children they want to fund, but the public policy served here is parental discipline, not the necessary education of infants.[70]

2. Job Training

Courts often consider job training the prime purpose of education,[71] that is, education "by which he would be better enabled to earn a livelihood."[72] If it will not achieve this goal, the education is not a necessary.[73] This view ignores education for the "intelligent discharge of civil, political and religious duties."[74]

3. Cheaper Alternatives

Courts consider the existence and quality of free or cheaper alternatives to the chosen education relevant to determine what constitutes a necessary.

Is private education a necessary if free public education is available? In the 1902 case of *Cory v. Cook*,[75] the Rhode Island court did not believe "that, simply because the state, through its public-school system, furnishes the facilities for a common-school education, the father cannot be held liable for anything in the way of supplemental or additional training for the child. ... If the child lives in a city like Providence, for instance, where, under its very superior system of public schools, which system includes both mental and manual training, he can obtain at the public expense an education which is probably equal, if not, indeed, superior, in practical value to a college education of a century ago, it may perhaps be doubted whether the father could be legally held liable for anything in addition thereto in the way of educational training. But where, as in the case at bar, the child lives in a country town, the schools of which do not furnish, and cannot be expected to furnish those facilities for a broad education, including a business or commercial training, which many city schools do furnish, we do not think it would be reasonable to hold that the father, by reason of the existence of public schools in the town, is necessarily relieved from all liability for the additional training of his

child."[76]

Eugene F. Bear, an 18 year old infant, executed a $265 promissory note for board and tuition for one session of common school education at Randolph Macon Academy. Whether "the sending of a boy to a distant academy, or boarding school, when there was a good public school and high school convenient to his home" was necessary was held a question of fact with "ample room for different conclusions to be drawn therefrom by reasonable men."[77] The Virginia Supreme Court of Appeals in 1921 approved putting the question to the jury.

Under the facts of *In re Johnstone's Estate*[78], the infant perhaps was found by the jury to have had cheaper alternatives. Robert B. Johnstone Jr. "was at the top of his class in high school."[79] He attended Dartmouth College in Hanover, New Hampshire paid for by a bank loan to his parents. "[T]here was available to the minor a full tuition scholarship to the University of Chicago. The [trial] Court could have found from the evidence that the minor might have received from Dartmouth either a scholarship or a loan on more favorable terms than the one received from La Salle National Bank." The appellate court affirmed the jury's decision that a Dartmouth College education was not a necessary.

Judicial review of consumer judgment contrasts with the law's hands-off policy on most business judgements. A court might even decide that public school education is more beneficial to the student than private school education.[80]

4. Social Status

The infant's social status can determine whether a type of education is a necessary. "[T]hat such an education and training as will fit one for the ordinary duties of life in the sphere in which he moves ... should be so classed [with necessaries], we have no doubt."[81] "[I]t is then for the jury to determine whether, under all the circumstances, the things furnished were actually necessary to the position and condition of the infant ...."[82] For example, college education might be a necessary if there are "extraneous circumstances ... such as wealth, or station in society ...."[83]

What is a necessary is relative, as the 1909 Maine Supreme Judicial Court said, determined "by taking into consideration the infant's state and condition in life ... what might be considered necessaries for one infant would not be so considered for another whose status is different as to rank, fortune, and social position. The question is one to be determined from the facts surrounding each particular case."[84] In 1912, the New York Court of Appeals reiterated this reasoning.[85] Edward Connelly subscribed for a course of correspondence instruction in "Complete Steam Engineering" for $75.20 payable in $5 monthly installments.[86] The court stated

that "[t]he word 'necessaries,' as used in the law, is a relative term ... and depends on the social position and situation in life of the infant as well as upon his own fortune and that of his parents. What would be necessary in a legal sense for an infant with ample means of his own might not be so for one with no means at all."[87] In American case law, one's means determine one's needs.

The 1844 Virginia Supreme Court applied this principle and agreed with the lower courts that the infant E.C. Hayes's "circumstances and prospects in life did not call for or justify further outlay in his education and support; and that common sense and prudence required that he be put to some business, so as to support himself."[88] Here, the step-father "and his wife chose to maintain this boy ..., and to clothe him finer than other youths in the neighborhood, and give him a classical education, and furnish him with a riding-horse and other equipments for his pleasure; all these were luxuries and accomplishments; but, in no sense of the word, or of the law, could they be called or construed to be necessaries."[89] Don't get too uppity, says the law. Get a job.

The wealth of an infant or the infant's parents alone will not assure the proving of a necessary, especially if the contract is ancillary to a questionable necessary and the parents are ready and willing to pay. In *Moskow v. Marshall*,[90] a landlord sued for quantum meruit on the lease by two minors of a "suite of rooms in 'a privately owned dormitory ... used exclusively for students at Harvard College'."[91] Not only must the plaintiff prove that the living quarters were "essential to a college course",[92] he has to prove that the college education itself was a necessary. In this case, Richard B. Marshall and Lewis R. Burchill entered their second year at Harvard College in September 1928. The court considered their financial resources. "Burchill prepared for college at an academy 'located one hundred twenty miles from his home, where the annual fee was $1,050.' The father of ... Marshall is associated with a firm or corporation 'in the bond business.'"[93] But, it is not sufficient to find that "'[a] college course was not extravagant or unreasonable in respect of either defendant, considering his father's means and manner of living and his own prospects in life,' do not go far enough for this purpose. The affirmative fact of necessity is not established by the negation of extravagance and unreasonableness."[94] The landlord lost.

Using social status to determine whether education is a necessary for an infant has troubled only the Supreme Judicial Court of Massachusetts in a 1938 case governed by New York law, and then not enough to reverse the trial court's decision. "[John P. Adamowski's] father was a weaver. The money which the plaintiff [infant] paid was in part saved by himself from his manual labor and in part contributed by his family from their savings. In this country ... any

stratification of society is transient and shifting. Many a young man without capital or influential connection attains education and advancement in life through his own labors. It would be hard to say that education in aviation was less necessary for the plaintiff than it would have been for another more affluent.... The judge found that the courses in instruction were not necessaries for the plaintiff. That finding was proper, though possibly not required as matter of law."[95] Perhaps the court wanted to avoid a finding that the education was a necessary which would have prevented, at least in part, the infant's recovery of the $1,600 he had paid.

The courts give great weight to social status. Education necessary for one infant may not be necessary for another with equal educational background and intellectual ability, but lower social status. Why do most courts seem to accept fixed social classes? Is the law recognizing a psychological need developed by habituation to a certain style of life? Are necessaries determined by the class into which one is born and infants discouraged from aspiration and motivation for improvement? Are lower classes not expected to be educated above their current status? Or are less affluent infants being protected from liability beyond their financial means, whereas the wealthy can afford imprudent expenses?[96] Should infants of lower social status go to work rather than get more education? Is that advice wise? Is money spent on education a poor investment, or is it in fact an effective way to elevate social status? Or does the law ratify the self-fulfilling prophecy that all those who have not yet achieved higher social status have not because they cannot?

5. Special Suitability

Special suitability of an infant for particular education might also be considered. For example, "that he exhibited peculiar indications of genius or talent, which would suggest the fitness and expediency of a college education for him, more than for the generality of youth in community."[97] Also, in *Sisson*, "The daughter was 12 years old, showed aptitude for music, and was the pianist of the neighborhood."[98] On the other hand, ordinary proficiency, even in Harvard College, is not sufficient; "Nor does the fact that the defendants were able to continue in college until the second year of the course prove that for them a college education was necessary."[99]

6. Educational Background

An infant's educational background may be used to determine whether further education is a necessary. The Georgia Supreme Court considered in 1906 "the particular sphere in society or calling in life which her previous education and attainments had prepared and fitted her to occupy or fill."[100]

In the *International Text-Book Co.* v. Doran[101] case of 1907, James W. Doran, not yet 21, signed a contract for written instruction "of a preliminary and suitable nature in arithmetic, algebra, geometry, and mechanical drawing.... He had previously spent two years in a high school." The Supreme Court of Errors of Connecticut held that "Education furnished to an infant may be necessary to him, but only when it is suitable to his wants and condition. Whether education of a merely preliminary character, such as was furnished in the present case, was a necessary to one who had spent two years at a high school, was a question of fact ...."[102] The court appears to think that although the instruction may be part of a good common school education, Doran should have learned the material the first time around. The finding may be that remedial education is not a necessary.

7. *Gender*

It seems that formal education of women was historically less common and courts were less likely to consider it necessary for them.[103] In the reported cases, women were educated only in piano playing,[104] stenography,[105] and religion.[106] Discussing college education, the *Middlebury College* court considers "men in general".[107] In *Adamowski*, the judge's conception of class fluidity refers to "many a young man"[108] and may not extend to young women.[109] Gender stereotyping is now rejected, and what education is necessary should be determined by the same standards for both young men and young women.

CONCLUSION

How we view education tells us volumes about our society. Exploration of the legal and sociological aspects of the education of infants reveals, embedded in the law, acceptance of discredited views on such issues as parental power over infant children, continued separation of the classes, and the purpose of education.

We should reconsider the assumptions underlying the cases concerning infants' contracts for education. As society changes, so must our view of what types of education can be necessaries. A college education is as much a necessary today as a common school education was in 1844. Even if it is appropriate for the law to play a role in the determination of the allocation of limited educational resources, it should be careful not to establish public policy that entrenches the status quo simply because of tradition. The minds of infants are our most valuable resource and should be nurtured to achieve the highest goals of which they are capable without regard to parental control, social status, and gender. Changes should therefore be considered in statutory law, common law, and equitable principles.

The babes in briefs are our hope for the future. In today's American society their education, including a college education, is necessary and should be recognized as such by the law.

ENDNOTES

1. Judges deciding contracts cases usually rely on recent opinions from the same jurisdiction. In this area of the law, perhaps due to the relatively small number of reported cases, courts often cite old opinions from other jurisdictions; therefore, all cases discussed are treated as belonging to a single body of law.

2. This paper deals with contract law, but a growing body of divorce cases considers if education is a necessary to an infant and therefore the legal responsibility of the parent who pays support. Although the issue raised is whether education is a "necessary" and the cases are sometimes cited in contract cases, these are not cases in which an infant disaffirms a contract. There is overlap of public policy in these two scenarios, but also a difference. Whereas if education is found to be a necessary in disaffirmance cases infants pay for their education, in divorce cases such a finding results in payment by a parent. *See* Ogle v. Ogle, 275 Ala. 483, 156 So.2d 345 (1963); Ex parte Bayliss, 550 So.2d 986 (Ala. 1989); Haag v. Haag, 240 Ind. 291, 163 N.E.2d 243 (1968); Jonitz v. Jonitz, 25 N.J. Super 544, 96 N.Y.S. 422 (1930); Cohen v. Cohen, 82 N.Y.S.2d 513 (1948); Calogeras v. Calogeras, 10 Ohio St. 2d 441, 163 N.E.2d 713 (1959); Jackman v. Short, 165 Or. 626, 100 P.2d 860 (1941); Esteb v. Esteb, 138 Wash. 153, 244 P. 264 (1926).

3. Restatement, Second, Contracts § 14, comment a.

4. The Legal Status of Adolescents 1980 (U.S. Dept. of Health 1981). The reduction in the age of majority has apparently significantly reduced the number of cases concerning the contractual capacity of infants.

5. *See* 2 Williston on Contracts § 226; Restatement, Second, Contracts § 14.

6. Adamowski v. Curtiss-Wright Flying Serv., 300 Mass. 281, 15 N.E.2d 467 (1938).

7. International Text-Book Co. v. Doran, 80 Conn. 307, 68 A. 255, 256-57 (1907).

8. *See* 2 Williston § 327; 10 Williston § 1214.

9. Myers v. Hurley Motor Co., 273 U.S. 18, 47 S.Ct. 277 (1927). In some cases, what is apparently fraud may, in fact, not

be. The (form) contract in the International Text-Book correspondence-course cases "provided that a student not of age enrolling on the installment plan must furnish a written guaranty for the payment of the installments, signed by a parent, guardian, or other responsible party." There was no guarantor in *Doran* because, at the direction of the sales agent, Doran wrote "21" as his age when he was not yet 21. Therefore, there was neither innocent nor fraudulent misrepresentation because there was no scienter on the part of the infant and no reliance by the agent. International Text-Book Co. v. Doran, 80 Conn. 307, 68 A. 255, 256 (1907).

10. Adamowski v. Curtiss-Wright Flying Serv., 300 Mass. 281, 15 N.E.2d 467, 469 (1938).

11. International Text-Book Co. v. Doran, 80 Conn. 307, 68 A. 255, 256 (1907).

12. International Text-Book Co. v. Doran, 80 Conn. 307, 68 A. 255, 257 (1907).

13. Nielson v. International Textbook Co., 106 Me. 104, 75 A. 330, 331 (1909).

14. Restatement, Second, Contracts § 14, comment b.

15. The Model Minor Student Capacity to Borrow Act states that "Any written obligation signed by a minor sixteen or more years of age in consideration of an educational loan received by him from any person is enforceable as if he were an adult at the time of execution ...." Uniform Laws Annotated, Master Ed., Vol. 13. This statute has been adopted by Arizona, Mississippi, North Dakota, Oklahoma, and Washington. California adopted it in 1970, but repealed it in 1972. Other states, such as New York, have adopted similar statutes. "A contract hereafter made by an infant after he has attained the age of sixteen years in relation to obtaining a loan or extension of credit ... for the purpose of defraying all or a portion of the expenses of such infant's attendance upon a course of instruction in an institution of the university of the state of New York or any other institution for higher education ... may not be disaffirmed by him on the ground of infancy." N.Y. Educ. Law § 281 (McKinney 1990).

16. Middlebury College v. Chandler, 16 Vt. 683, 685-86 (1844).

17. Wallin v. Highland Park Co., 127 Iowa 131, 102 N.W. 839, 839 (1905).

18. Pardey v. American Ship-Windlass Co., 20 R.I. 147, 37 A. 706 (1897).

19. *Id.*

20. *Id.* at 706.

21. *Id.*

22. *Id.* at 707.

23. 2 Williston on Contracts § 240 at 51.

24. Siegel & Hodges v. Hodges, 9 N.Y.2d 747, 214 N.Y.S.2d 452, 452-53, 174 N.E.2d 533 (1961).

25. International Text-Book Co. v. Connelly, 206 N.Y. 188, 99 N.E. 722, 725 (1912). In *Pardey*, the court considered it relevant that "The contract ... was made with the sanction of [Pardey's] father." Pardey v. American Ship-Windlass Co., 20 R.I. 147, 37 A. 706, 707 (1897). "An infant is liable for necessaries suitable to his rank and condition, when he has no other means of obtaining them except by the pledge of his own personal credit. But if he is under the care of a parent or guardian, who has the means, and is willing to furnish him what is actually necessary, the infant can make no binding contract for any article whatever, without the consent of his legal protector and adviser." Kline v. L'Amoureux, 2 Paige (N.Y.) 419 (1931).

26. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844).

27. 1 Cooley's Blackstone, 412 Attributed to Lord Coke in the plaintiff's brief in Middlebury College v. Chandler, 16 Vt. 683, 684 (1844); Kilgore v. Rich, 83 Me. 305, 22 A. 176, 176 (1891).

28. Pardey v. American Ship-Windlass Co., 20 R.I. 147, 37 A. 706, 707 (1897).

29. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253 (1930).

30. McKanna v. Merry, 61 Ill. 177, 178-79 (1871).

31. Piano tuning was found necessary for proper piano instruction. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253 (1930).

32. Walter v. Everard, 2 Q.B. 369, 376 (1891).

33. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253, 253 (1930).

34. 16 Vt. 683, 686 (1844).

35. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844). *Accord* International Text-Book Co. v. Connelly, 206 N.Y. 188, 99 N.E. 722, 725 (1912).

36. Bear's Adm'x v. Bear, 131 Va. 447, 109 S.E. 313 (1921); Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253, 253 (1930).

37. Gayle v. Hayes' Adm'r & Als., 79 Va. 542, 547 (1884).

38. Bear's Adm'x v. Bear, 131 Va. 447, 109 S.E. 313, 315 (1921).

39. 251 Mich. 553, 232 N.W. 253 (1930).

40. Apparently, this case was based not on the minor daughter's quasi-contractual liability, but on a father's responsibility at common law for his infant child's necessaries. Liability in this 1930 case does not extend to the mother even though she expressly assented to the contract.

41. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253, 253 (1930).

42. De Moss v. Giltner, 5 Ky. Rep. 691 (1884).

43. St. John's Parish v. Bronson, 40 Conn. 75, 76 (1873).

44. *Id.*

45. Here, as in *Sisson*, the suit is against the father for the education of an infant child based on a contract formed by the child and her mother.

46. St. John's Parish v. Bronson, 40 Conn. 75, 76-77 (1873).

47. In the context of the obligations of divorced parents, "[t]he furnishing of a private college education to one's children is not a necessary for which [a parent] can be obligated to pay unless 'unusual circumstances' warrant such a holding." Hawley v. Doucette, 349 N.Y.S.2d 801 (1973).

48. Middlebury College v. Chandler, 16 Vt. 683, 686 (1884).

49. International Text-Book Co. v. Connelly, 206 N.Y. 188, 99 N.E. 722, 725 (1912).

50. Moskow v. Marshall, 271 Mass. 302, 171 N.E. 477, 479 (1930).

51. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253, 253 (1930). This question was also raised, but not directly addressed, in *In re Johnstone's Estate*. 64 Ill. App. 2d 447, 212 N.E.2d 143 (App. Ct. 1965).

52. Esteb v. Esteb, 138 Wash. 174, 181, 244 P. 264, 266-67 (1926)("The rule in *Middlebury College v. Chandler* ... was clearly based upon conditions which existed at that time. An opportunity at that early date for a common school education was small, for a high school education less, and for a college education was almost impossible to the average family, and was generally considered as being only within the reach of the most affluent citizens.... But conditions have changed greatly in almost a century that has elapsed since that time. Where the college graduate of that day was the exception, to-day such a person may almost be said to be the rule.... That it is the public policy of the state that a college education should be had, if possible, by all its citizens, is made manifest by the fact that the state of Washington maintains so many institutions of higher learning at public expense. It cannot be doubted that the minor who is unable to secure a college education is generally handicapped in pursuing most of the trades or professions of life, for most of those with whom he is required to compete will be possessed of the greater skill and ability which comes from such an education.")

53. "Hundreds of thousands of jobs, once performed creditably without a college degree, are going to college graduates today as employers take advantage of an oversupply of them.

    College graduates are being found more and more among the nation's bakers, traveling salespeople, secretaries, bookkeepers, clerks, data processors and factory supervisors. And they are shutting out qualified high school graduates from many jobs, according to Labor Department officials, corporate executives and economists." N.Y. Times, 18 June 1990, at A1, col. 1.

54. In 1988, 58.9 percent of high school graduates ages 18-24 were attending or had attended college. Source: Bureau of Labor Statistics. "[R]oughly 25 percent of the work force" are college graduates. N.Y. Times, 18 June 1990, at A1, col. 1. The number of total annual college graduates rose from 27,410 in 1900, to 122,484 in 1929-30, to 999,548 in 1979-80. Source: Department of Education, Center for Education Statistics. The total United States resident population was 75,994,575 in 1900, 122,775,046 in 1930, and 226,545,805 in 1980. Source: Department of Commerce, Bureau of the Census. Therefore, as a percentage of the total resident population, total annual college graduates were .0361 in 1900, .0998 in 1930, and .4412 in 1980. By any measure, college graduates are far more common today than in 1930 and certainly than in 1844.

55. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844).

56. Pardey v. American Ship-Windlass Co., 20 R.I. 147, 37 A. 706, 706 (1897).

57. *Id.* at 707. *See* Cooper v. Simmons, 7 H.& N. 707(1862)("[I]n which the indenture of apprenticeship provided for the instruction of the infant in the art of a rim and mortice cock maker, and it was held that the apprentice was held by his contract of service.")

58. Wallin v. Highland Park Co., 127 Iowa 131, 102 N.W. 839, 839 (1905). It is not clear whether the concession was made by the defendant or the court.

59. *Id.*

60. Mauldin v. Southern Shorthand & Business Univ., 126 Ga. 681, 55 S.E. 922 (1906).

61. Curtiss v. Roosevelt Aviation School, U.S. Aviation Rep. 133, Air L. Rev. 382, 382 (1934).

62. Adamowski v. Curtiss-Wright Flying Serv., 300 Mass. 281, 15 N.E.2d 467, 468 (1938).

63. Three cases from different states concern correspondence courses from the International Text-Book Co.. International Text-Book Co. v. Doran, 80 Conn. 307, 68 A. 255 (1907); Nielson v. International Textbook Co., 106 Me. 104, 75 A. 330 (1909); International Text-Book Co. v. Connelly, 206 N.Y. 188, 99 N.E. 722 (1912).

64. Nielson v. International Textbook Co., 106 Me. 104, 75 A. 330, 330-31 (1909).

65. Publishers Agency v. Brooks, 14 Mich. App. 634, 166 N.W.2d 26, 29 (Mich. Ct. App. 1968)(A "14 volume New American Educator Encyclopedia, a 2 volume Webster dictionary, a 4 volume science library, a 1 volume World Atlas, a 3 volume reference library and certain upkeep services ...." were purchased. The court determined that whether the books were a necessary was a question of fact for the jury.)

66. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253, 253 (1930).

67. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844).

68. International Text-Book Co. v. Connelly, 206 N.Y. 188, 99 N.E. 722, 725 (1912).

69. Exodus 20:12, The Torah: The Five Books of Moses (1962).

70. Perhaps teaching of the decalogue is viewed as the most necessary education.

71. Cory v. Cook, 24 R.I. 421, 53 A. 315 (1902)("[E]nable him to earn a respectable and honest living in his chosen vocation ....")

72. Pardey v. American Ship-Windlass Co., 20 R.I. 147, 37 A. 706, 707 (1897).

73. Gayle v. Hayes' Adm'r & Als., 79 Va. 542, 547(1884) ("[C]ommon sense and prudence required that he be put to some business, so as to support himself.")

74. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844).

75. 24 R.I. 421, 53 A. 315 (1902).

76. *Id.* at 316. This case deals with a father's duty to provide necessary education to his child.

77. Bear's Adm'x v. Bear, 131 Va. 447, 109 S.E. 313 (1921).

78. In re Johnstone's Estate, 64 Ill. App. 2d 447, 212 N.E.2d 143 (App. Ct. 1965).

79. *Id.* at 145.

80. *See* Borden v. Borden, 130 N.Y.S.2d 831 (1954). In this Manhattan child support case, the father was not required to pay for his child's education at a segregated private school when public school education was available. The court discussed at length the role of public schools in society and the importance of integration to the community citing Brown v. Board of Ed. of Topeka, 347 U.S. 483, 74 S.Ct. 686 (1954).

81. Cory v. Cook, 24 R.I. 421, 53 A. 315, 316 (1902).

82. Bear's Adm'x v. Bear, 131 Va. 447, 109 S.E. 313 (1921).

83. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844). The court in *Sisson* noted that Schultz "owned a farm in Lapeer county where he and his family resided. He owned an automobile, paid his bills, and lived as comfortably as the ordinary farmer." 251 Mich. 553, 232 N.W. 253 (1930).

84. Nielson v. International Textbook Co., 106 Me. 104, 75 A. 330, 330 (1909).

85. International Text-Book Co. v. Connelly, 206 N.Y. 188, 99 N.E. 722 (1912). Called "[t]he leading case" in Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253, 253 (1930).

86. International Text-Book Co. v. Connelly, 206 N.Y. 188, 99 N.E. 722, 724 (1912).

87. *Id.* at 725.

88. Gayle v. Hayes' Adm'r & Als., 79 Va. 542, 547 (1884).

89. *Id.*

90. 271 Mass. 302, 171 N.E. 477 (1930).

91. *Id.* at 478.

92. *Id.* at 479.

93. *Id.* at 478.

94. *Id.*

95. Adamowski v. Curtiss-Wright Flying Serv., 300 Mass. 281, 15 N.E.2d 467 (1938).

96. The court in *Sisson* said of the $5 fee for a piano tuning, "The amount involved is small and easily within the father's means." Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253, 254 (1930).

97. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844).

98. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253 (1930).

99. Moskow v. Marshall, 271 Mass. 302, 171 N.E. 477, 479 (1930).

100. Mauldin v. Southern Shorthand & Business Univ., 126 Ga. 681, 55 S.E. 922 (1906).

101. International Text-Book Co. v. Doran, 80 Conn. 307, 68 A. 255 (1907).

102. *Id.* at 256.

103. Whereas 22,173 men graduated from college in the United States in 1900, only 5,237 women graduated that year, a ratio of 4.23:1. By comparison, in 1979-80, 470,000 men and 465,000 women graduated, a ratio of 1.01:1. Source: Department of Education, Center for Education Statistics.

104. Sisson v. Schultz, 251 Mich. 553, 232 N.W. 253 (1930).

105. Mauldin v. Southern Shorthand & Business Univ., 126 Ga. 681, 55 S.E. 922 (1906).

106. St. John's Parish v. Bronson, 40 Conn. 75 (1873).

107. Middlebury College v. Chandler, 16 Vt. 683, 686 (1844).

108. Adamowski v. Curtiss-Wright Flying Serv., 300 Mass. 281, 15 N.E.2d 467 (1938). "Man" and "men" often meant "person" and "people", but the context of these usages suggests that the authors intended to be gender specific.

109. Mothers are discriminated from fathers in Sisson v. Schultz, 251 Mich. 553, 232 N.W.253 (1930) and St. John's Parish v. Bronson, 40 Conn. 75 (1873) in which the mothers enter into agreements for their children and the fathers were sued (either because the wives lacked contractual capacity or lacked property rights).

THE LIABILITY OF THE AGENT OF AN UNDISCLOSED OR PARTIALLY DISCLOSED PRINCIPAL

by

Gary K. Sambol*

Introduction

When an agent, acting within the scope of his authority on behalf of a principal, enters into a contract with a third party, the agent is usually not liable to the third party for the contract's performance.[1] However, under certain circumstances, an agent may be liable as a party to the contract. The purpose of this article is to discuss the rules of agency law which determine the liability of an agent who acts within the scope of his authority.[2] In the first part of this article, I present the general rules in the abstract. Next, I discuss the theoretical justifications for and the theoretical difficulties with these rules. Specifically, I attempt to point out the theoretical difficulties which arise when these rules are applied to cases where an agent negotiates a contract on behalf of a business which, unbeknownst to the third party, is owned by someone other than the agent, or if owned by the agent, is incorporated. I suggest that, in such cases, agent liability may result even where it is not a fair conclusion that the third party or the agent manifested an intent for the agent to be liable or that the third party relied on the liability of the agent. Finally, I discuss an approach found in a few cases which denies agent liability where it is not a fair conclusion that the third party dealt with the agent as an individual, rather than as an agent, or relied on his individual liability.

General Rules

Whether an agent is liable as a party to a contract made

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on behalf of a principal essentially depends upon the agreement between the agent and the third party.[3] However, in determining whether the agent and the third party intended for the agent to be liable, courts apply certain rules of agency law which are as follows. While the third party has the initial burden of showing that the agent made a contractual promise,[4] the agent, to avoid liability, must establish that, at the time that the contract was made, the third party had notice that the agent was acting in a representative capacity as well as notice of the principal's identity.[5] Where the third party has notice of the fact of agency and of the identity of the principal, the principal is said to be "disclosed".[6] In such a case, the agent is not personally liable unless, of course, the third party can establish that there was nonetheless an agreement for the agent to be liable.[7] Where the third party is without notice of the fact of agency, the principal is said to be "undisclosed".[8] In this situation, the agent is liable as a party to the contract.[9] Where the third party has notice that the agent is or may be acting in a representative capacity, but is without notice of the identity of the principal, the principal is said to be "partially disclosed".[10] The agent of a partially disclosed principal is presumptively liable as a party to the contract. That is, the agent is liable unless he can establish that there was a mutual intention that he not be liable.[11]

To illustrate these rules, consider the hypothetical case of Arnold Agent, an interior decorator who is hired by his client, Polly Principal, to purchase an oriental rug on her behalf. First, suppose that Arnold orders the rug and that, at the time of the order, he tells the seller that he is acting as an agent on behalf of Polly Principal. Because the seller has notice of the fact of agency as well as notice of the identity of the principal, the principal is disclosed and Arnold is presumptively not liable for the contract. Suppose now that Arnold orders the rug in his own name without indicating that he is purchasing the rug as an agent of another. Because in this case, the seller is without notice that Arnold is acting in a representative capacity, the principal is undisclosed and Arnold is liable as a party to the contract. Finally, suppose that Arnold tells the seller that he is purchasing the rug for "a client" without informing her of the name of the client. Because here, the principal is only partially disclosed, Arnold is presumptively liable as a party to the contract.[12]

Theoretical Considerations

Underlying the liability of the agent of an undisclosed principal is the assumption that, without notice of the existence of the principal, the third party obviously intends to deal with the agent as an individual, not as an agent.[13]

In other words, the third party intends for the agent to be liable as the ostensible principal.[14] Underlying the presumptive liability of the agent of a partially disclosed principal is the assumption that, without notice of the identity of the principal, the third party is probably unwilling to rely solely on the credit of the unknown principal and therefore intends for the agent to be personally liable as well.[15] Moreover, it has been explained that it may also be presumed that the agent agrees to be liable.[16] Finally, the liability of the agent of an undisclosed or partially disclosed principal has been justified on the basis that an agent can easily avoid liability simply by disclosing, at the time of the contract, the existence and identity of the principal.[17]

In the above hypothetical examples involving an undisclosed and a partially disclosed principal, the liability of the agent makes sense in terms of the probable intent of the parties. That is, in the example where Arnold's principal is undisclosed, the seller has no reason to believe that Arnold is acting on behalf of anyone but himself and thus obviously intends for Arnold to be liable as the ostensible principal. In the example where Arnold simply indicates that he is purchasing the rug for "a client", it is also a fair inference that, without notice of the name of the client, the seller is relying on Arnold as a party to the contract. In addition, in either example, it is probably a fair conclusion that Arnold agrees to be liable.

While in the above hypothetical examples, the rules determining the liability of an authorized agent are rather straightforward, they present a number of theoretical difficulties in certain cases. To illustrate, consider the cases of *Saco Dairy Co. v. Norton*[18] and *Judith Garden, Inc. v. Mapel*.[19] In *Saco Dairy*, the manager of the "Breakwater Court", a hotel owned by his mother, was held liable for dairy goods that he had ordered for the hotel even though all bills were in the name of the hotel and the plaintiff never charged the manager personally until the hotel failed to make payment. On appeal, the manager argued that his use of the hotel's name in ordering the goods was notice of the fact of agency and of the identity of the principal to relieve him of personal liability for the contract. In rejecting the manager's argument, the higher court explained that "[t]he fact that the defendant was operating the business of a hotel under the name of 'Breakwater Court' was at least as consistent with the fact that he was the proprietor as that he was the manager for another".[20] Therefore, the court refused to disturb the lower court's finding that the manager acted as the agent of an undisclosed principal.[21]

In *Judith Garden*, the court held the operator of "The Gazebo", an incorporated retail store, liable for an oral contract that she had negotiated to purchase certain

merchandise for the store. Even though the plaintiff itself was an incorporated retail store similar to "The Gazebo",[22] the court concluded that the defendant acted as the agent of an undisclosed principal because, at the time of the contract, she did not make the plaintiff aware that "The Gazebo" was a trade name used by a corporation rather than a trade name under which she did business as an individual proprietor.[23] The court explained that it is the burden of the party seeking to avoid personal liability to disclose the fact of agency and the name of the principal and that "[i]t is not a tenable defense to urge that the other party had the means to discover this."[24] The significance of the corporate status of the business is, of course, that a corporation is generally recognized as an entity which is legally distinct from its owners, the shareholders.[25] Thus, unlike a sole proprietor who is personally liable for contractual obligations incurred in operating her business,[26] or a general partner who is personally liable for the contractual obligations of the partnership,[27] a shareholder, as a general rule, is not personally liable for the contractual obligations of the corporation.[28] However, as illustrated by *Judith Garden*, a shareholder who negotiates a contract on behalf of a corporation acts as an agent of the corporation and thus, may become a party to the contract under agency law.[29]

Saco Dairy and *Judith Garden* are typical of cases where the third party was aware that the agent was acting on account of some business, but the agent could not show that, at the time that the contract was made, the third party had reason to know that the business was owned by someone other than the agent,[30] or if owned by the agent, was incorporated.[31] In such cases, most courts have held, as in *Saco Dairy* and *Judith Garden*, that an agent's use of the principal's trade name in negotiating a contract is not, at least as a matter of law, sufficient notice of the fact of agency and of the identity of the principal to relieve the agent of liability.[32] Thus, in cases like *Saco Dairy* and *Judith Garden*, where the principal's trade name and other circumstances surrounding the contract are consistent with the possibility that the agent is the real principal in interest, the agent must make known, at the time of the contract, who the actual proprietor of the business is, and in the case of an incorporated business, that the business is incorporated. Otherwise, the principal may be deemed undisclosed and the agent liable as the ostensible principal.[33] Alternatively, the agent may be liable as the agent of a partially disclosed principal on the theory that although the third party has notice that the agent is or may be acting in a representative capacity, the "true" principal is not disclosed or, at least, not sufficiently disclosed.[34] It is important to note that, under the specific circumstances of a case, the use of the principal's trade name may be sufficient notice of the existence and identity of the principal.[35] However, where the third party has no reason to know that the business on whose account the agent is acting is something other than a sole proprietorship owned by the agent or perhaps, a partnership in which the agent is a partner, the agent may be liable as a matter of law.[36]

Where the third party knows that the agent is acting on account of a business and the business is identified by some name, to say that the principal is undisclosed or partially disclosed presents several theoretical difficulties. The first theoretical difficulty concerns the assumption implicit in cases like *Saco Dairy* and *Judith Garden* that, at the time of the contract, the third party intended for the agent to be liable. In this regard, it is obviously not always a fair inference that, in entering into a contract like the one in *Saco Dairy* or that in *Judith Garden*, the third party assumes that the agent is personally doing business as an individual proprietor or partner and thus intends for the agent to be liable. For example, in the absence of some representation by the defendant or other circumstances suggesting that the defendant actually owned the "Breakwater Court", is it really a fair inference that the plaintiff in *Saco Dairy* assumed that it was dealing with the defendant as an individual?[37] Similarly, in *Judith Garden*, given that the plaintiff itself was an incorporated retail business, is it really a fair inference that the plaintiff's president, who negotiated the contract, assumed that "The Gazebo" was not incorporated? Isn't it more likely that she simply did not know one way or the other how "The Gazebo" was organized? Moreover, in a case like *Judith Garden*, where a third party enters into a contract with a business without any reason to know and without inquiring into the status of the business or that of the agent, doesn't she really agree to a contract with the business, whoever the owner of the business is and whether the business is incorporated or not, and not with the agent as an individual?

The second theoretical difficulty concerns the intent of the agent. Under traditional contract principles, the basis for contract liability is one's objective manifestations of assent.[38] However, can it be said that, in a case like *Saco Dairy* or *Judith Garden*, the agent manifests his assent to be liable? That is, informal contracts negotiated by agents using only the principal's trade name are commonplace, if not usual. Therefore, it can hardly be said that in ordering the dairy goods in the name of the "Breakwater Court" or in purchasing merchandise in the name of "The Gazebo", the defendants in *Saco Dairy* and *Judith Garden*, respectively, manifested their assent to be liable. Yet, in each case, the plaintiff was able to recover against the defendant.

The third theoretical difficulty involves the concern that, under the approach taken in *Saco Dairy* and *Judith Garden*, a third party may recover against the agent even where it is unlikely that she relied on the individual liability of

the agent. In *Saco Dairy*, for example, it is hardly likely that the ownership of the "Breakwater Court" was in any way material to the plaintiff's agreement to supply dairy goods to the hotel. The plaintiff made all bills out to the hotel and never charged the defendant personally until the hotel failed to make payment. In *Judith Garden*, where the plaintiff itself was an incorporated retail business similar to "The Gazebo" and whose president thus had good reason to suspect that "The Gazebo" might also be incorporated, it is unlikely that, in agreeing to sell the merchandise to "The Gazebo", the plaintiff relied on the individual liability of the defendant. Yet, in each case, the plaintiff was able to recover against the defendant.[39]

An Alternative Approach

Although most courts have followed the approach illustrated by *Saco Dairy* and *Judith Garden*, a few courts have denied agent liability even though the circumstances surrounding the contract were consistent with the possibility that the agent was the real principal in interest. Consider, for example, the cases of *Hess v. Kennedy*,[40] *Rabinowitz v. Zell*[41] and *Sweitzer v. Whitehead*.[42] In *Hess*, the plaintiff purchased a dress from a department store owned by the sons of the defendant under the family name "Kennedy". The sale was made by a sales clerk, but in the presence of the defendant who apparently helped negotiate the contract. Subsequent to the sale, the plaintiff tried to return the dress at which time the defendant approved an exchange and directed an employee to take the dress back. After the plaintiff was unable to find another dress to her liking, she brought suit against the defendant for the return of the purchase price. The trial court concluded that the defendant held herself out as the principal and was therefore liable to the plaintiff.[43] In reversing the trial court, the appellate court pointed out that there was nothing in the record which showed that the defendant "did anything which was calculated to cause the plaintiff to believe that she owned the store, other than to exercise the authority which is usually intrusted to the head of the sales department."[44] The court also stated that

> [u]ndoubtedly, when the plaintiff entered this store for the purchase of the dress, she understood that she was dealing with the proprietor of the store, whoever that might be .... [and that] it certainly cannot be contended that the purchaser ... can hold the salesman, or even the superintendent of the store ... as a party to the contract of sale, upon the theory that it is the duty of one left in charge of a store to disclose that he is an agent, and not the proprietor of the store.[45]

In *Rabinowitz*, the same court that decided *Hess* refused

to hold an agent liable for a written contract that he had signed using only the trade name of his employer. In this case, the plaintiff had addressed a written offer to sell certain goods to "Eastern Leather Goods". The defendant Zell, an employee of an individual doing business under the trade name "The Eastern Leather Specialty Company", then accepted the offer by signing the plaintiff's offer "The Eastern Leather Specialty Company, D. H. Zell". In reversing the trial court's judgment holding the defendant personally liable, the appellate court explained that "it [was] evident that his signature was intended to show who the person was who signed for the person or persons operating under the trade name."[46] The court further explained that

> [t]he plaintiff was dealing with the business house using the trade name referred to .... [and that] [i]t is of no importance in this action against [the defendant] for goods sold that the plaintiff did not know who was trading under the trade name. His agreement was with the person or persons so trading. If I agree with "Billy, the Oyster Man", and do not know his name, my contract is nonetheless with the person, whoever he is, conducting business under that name.[47]

Finally, consider the case of *Sweitzer v. Whitehead* in which the Pennsylvania Supreme Court refused to hold two officers of a corporation liable for a contract that they had negotiated even though, at the time of the contract, the plaintiffs were not made aware of the corporate status of the defendants' business and during negotiations, one defendant referred to the other as his "partner". In this case, the defendants, Land and Whitehead, entered into a contract on behalf of "Land-Whitehead Equipment Company" to sell on a commission basis certain equipment owned by the plaintiffs. After the equipment went unsold and the plaintiffs discovered that some of the equipment was missing and the rest damaged, the plaintiffs brought suit against the defendants individually as well as their corporate principal. The jury returned a verdict for the plaintiffs and the defendants moved for judgment n.o.v. In denying the defendants' motion, the lower court explained that "whether they acted as principals or agents for a disclosed principal was ... primarily a question for a jury and that there was sufficient evidence to sustain the jury's finding that ... [the defendants] acted as and were understood by [the plaintiffs] to be acting as principals rather than agents."[48] On appeal, the Pennsylvania Supreme Court held that judgment n.o.v. should have been entered in favor of the defendants because the plaintiffs had notice that the defendants were acting in a representative capacity as well as notice of the principal's identity.[49]

While purporting to apply agency law, the court supported its decision largely on the basis that the plaintiffs did not deal with the defendants as individuals or rely on their

individual liability. In this regard, the court noted that the plaintiffs had entrusted the defendants with their equipment without investigating the status of the defendants or that of "Land-Whitehead Equipment Company", and that apart from the reference to Land as Whitehead's partner and the absence of an indication that their business was a corporation, there was no evidence which could justify the assumption that the plaintiffs dealt with the defendants as individuals rather than as agents of "Land-Whitehead Equipment Company".[50] Thus, the court concluded that "[t]o premise individual liability on the quantum of proof adduced by [the plaintiffs] would substitute conjecture and surmise for proof."[51]

In each of these three cases, even though the circumstances surrounding the contract were consistent with the possibility that the agent was the real principal in interest, the agent was able to avoid personal liability. In terms of agency principles, perhaps the approach in these cases may be stated as follows. Where the third party knows that the agent is acting on account of a business and the business is identified by some name, although a trade name, the principal is disclosed and the agent, at least presumptively, not liable. This approach is a sensible one because it recognizes that in many informally arranged contracts, where a third party enters into the contract without sufficient reason to know and without inquiring into the status of the agent or that of the business on whose account the agent is acting, she essentially agrees to a contract with the business, whoever its owner is and whether or not it is incorporated, and not with the agent as an individual. Conversely, it is usually not a fair inference that an agent, who uses the trade name of a business without indicating the name of the proprietor of or the corporate status of the business, agrees to be personally liable. Thus, under such circumstances, the third party should not be able to recover against the agent as an individual.

Presumably, even under this alternative approach, where the third party can show that she dealt with the agent as an individual or relied on his individual liability, she may recover against the agent. However, in the absence of any prior dealings between the third party and the agent as an individual or of any representations by the agent unequivocally indicating that he is the real principal in interest, it is difficult to see how the third party can satisfy this burden. For example, in *Sweitzer*, the court concluded that evidence that the plaintiffs were not made aware of the corporate status of the defendants' business and that one defendant referred to the other as his "partner" was simply not sufficient to even raise a question for the jury as to "whether reliance was placed on the individuals as such rather than the entity."[52] Even assuming that the third party can show that she dealt with the agent as an individual, must her failure to inquire into the status of the agent and that of the business have been reasonable? That is, are there circumstances under which a third party has a duty to inquire? Thus, while the alternative approach avoids the theoretical difficulties arising under the approach taken in *Saco Dairy* and *Judith Garden*, the approach is not without its own practical and theoretical difficulties.

Summary

While, in the abstract, the rules imposing liability on the agent of an undisclosed or partially disclosed principal are fairly straightforward, they present a number of theoretical difficulties in cases where an agent negotiates a contract in the name of a business, which unbeknownst to the third party, is owned by someone else or is incorporated. Under the approach followed by most courts, the agent, in such cases, may be held liable as the agent of an undisclosed or partially disclosed principal. However, this approach is theoretically problematic because agent liability may result even though it is not a fair conclusion that the third party or the agent manifested an intent for the agent to be liable or that the third party relied on the individual liability of the agent. Under an alternative approach, the third party is unable to recover against the agent where it is not a fair conclusion that the third party dealt with the agent as an individual or relied on his individual liability. Although this alternative approach avoids the theoretical difficulties arising under the majority approach, it is not without its own practical and theoretical difficulties.

ENDNOTES

1. *See, e.g.*, 1 FLOYD R. MECHEM, LAW OF AGENCY § 1406, at 1037 (2d ed. 1914) ("If the agent makes a full disclosure of the fact of his agency and of the name of his principal, and contracts only as the agent of the named principal, he incurs no personal responsibility.").

2. This article deals only with the liability of an agent who acts within the scope of his authority. When an agent acts without actual authority, he may be liable to the third party on a breach of warranty theory. Specifically, when an agent purports to act on behalf of a principal, he is held to impliedly warrant that he has actual authority to enter into the contract in question. If he does not have actual authority and as a result, the principal is not bound to the third party, the agent is liable to the third party for breach of an implied warranty of authority. *E.g.*, RESTATEMENT (SECOND) OF AGENCY § 329 (1957).

3. RESTATEMENT (SECOND) OF AGENCY § 320 comment a (1957).

4. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 320 comment b (1957) (stating that the third party has the initial burden of showing that the agent is a party to a contract and that this "burden is satisfied if the [third party] proves that the [agent] has made a promise, the form of which does not indicate that it was given as an agent.").

5. RESTATEMENT (SECOND) OF AGENCY § 320 comment b (1957). Whether the third party had notice of the fact of agency and the identity of the principal is generally a question for the trier of fact. *E.g.*, Myers-Leiber Sign Co. v. Weirich, 410 P.2d 491, 493 (Ariz. Ct. App. 1966). Under the Restatement, the third party "has notice of the existence or identity of the principal if he knows, has reason to know, or should know of it, or has been given notification of the fact." RESTATEMENT (SECOND) OF AGENCY §4 comment a (1957). However, some cases have stated that the third party must have actual knowledge of the existence and identity of the principal. *See, e.g.*, Cobb v. Knapp, 71 N.Y. 348, 352 (1877)("It is not sufficient that the seller [third party] may have the means of ascertaining the name of the principal .... He must have actual knowledge."); Vander Wagen Bros. v. Barnes, 304 N.E. 2d 663, 665 (Ill. App. Ct. 1973)("It is not sufficient that the third party has knowledge of facts and circumstances which would, if followed by reasonable inquiry, disclose the identity of the principal."). For a discussion of the subjective and objective standards for notice, as applied in Louisiana cases, *see* John C. Geyer, Note, *Let the Agent Beware: Wilkinson v. Sweeny and Undisclosed Corporate Status*, 50 LA. L. REV. 1183, 1190-1193 (1990)

6. RESTATEMENT (SECOND) OF AGENCY § 4(1) (1957).

7. RESTATEMENT (SECOND) OF AGENCY § 320 (1957).

8. RESTATEMENT (SECOND) OF AGENCY § 4(3) (1957)

9. RESTATEMENT (SECOND) OF AGENCY § 322 (1957).

10. RESTATEMENT (SECOND) OF AGENCY § 4(2) (1957).

11. RESTATEMENT (SECOND) OF AGENCY § 321 (1957). That the agent may be liable under the foregoing rules does not preclude the liability of the principal as well. If the agent has actual authority to act on behalf of the principal, the principal, whether disclosed, partially disclosed or undisclosed, is generally liable. *See* RESTATEMENT (SECOND) OF AGENCY §§ 144, 147, 186 (1957). Under the traditional rule, the liability of the agent and the principal is in the alternative and the third party must elect whether to pursue the agent or the principal. *See, e.g.*, Vander Wagen Bros. v. Barnes, 304 N.E. 2d 663, 665 (Ill. App. Ct. 1973). Many modern courts have rejected the application of the doctrine of election of remedies in this context and have held the liability of the agent and the principal to be joint and several. *See, e.g.*, Crown Controls, Inc. v. Smiley, 756 P.2d 717 (Wash. 1988). For a theoretical discussion of, among other things, the liability of the principal in the undisclosed principal situation, see Randy E. Barnett, *Squaring Undisclosed Agency Law with Contract Theory*, 75 CALIF. L. REV. 1969 (1987).

12. It has been pointed out that it is sometimes to the principal's advantage for the agent to intentionally conceal the existence and/or identity of the principal because the third party might charge the principal more or pay him less than she would the agent, or might not deal with the principal at all. However, with certain exceptions, the third party is generally liable to the partially disclosed and even undisclosed principal on the terms negotiated by the agent. Thus, a principal may instruct his agent not to disclose the existence or identity of the principal. *See* Martin Schiff, *The Problem of the Undisclosed Principal and How it Affects Agent and Third Party*, 1984 DET. C.L. REV. 47, 47-49.

13. James G. Smith & Assoc. v. Everett, 439 N.E.2d 932, 935 (Ohio Ct. App. 1981).

14. *See, e.g.*, MECHEM, *supra* note 1, § 1410, at 1039-40 ("An agent who conceals the fact of agency and contracts as the ostensible principal is liable in the same manner and to the same extent as though he were the real principal in interest."); WARREN A. SEAVEY, LAW OF AGENCY 211 (1964) ("Obviously, if the existence of the principal is unknown, the agent makes a personal promise.").

15. James G. Smith & Assoc. v. Everett, 439 N.E.2d 932, 935 (Ohio Ct. App. 1981). *See also* Benton v. Campbell Parker & Co., [1925] 2 K.B. 410, 414 ("It is presumed that the other party is unwilling to contract solely with an unknown man. He is willing to contract with an unknown man, and does so, but only if the agent will make himself personally liable ....").

16. *See, e.g.*, Cobb v. Knapp, 71 N.Y. 348, 352-53 (1877) (stating that when agents fail to indicate the name of their principal, "it must be presumed that they intend to be liable").

17. *See, e.g.*, *Id.* at 352 ("There is no hardship in the rule of liability against agents. They always have it in their power to relieve themselves ....).

18. 35 A.2d 857 (Me. 1944).

19. 342 N.Y.S.2d 486 (Civ. Ct.), *aff'd*, 348 N.Y.S.2d 975 (App. Term 1973).

20. 35 A.2d at 858.

21. *Id.* at 859.

22. 342 N.Y.S.2d at 487.

23. *Id.* at 488.

24. *Id.*

25. *E.g.*, 1 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 25 (perm. ed. rev. vol. 1990).

26. *E.g.*, HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 58 (1983).

27. *E.g.*, *Id.* at 73-75.

28. *E.g.*, *Id.* at 348. However, under certain circumstances, such as where the corporate form has been used to protect fraud, a court may "pierce the corporate veil" and hold individual shareholders personally liable. *E.g.*, 1 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41 (perm. ed. rev. vol. 1990)

29. *E.g.*, 3A WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1117, 1120 (perm. ed. rev. vol. 1986); Bernard A. Riemer, *Personal Liability of Corporate Officer for Purchases Made Without Disclosure of His Representative Capacity*, 72 COM. L.J. 5 (1967).

30. *See, e.g.*, Givner v. United States Hoffman Machinery Corp., 197 N.E. 354 (Ohio Ct. App. 1935); Amans v. Campbell, 73 N.W. 506 (Minn. 1897).

31. *See, e.g.*, G. W. Andersen Construction Co. v. Mars Sales, 210 Cal. Rptr. 409 (Cal. Ct. App. 1985); Van D. Costas, Inc. v. Rosenberg, 432 So. 2d 656 (Fla. Dist. Ct. App. 1983); McCluskey Commissary, Inc. v. Sullivan, 524 P.2d 1063 (Idaho 1974); Lankton-Ziegle-Terry & Assoc. v. Griffin, 509 N.E.2d 785 (Ill. App. Ct. 1987); Alsco Iowa, Inc. v. Jackson, 118 N.W.2d 565 (Iowa 1962); Haas v. Harris, 347 N.W.2d 838 (Minn. Ct. App. 1984); Como v. Rhines, 645 P.2d 948 (Mont. 1982); David v. Shippy, 684 S.W.2d 586 (Mo. Ct. App. 1985); African Bio-Botanica, Inc. v. Leiner, 624 A.2d 1003 (N.J. Super. Ct. App. Div. 1993); New England Marine Contractors v. Martin, 549 N.Y.S.2d 535 (App. Div. 1989); Lumer v. Marone, 569 N.Y.S.2d 321 (App. Term 1990); Howell v. Smith, 134 S.E.2d 381 (N.C. 1964); Lachmann v. Houston Chronicle Publishing Co., 375 S.W.2d 783 (Tex. Civ. App. 1964); Crown Controls, Inc. v. Smiley, 756 P.2d 717 (Wash. 1988).

32. *E.g.*, Lachmann v. Houston Chronicle Publishing Co., 375 S.W.2d 783, 785 (Tex. Civ. App. 1964) (citing Annotation, *Use of tradename in connection with contract executed by agent as sufficient disclosure of agency or principal to protect agent against personal liability*, 150 A.L.R. 1303 (1944)).

33. *See, e.g.*, Como v. Rhines, 645 P.2d 948 (Mont. 1982) (holding president of "Sound West, Inc." liable for breach of an employment contract where he could not show that, at time of hiring, plaintiff understood he was hired by "Sound West, Inc.", a corporation, rather than by an individual doing business as "Sound West"); African Bio-Botanica, Inc. v. Leiner, 624 A.2d 1003 (N.J. Super. Ct. App. Div. 1993) (holding sole shareholder/president of "Ecco Bella Incorporated" liable for merchandise ordered on behalf of "Ecco Bella" where she could not show that plaintiff had notice that her business was a corporation); Howell v. Smith, 134 S.E.2d 381 (N.C. 1964) (holding owner of "Atlantic Block Company" liable for purchase of petroleum products where he failed to make known that "Atlantic Block Company" was actually "Atlantic Block Co., Inc.", a corporation); Givner v. United States Hoffman Machinery Corp., 197 N.E. 354 (Ohio Ct. App. 1935) (holding defendant liable for equipment he ordered in the name of "Givner's Dry Cleaning", a business actually owned by his wife, because the name "Givner's Dry Cleaning" did not indicate that it was something other than a trade name under which defendant himself did business); Crown Controls, Inc. v. Smiley, 756 P.2d 717 (Wash. 1988) (holding president of corporation liable for equipment he ordered for his business "Industrial Associates" because seller was unaware of corporate status and corporate name of defendant's business and trade name "Industrial Associates" signified partnership).

34. *See* RESTATEMENT (SECOND) OF AGENCY § 321 comment a (1957) ("The inference of an understanding that the agent is a party to the contract exists unless the agent gives such complete information concerning his principal's identity that he can be readily distinguished.") For cases holding an agent liable on the basis that the principal was only partially disclosed, *see, e.g.*, Van D. Costas , Inc. v. Rosenberg, 432 So. 2d 656 (Fla. Dist. Ct. App. 1983) (finding principal partially disclosed where officer/one-third owner of "Seascapes, Inc." contracted for construction services using the corporation's trade name "The Magic Moment Restaurant"); Alsco Iowa, Inc. v. Jackson, 118 N.W.2d 565 (Iowa 1962) (finding principal, at best, partially disclosed where majority shareholder of "Soo Corporation" negotiated a contract for the purchase of goods using the corporation's trade name, "American Insulation & Supply"); David v. Shippy, 684 S.W.2d 586 (Mo. Ct. App. 1985) (finding principal partially disclosed where officer/one-half owner of "Captain W.T. Walkers, Inc.", an incorporated restaurant business, contracted for advertising services using the trade name of the restaurant - "Captain W.T. Walkers").

35. *E.g.*, *Saco Dairy*, 35 A.2d at 859. *See, e.g.*, Myers-Leiber Sign Co. v. Weirich, 410 P.2d 491 (Ariz. Ct. App. 1966) (holding that plaintiff was properly denied recovery against defendant who signed written contract in the name of "Northern-Aire Lodge and Country Club" because there was sufficient evidence from which trial court could have found that plaintiff knew "Northern-Aire Lodge and Country Club" was the trade name of "Northern-Aire Development Company", a corporation). Even where the third party did not know the precise corporate name of the principal, where the third party knew or had reason to know that the principal was a corporation, the agent has also not been held liable. *See, e.g.*, Wired Music, Inc. v. Weimann, 468 S.W.2d 668 (Mo. Ct. App. 1971) (holding defendant/president of "Haystack, Inc." not liable for a written contract entered into in the name of "Haystack Restaurant" where the contract, on its face, showed defendant signed contract only as president of a corporate entity, whatever its precise name). *Cf.* Seattle Ass'n of Credit Men v. Green, 273 P.2d 513 (Wash. 1954) (rejecting argument of creditors that they intended to do business with a partnership where the trade name of the business contained the word "Company" and thus placed creditors on inquiry notice of the corporate status of business). However, several courts have held that, even where the third party knows that the agent is acting on behalf of a corporation, the agent is still liable unless the third party knows the corporation's corporate name. *See, e.g.*, Resnick v. Abner B. Cohen Advertising, 104 A.2d 254 (D.C. 1954) (acknowledging that written contract showed defendant was acting as an officer of a corporation when he signed the contract as president of "American Communication Co.", but nonetheless remanding case to determine whether plaintiff knew "American Communication Co." was only the trade name of "Royal Appliance Co., Inc."); Western Seeds, Inc. v. Bartu, 704 P.2d 974 (Idaho Ct. App. 1985) (stating that trial court erroneously assumed that partial disclosure of the principal - disclosure of the corporate status of defendant's business - was sufficient to relieve from liability defendant who used the trade name "Farmers Feed and Seed" rather than the corporate name "Pocatello Cold Storage, Inc."); Detroit Pure Milk Co. v. Patterson, 360 N.W.2d 221 (Mich. Ct. App. 1984) (stating that plaintiff's knowledge of the corporate status of defendant's business was not sufficient to relieve defendant of liability as the agent of a partially disclosed principal where plaintiff did not know principal's corporate name); James G. Smith & Assoc. v. Everett, 439 N.E.2d 932 (Ohio Ct. App. 1981) (holding defendant, who contracted for advertising services for "The Clubhouse", the registered trade name of "Dale F. Everett Company, Inc.", liable as the agent of a partially disclosed principal, or alternatively, as the agent of a principal without legal capacity or status, even though all billings were sent to "The Clubhouse, Inc." and trial court found that the evidence strongly indicated that plaintiff intended to deal with a corporate client).

36. *See, e.g.*, Como v. Rhines, 645 P.2d 948 (Mont. 1982) (holding trial court did not err in finding defendant owner of "Sound West, Inc." liable as a matter of law where there was no showing that plaintiff understood that defendant was acting for a corporation rather than as an individual doing business as "Sound West"); New England Marine Contractors v. Martin, 549 N.Y.S.2d 535 (App. Div. 1989) (holding that summary judgment was properly granted where documentary evidence did not indicate that the contracting party for clean-up services was "Jim Martin Chevrolet, Inc." rather than Jim Martin doing business as "Jim Martin Chevrolet").

37. From the appellate court's opinion in *Saco Dairy*, it cannot be determined whether there was any evidence presented at the trial level which showed that the plaintiff was led to believe that the hotel was owned by the defendant. The point being made is simply that the plaintiff could theoretically have recovered against the defendant simply because the defendant could show that the plaintiff had notice that the hotel was owned by the defendant's mother rather than by the defendant.

38. *E.g.*, E. ALLAN FARNSWORTH, CONTRACTS, §§ 3.1, 3.6 (2d ed. 1990).

39. While reliance is not an essential element in contract analysis, *see, e.g.*, Restatement (Second) of Contracts § 72 comment b (1979) (noting reliance is not necessary for a promise to be supported by consideration; a bargain is sufficient), it is nonetheless an important concern. *See, e.g.*, Randy E. Barnett, *A Consent Theory of Contracts*, 86 COLUM. L. REV. 269, 271 (1986). Moreover, reliance underlies the presumptive liability of the agent of a partially disclosed principal. *See* note 15 and accompanying text. Finally, reliance is a necessary element of an analogous doctrine - partnership by estoppel. *See* William H. Painter, *Partnership by Estoppel*, 16 Vand. L. Rev. 327, 332-335 (1963) (discussing the requirement of reliance as well as the different judicial views on what constitutes sufficient reliance). Under the partnership by estoppel doctrine, one who expressly or impliedly represents himself to be, or consents to being represented as, a partner in an actual or apparent partnership, may be held liable to a third party who, on the faith of this representation, has extended credit to the actual or apparent partnership. UNIFORM PARTNERSHIP ACT § 16(1) (1914). In addition, the ostensible partner is deemed to be an agent of those actual or apparent partners consenting to this representation and thus has the power "to bind them to the same extent and in the same manner as though he were a partner in fact, with respect to persons who rely upon the representation". UNIFORM PARTNERSHIP ACT § 16(2) (1914). Clearly, the theoretical concerns underlying the partnership by estoppel doctrine also underlie the rule imposing liability on the agent of an undisclosed principal. Moreover, some of

the cases which have been analyzed under agency law could have been resolved under the partnership by estoppel doctrine. *See, e.g.*, McCluskey Commissary, Inc. v. Sullivan, 524 P.2d 1063 (Idaho 1974) (noting trial court finding that plaintiff, who supplied goods to defendants' incorporated business, was led to believe that the business was a partnership or joint venture, but nonetheless affirming the trial court on the basis of agency law). Yet, under agency law, at least under the approach illustrated in *Saco Dairy* and *Judith Garden*, a third party can recover against an agent even where the third party did not rely on the individual liability of the agent.

40. 171 N.Y.S. 51 (App. Term 1918).

41. 191 N.Y.S. 720 (App. Term 1922).

42. 173 A.2d 116 (Pa. 1961).

43. 171 N.Y.S. at 52.

44. *Id.*

45. *Id.*

46. 191 N.Y.S. at 721.

47. *Id.*

48. 173 A.2d at 118.

49. *Id.* at 119.

50. *Id.* at 118-19.

51. *Id.* at 119.

52. *Id.*

THE SECRETS OF TEACHING INTERNATIONAL LAW IN AN EXISTING UNDERGRADUATE BUSINESS LAW COURSE

by

Robert Weill*

For most undergraduate law professors the inclusion of international business law on their syllabi has yet to be accomplished. Many professors confess they know little about the subject and would not, in any event, know how to include this material in their current courses. This paper will attempt to show that international business is a very significant and timely topic and that, consequently, international business law is a very important and relevant subject. This paper will provide a format for bringing international business law into the undergraduate law curriculum so that even the most uninitiated professors in this area can successfully bring this topic in from "left field" and include it in their course coverage.

. . . .

Before World War II, the United States was a country consistently trying to improve its national economy with little regard economically towards the rest of the world. As the last fifty years have passed, this country and other nations have developed a complex web of international trading patterns for goods and services that has created the global marketplace that exists today. Whether it be singular export or import transactions or the mass movements of goods, services, capital or technology across country borders, businesses around the world derive an ever-increasing percentage of their revenues from international transactions.[1]

Recognizing this state of affairs, universities, first gradually and now with an unprecedented fervor, are internationalizing their curricula.[2] While management, marketing, accounting and other traditional business courses have been the main beneficiaries of this infusion of international material, undergraduate law courses seem to have been modified only minimally in this direction. Yet the need and rewards of covering this material in greater depth is ever present.

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When I talk to law school and graduate professors regarding teaching international law, their approach is usually intellectual and straight forward. One starts by explaining the Act of State Doctrine, which basically holds that one country's courts cannot sit in judgement over the validity of another country's actions, and then proceed into the principle of Sovereign Immunity. This doctrine holds that one country does not have to adhere to another country's court verdicts anyway, since there is no jurisdiction. And then these erudite professors continue with other treaties and the many regulatory laws.

When I talk with undergraduate professors about teaching international law, especially as regards to including this material in existing courses, they tend to throw up their hands and confess they would not even know where to begin, since the aforementioned topics are just too sophisticated for the undergraduates. Adding to the dilemma is the fact that most business law books, at best, have just one chapter on international law, so there is not much material to teach from in any event. As a consequence, most professors tend to avoid the topic altogether. And yet, as noted above, more than ever we are in a global marketplace. So, how can we encourage professors to cover some important international legal issues, especially in the second or third semester business law course?

Some insights into making this material more palatable came to me when I was innocently taking surveys of my classes to see how much international material, in general, they had encountered in their classes. The responses from the surveys have been consistent, i.e., the students have had virtually no exposure to international issues in their basic courses. Most schools do not emphasize this material until senior level or graduate courses. So, the first insight became apparent: start with a little international business in general, open their eyes to today's world of global transactions, and then step into the accompanying legal issues.

As just mentioned, since the students have only had minimum, if any, exposure to international transactions, the most elementary approach is appropriate here. And since the average undergraduate law professor's knowledge of this area most likely consists of material gleaned from newspapers, journals and the media in the normal course of keeping up with current events, a simplistic approach is that much more desirable. A little time invested in the introductory chapters of international business books will allow the law professor to cover the beginning issues in this area, such as the following:

1. How important and how frequently occurring are international transactions today?
2. How many everyday consumer products are now the result of international trade?
3. How does an individual or company begin participating in the global marketplace and what format does expansion in this area take?

From the outset I have found that, once students are exposed to international issues, they are amazingly enthusiastic, because they do know to some extent what is happening out there. They know British Airways just sank $300,000,000 into US Air. They know McDonald's and Levi jeans are all over the world. And, of course, the professor can inject into the discussions the lure and intrigue of international travel and the excitement of learning about other cultures. Additionally, the professor can stress the fact that so many of today's best jobs are with international companies. Since I teach a large number of accounting majors in my classes, I point out the demand for graduating seniors to work as internal auditors for multinational companies. Emphasizing these employment opportunities creates even more interest in this material.

Another insight into effectively teaching this material is to use humor. Since these students have not had much, if any, international business, they are in for a number of interesting surprises and funny anecdotes, because no other area I know of is fraught with so many humorous situations and comical mistakes made over and over again as people and companies try to do business overseas. There are even books published on these humorous episodes.[3] Examples can include the countless stories of fledgling international attempts to "go global" like Chevrolet's unsuccessful efforts some years ago to market one of its models in Latin America. Believe it or not, it was not until Chevrolet was advised that "Nova" in Spanish means "no go" that Chevrolet even understood the problem.

Another humorous and educational situation occurs when I write the names of some top selling American car models on the board and ask the students how many of the models are "American made." When they are given the answer that only one, the Honda Coupe, made in Ohio, qualifies as "American made," at first they are shocked, then amused. (We are using the prevailing definition of "American made" which is that 75% of the car must be made or assembled in the U.S.A.)

Finally, another strategy of introducing this new material to the students is to comfort the students with the knowledge that international law is just an extension of the areas of law the students have already studied - contracts, civil procedure, constitutional law, insurance, tax, agency, partnerships, joint ventures, and corporations. It should be reassuring to the students that the latter subjects - agency, partnerships, joint ventures and corporations - which provide the legal formats for doing business domestically, are also the same legal structures for doing business overseas. This

is true whether it is the simplest import or export transaction or the larger commitment to foreign investment by building plants and setting up operations in other countries. Joint ventures are especially popular in international business as they provide a setting for combining assets and expertise. Additionally, a joint venture with a local company or the host government is often a prerequisite for doing business in a foreign country.

After spending as much time as is appropriate and/or available on the basics of international business, I then venture into international business law with a somewhat alphabetical survey of legal issues that arise in international transactions. I find that by using this alphabetical approach the students have a better sense of where we are going, since a lot of the material may not be in their book and is covered by handouts and lecture notes. The following are examples of this teaching method:

A - Anti-dumping Issues. Currently, many countries are sending goods to foreign markets and selling the goods at lower prices than the "fair value" of the goods in order to penetrate the target areas. Underselling competitors in this manner is deemed an unfair trade practice. As regards the U.S. market, foreign made mini-vans and steel are two examples of recent "dumping" situations. While anti-dumping measures, including additional duties, is traditionally the retaliatory measure, new wrinkles in this area are developing as foreign competitors now increasingly seek to avoid anti-dumping measures by exporting individual parts and materials and, later, assembling them in the country of destination.[4]
E - Expropriation of Property by a Foreign Government. The forfeiting of property to a "host" government is always a very real risk, and the legality or validity of such action may be a moot point due to the Act of State Doctrine. If the expropriation is done without compensation to the owner of the property or business, the action is specifically labeled "confiscation." Cuba's takeover of foreign investments in 1960 is one glaring example of this risk. The term "nationalization" consists of many expropriations in that all businesses or properties in a certain sector of the economy are taken over by the host government. For example, this happened in the past to the steel industry in Great Britain.[5]
E - European Economic Community. The banding together of European countries in this trading block continues to create economic and legal obstacles for outside countries. "Europe 92," the most recent attempt at even greater solidarity by these nations, certainly keeps these economic and legal issues at the forefront of corporate planning for non-member countries.
F - Foreign payoffs and the Foreign Corrupt Practices Act. While payoffs to foreign officials to secure

business opportunities is considered normal and appropriate, even if costly, by the great majority of nations, the U.S. Government has thrown controversy into this already complex arena by passing in 1977 a law that has sought to prohibit American firms from "bribing" foreign officials by making it criminal for public companies to make false bookkeeping entries which traditionally were used to shield these "pay offs."[6]
F - Free Trade Areas. In these locations all barriers to trade among member nations are virtually removed. There are, presumably, no taxes, quotas or tariffs. Two of the most well-known free trade areas exist between the member European countries (European Community) and between the United States and Canada.[7] On a consumer level, many people are aware of these privileges found in "duty free areas," such as certain ports (e.g., Hong Kong, St. Thomas, etc.), international airports, and ships and ferries that sail from one country to another.
G - General Agreement on Tariffs and Trade. This treaty has had historic importance as a vehicle to reduce trade barriers and encourage freer trade among member nations. As "rounds" of talks under this agreement strive for progress, world-wide events, such as the recent European demonstrations and protests regarding government subsidies, constantly highlight the significance of this agreement. And the drama continues to unfold as newer member countries seek to qualify for the special benefits under the agreement's "most favored nation" clause. Recent history of the GATT Agreement reveals optimistic statistics -- ninety percent of the disputes brought to GATT for resolution have been settled successfully and the average tariffs in industrial countries have drifted down to approximately five percent compared to an average of forty percent in 1947. However, in spite of these apparent successes, GATT is proving somewhat ineffective in the more recent wave of government subsidies which allow a country's own companies to compete more effectively globally through government support. Further, GATT rules do not cover services, foreign investments or intellectual property rights.[8]
I - Intellectual Property Issues. Copyright, patent, and trademark infringement are constant worrisome issues in international expansion. Whether it is McDonald's protecting its name and logos or pharmaceutical companies trying to protect formulas, this area continuously provides legal challenges as copyright and patent protection around the world is inconsistent and, at times, non-existent. Licensing and franchising agreements, which seek to grant rights to a third party for use of the grantor's intellectual properties, likewise have problems as regards contract formation, compensation, and undesirable consequences.[9]
L - Labor Laws. Labor laws in foreign countries pose many perplexing problems regarding visas and work

permits, employment contracts, and especially decisions regarding employee termination due to a recurring pesky problem - the lack of ability of foreign companies in many countries to discharge local employees, even with good cause. More traditionally, many countries require that foreign companies employ a certain percentage of their own citizens.[10]

M - Marketing. Many countries have specific laws that regulate what does and does not constitute deceptive advertising. Also, many countries have legislation that restrict the use of promotional devices or forbid advertisements that compare a company's products to the competition.[11] Many U.S. firms are thus finding their marketing efforts overseas more strictly controlled and monitored than in the United States.

N - Non-tariff Trade Barriers. Virtually all countries exercise government policies and establish bureaucratic measures that, in one way or another, limit imports. These may consist of quotas or bureaucratic regulations that frustrate the importation of goods under labels of safety or performance standards.[12] Further examples of technical and frustrating laws in this area include "local content regulations that require a certain percentage of the raw materials or component parts used in the final product to come from the host country's local sources.[13] Such requirements limit foreign companies' importation of desired materials to be used in the finished product and lead to claims that, because of these requirements, the finished product cannot meet desired quality standards.

P - Profit Repatriation. Many countries set limits on the amount of profits that can be returned or repatriated to the home country. While the host countries, through these laws, are presumably protecting their local economies and currencies and seeking reinvestment, this can be frustrating, for example, to companies who want to transfer profits back to the parent company.[14]

T - Tariffs. Tariffs are the traditional laws that impose taxes or levies on incoming goods, usually based on the value of the imports. Tariffs have often been based on a nation's need to protect its own industries. One of the more notable incidences of a protectionist tariff occurred in 1983 when the United States International Trade Commission imposed a five year 49.4 percent tariff on imported Japanese heavy motorcycles in order to allow the American corporation, Harley-Davidson, to compete effectively with the Honda and Kawasaki companies of Japan.

T - Taxation. Besides the more straightforward issue of profits being taxed in the country where realized is the more perplexing issue of a government attempting to tax profits on foreign subsidiaries around the world, when the parent multinational corporation is headquartered in the country in question. Further complicating this issue

is the practice of multinations to defer payment of taxes until the income is returned to the parent corporation. "Transfer pricing," if allowed by law, is also a device to depress the impact of taxes.[15] But in the United States the Internal Revenue Code clouds the effectiveness of this technique in order to prevent tax evasion.[16]

U - United Nations Convention on Contracts for the International Sale of Goods (CISG). This document sets forth uniform rules to govern the formation of international sales contracts between parties of subscribing nations. The rights and obligations of the parties are also covered in the document, which is itself strongly influenced by the Uniform Commercial Code of the United States. The need for this important document derives from the fact that parties from different nations have to decide which country's laws will prevail or the parties have to agree to a common, uniform set of rules.[17]

As these legal issues are being covered, each can easily be exemplified by current situations such as BMW recently making commitments to open up an automobile assembly plant in South Carolina or the French farmers recent demonstrations aimed at thwarting progress in the current round of the GATT (General Agreement on Tariffs and Trade) talks.

The students now have a fledgling knowledge of international business and attendant legal issues - so it is time to put their knowledge and imagination to work. For their most interesting assignment in this area, I tell them to choose any product and select any country - as long as there is no repetition - and prepare a report introducing this product into the foreign country utilizing one of the legal formats we have already studied (joint venture, corporation, etc.). The students are directed to do background research on the chosen country and identify and analyze at least six legal issues they foresee having to grapple with as they "internationalize" their product. As part of the project the students are taken to the college library where they are shown the vast array of books and publications that exist on almost every country. There is an unbelievable amount of information on the social, cultural, legal and economic issues of most countries. And the students have responded most enthusiastically - their papers have reflected diligent efforts and creative thinking as to their products that they will "sell" in the "host" country. The papers have also displayed serious attempts at analyzing the legal issues that are expected to arise as the students "internationalize" their product.

After the reports have been written, the students make oral presentations of their papers. Again, their enthusiasm and creativity is very apparent. They draw country maps on the board and list the various laws and legal issues their

research has uncovered; many even go to the effort of duplicating and handing out materials to make their presentations more effective. And some students even create prototypes of their products, which make their presentations that much more "corporate" and "realistic."

For all these reasons, injecting international business law into a business law class is not only interesting and rewarding, but appropriate and timely as we become increasingly more a global marketplace, and colleges show continued progress in "internationalizing" their curricula.

ENDNOTES

1. See David A. Ricks, Series Forward to Michael Litka, International Dimensions of the Legal Environment of Business, V (2nd ed. 1991).

2. See id. at V-VI.

3. See, e.g., David A. Ricks, Blunders in International Business (1993).

4. Michael Litka, International Dimensions of the Legal Environment of Business, 87-88 (2nd ed. 1991).

5. Id. at 68-69.

6. Id. at 115-117.

7. Michael R. Czinkota et al., Rivoli and Ronkainen, International Business, 110 (2nd ed. 1992).

8. Donald A. Ball & Wendall H. McCulloch, Jr., International Business, Introduction and Essentials, 139-140 (5th ed. 1993).

9. See Betty Jane Punnett & David A. Ricks, International Business, 260 (1992).

10. Vern Terpstra & Kenneth David, The Cultural Environment of International Business, 207 (3rd ed. 1991).

11. Czinkota, supra note 7, at 193.

12. Richard Schaffer et al., Earle & Agusti, International Business Law and Its Environment, 257 (1990).

13. Terpstra & David, supra note 10, at 215.

14. Punnett & Ricks, supra note 9, at 133.

15. See generally, Czinkota et al., supra note 7, at 426-428.

16. See Internal Revenue Code, Section 482.

17. See generally Roy J. Girasa, Legal Aspects of Selling Goods Abroad: The United Nations Convention, Westchester Bar Journal, Vol. 19, No. 2, Spring 1992 (analyzing the Articles of the United Nations Convention and comparing and contrasting them with the appropriate sections of the U.S. Uniform Commercial Code).

A CONSERVATIVE LITERALIST - JUSTICE SCALIA'S LEGAL PHILOSOPHY AS SEEN THROUGH AUSTIN V. MICHIGAN CHAMBER OF COMMERCE AND TEXAS V. JOHNSON

BY

WALTER E. JOYCE*

Introduction

Save for the abortion issue, no case in recent years has caused such a public furor as Texas v. Johnson 105 L.Ed.2,342. There, of course, the Court said in an opinion by Justice Brennan that the State of Texas' interest in preventing breaches of the peace did not support its conviction of Johnson who burned the American flag as part of a peaceful political protest demonstration. The court concluded there was no threat to the peace of the community. In addition Brennan wrote: "Nor does the State's interest in preserving the flag as a symbol of nationhood and national unity justify his criminal conviction for engaging in political expression". (105 L.Ed.2,364)

The anger and hostility toward the Court expressed by public officials, the acrimonious debate over whether a Constitutional amendment was needed to right such a "wrong decision", the passage of a federal statute prohibiting desecration of the national symbol, the anguished outcry by patriotic groups, and the confusion, exasperation and frustration expressed by ordinary citizens have just begun to subside, despite the recent decision declaring unconstitutional the new federal statute to ban "flagburning"[1], by the same majority of the Supreme Court and the defeat in the House of the proposed constitutional amendment.

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This public outcry was accompanied by the astonishment of conservatives, liberals and professional court watchers at the makeup of the majority in <u>both</u> "flagburning" decisions. For there lo and behold were not only the new Justice Kennedy but Justice Antonin Scalia, joining Justice William Brennan's majority opinion. The two Reagan appointees had broken with the "conservative bloc" and had joined the "liberal" bloc's intellectual leader. Shock and dismay abounded, with particular attention given to Scalia. For here was a man called by some "worse than Bork"[2], and whose record seemed to support those who questioned his position on cases involving the Bill of Rights.

This paper focuses on one recent case in the just completed term in an attempt to discover whether the Justice's position in Texas v. Johnson and the latest flagburning case are disparate from his philosophical jurisdictional bent.

The Justice

Although he has served but four terms, Scalia has already made an imprint on the court. An independent thinker, a man with a mission, a juristic loner, an intellectual gadfly[3], a Justice pursuing his own consistent intellectual agenda, he is one "whose constitutional theory and personal identity fuse.... the willing servant of a particular culturally induced interpretive world view and the carrier of lessons about what it means to approach the unruly world of constitutional adjudication as though it were amenable to such theoretical control."[4]

In the 1988 term he wrote the fewest opinions for the Court (12) but by all odds the most concurrences (23)[5] His voting alignment patterns in the same term was predictable:

Kennedy	85%
Rehnquist	82%
White	78%
O'Connor	76%
Stevens	59%
Brennan	54%
Marshall	54%

Legislative history does not particularly concern

him and precedent does not have the highest priority in statutory or constitutional interpretation. Rather he is a textualist, a positivist, a formalist who sees the text often independent of historical or contemporary context. Perhaps, as Kanmar has suggested, his scholastic training has so moulded his intellectual apparatus that words themselves, logic, and verbal jousting, become central to his thought processes.

"I adhere to the text where the text is clear. Where the text leaves room for interpretation I am guided in what it means by our societal traditions, not by a show of hands. Hey, maybe I don't like the result either."[6] Thus Scalia, in First Amendment cases, looks at the text to arrive at its "plain meaning" and then interprets it in terms of traditional societal values rather than taking the "absolute" approach as did his great predecessor Hugo Black, whose constitutional world was rationalized and supported in terms of historical evidence to a greater extent than Scalia's.

Both men are positivists and textualists but Black was content to rely on just the text. Scalia on the other hand, despite his reliance on strict textual discipline, would depart from Black on issues like obscenity and cases involving national security, such as the Pentagon Papers case, and, if his record on the D.C. circuit is any indication, in libel cases as well. In other words, Justice Scalia is no civil libertarian. Nor is he a closet liberal in First Amendment speech issues. Rather as this analysis of the recent case will point out, where there is no conflict with the text and his definition of traditional values and his coherent rational approach to the law, Scalia will go along with the text and let the chips fall where they may.

Socioeconomic and political issues are irrelevant; the words and their implied values are determinative. Scalia exhibits neither the pragmatic skepticism of a Holmes nor the positive absolutism of a Black. He may come to the same conclusion as those legal giants but that result fits into a neat, logical system of jurisprudence and that system emphasizes the textual definition of value. Thus in the case to be discussed, the majority deals with such issues as corporate wealth, the interests of minority stockholders, the size of corporations, the impact of that economic power on political debate and how all this relates to a state statute limiting the amounts corporations may spend in political debate. True to his philosophy, Scalia treats all

this as unimportant to the issue of the meaning of the First Amendment in the particular case. Scalia considers merely the value and meaning of the First Amendment, not the realpolitique of the situation.

The Case

To illustrate Justice Scalia's philosophy and constitutional approach on the speech clause of the First Amendment, this paper will analyze the recent case in the 1989-90 term of Austin vs. Michigan Chamber of Commerce 108 L Ed. 2 652.[7] There, Michigan prohibited a corporation from using its funds for independent expenditures in support of or in opposition to any candidate in election for state office. The statute defined an independent expenditure as one not made at the direction or under the control of another person, or to a committee working for or against a candidate. The law allowed corporations to make such independent expenditures from only segregated funds used solely for political purposes. The statute specifically exempted the media. The defendant in the case was a non-profit corporation whose membership consisted of both profit and non-profit corporations with the former constituting 75% of the membership. All members contributed annual dues. The Chamber of Commerce sought to use its general treasury for a newspaper advertisement in favor of a specific candidate for the Michigan House of Representatives. The Federal District Court held the statute valid under the First Amendment and under the equal protection clause of the 14th. However the Sixth Circuit reversed on these grounds:

1. The Chamber was founded to disseminate economic and political ideas and it considered itself a non-traditional corporation.

2. Its expenditures did not pose a threat or appearance of corruption.

3. There was no compelling state interest justifying infringement of free speech.

In an opinion by Justice Marshall the Supreme Court reversed. Marshall was joined by his usual confederates - Justices Brennan, Blackman and Stevens and in addition by two so called "Conservative", members, Chief Justice Rehnquist and Justice White. This unusual grouping shows the inherent danger of attempting to label justices as liberal or conservative and to predict voting patterns. Rehnquist seldom, if ever, votes with the "liberal"

wing on First Amendment issues, while White, though more of a swing vote, tends to view issues very narrowly, including those cases involving the first amendment. So divided was the Court here that in addition to the dissenting opinion written by Justice Kennedy for himself and Justices O'Connor and Scalia, there were three concurring opinions by Brennan, Stevens and Scalia.

The Court's opinion noted that Michigan identified as a serious danger the significant possibility that corporate political expenditures could undermine the integrity of the political process and had implemented a narrowly tailored solution to that problem. "By requiring corporations to make all independent political expenditures through a separate fund made up of money solicited expressly for political purposes the statute reduces the threat that huge corporate treasuries amassed with the aid of favorable state laws will be used to influence unfairly the outcome of elections."[8] Thus the State through this statute allowed corporations to express their political views while carefully eliminating the distortion that might be caused by corporate spending. The Court emphasized that the Act was "precisely targeted" to eliminate what it considered to be a legitimate state interest, i.e., the danger to political discourse. The majority concluded that "although we agree that expression rights are implicated in this case we hold that the Act is Constitutional because the provision is narrowly tailored to serve a compelling state interest."[9]

Scalia's Dissent

Justice Scalia disputed both the issues of a compelling state interest and the need to narrowly draw any limits on freedom of speech. The opinion is vintage Scalia - combative, colorful, pungent, independent, argumentative, appealing to the textual literalness of the First Amendment, scornful of the majority's attempt to refine a limitation on free speech and unwilling to consider that it is in society's interest to promote "fair" political debate. As is so often the case with dissenting and concurring opinions, there is a tendency to overstate ("Orwellian Censorship") since one is writing for oneself and appealing to a future day when the Court's opinion might be overruled.

"I dissent", states Scalia, because "Government, cannot be trusted to assure, through censorship, the fairness of political debate. This is incompatible with the absolutely central truth of

the first amendment ..... The object of the law we have approved today is not to prevent wrong doing but to prevent speech."[10] While not quoting Hugo Black or using Black's "absolute" approach Scalia comes very close to his position at least as far as political discourse in its rational form is concerned. "The Michigan statute is incompatible with the unrepealable wisdom of our First Amendment."[11] There is no such thing as too much speech. "A healthy democratic system can survive the legislative power to prescribe how much political speech is too much, who may speak and who may not."[12]

Yet he differs from Black since he accepts the compelling state interest test. And it is in this part of his opinion that he is particularly disdainful of the Court's analysis. Scalia simply sees no legitimate state interest. He sardonically questions the majority's argument of corporate wealth being used to corrupt the political process. Does one "think it would be lawful to prohibit men and women whose net worth is above a certain figure from endorsing political candidates?"[13] The mere fact of corporate wealth appears to be irrelevant to Scalia as far as First Amendment protection is concerned. "The advocacy of such entities .... that have 'amassed great wealth' will be effective only to the extent that it brings to the people's attention ideas while - despite the invariably self-interested and probably uncongenial source - strike them as true."[14]

The threat that the State of Michigan and the majority of the Court perceive in economic power having a negative impact on political debate is simply not supported by the philosophy of the First Amendment. Scalia is saying that the mere wealth of the speaker be it individual or corporation, is no basis for the compelling state interest test. "It is rudimentary that the State cannot exact as the price of special advantage (the corporate form), the forfeiture of First Amendment rights."[15] As to the question of whether corporations could "corrode" the political process by their use of funds, the Justice accuses the Court of equating corruption with unpopularity, with fear of the potential wrong to American society from powerful economic units taking direct part in the political debate..... For the first time since Justice Holmes left the bench, the court holds that a direct restriction upon speech is narrowly enough tailored if it extends to speech that has the mere potential for producing social harm."[16] Speech operates in a competitive setting and in this free-for-all environment, values and ideas which survive have passed a severe test.

Fairness, or merit, or equity are not necessarily part of the rules. There seems to be no difference between the wealthy individual and the modern corporation. Nor is there an assumption that wealth in and of itself should be considered as adversely affecting political debate. If wealth equals power so be it. That is part of our free system of government. "Under the Court's analysis of corruption by immense aggregation of wealth virtually any thing the Court deems politically undesirable can be turned into political corruption - by simply describing its effects as politically "corrosive" which is close enough to corruption to qualify. It is sad to think that the First Amendment will ultimately be brought down not by brute force but by poetic metaphor."[17]

It is anathema to Scalia to calibrate political speech to the degree of public opinion that supports it. What particularly annoyed Scalia was the general prohibition of corporate free speech activity by Michigan and not merely limiting independent expenditures above a certain amount or some other specific guidelines as long as the guidelines were reasonable and content neutral. As an example, in the case of Ward v Rock 105 L.Ed.2, 661, Scalia joined the majority which held that New York City's law requiring sponsors of park bandshell concerts to use sound - amplification equipment and sound technicians provided by the City was valid under the First Amendment as a reasonable regulation of place and manner of speech. The Michigan statute was not reasonable, was not narrowly tailored, because its rationale was the economic power of speech and thus it was aimed at the thought and content itself.

Conclusion

Scalia's position in Johnson and Eichman, appears to be consistent with his overall philosophy of constitutional interpretation. Once he acepted flag burning as expressive conduct, once he determined that there was no breach of the peace, Scalia sought the text and found protection for Johnson and Eichman. While the emphasis in Austin was on speech in its traditional sense (rational political discourse), Scalia was able to make the leap to find the extreme conduct of flag burning minus concurrent violence, as political expression and, thus protected. As abhorrent as the act was the Constitution shields it from attack by the State.

Endnotes

1. United States v. Eichman 110 L.Ed.2,287

2. See David Kaplan "Scalia Was Worse Than Bork", New York Times, April 19, 1987 p. 23. "Compared to Judge Bork, Antonin Scalia, who was confirmed 98-0, was not much better and ocasionally was much worse. While his writings as a law professor were not as prolific or pungent, several articles nonetheless revealed similar hostility to the courts as an anti-majoritarian institution. In one, written shortly before his appointment to the appeals court, Professor Scalia skewered affirmative action as "the most evil fruit of a fundamentally bad seed.

It is generally felt that Scalia sailed through the Senate hearing as well as the Senate itself because of the preceding rancorous debate over the promotion of Justice Rehnquist to Chief Justice and also because of their contrasting personalities. Scalia is warm, charming and outgoing, the father of nine and a natural for television exposure.

3. Scalia's colleague, Chief Justice Rehnquist, notes what is obvious to all who attend the public sessions of the Supreme Court. "He has... a reputation for incisive and persistent questioning of attorneys during oral argument." See, Rehnquist, The Supreme Court, Morrow, 1987, p. 259. In this he reminds one of the late Justice Frankfurter who was notorious for his questioning of counsel and lecturing his colleagues. Perhaps it was the teacher in both Justices; Frankfurter at Harvard and Scalia at Chicago.

4. See the recent article, George Kanmar, The Constitutional Catechism of Antonin Scalia, 9 Yale Law Journal, April 1990, No.6, at pp. 1299-1300. In this article Professor Kanmar's central point is, as his clever title would indicate, that Scalia..."as a pre Vatican II Roman Catholic absorbed very early a particular formalistic vision of how one perceives and evaluates the world, as well as a particular literalistic view of what one does with texts. Moreover by virtue of being an American Catholic interested in public affairs, Scalia also faced certain curturally complicated pressures as he sought to accommodate his personal moral views with his worldly participation, a conflict whose pragmatic resolution both drew upon and influenced his larger sense of the relationship between legal form and legal substance." <u>Ibid</u> p. 1300.

5. The statistical material is from Harvard Law Review, November 1989, pp. 394 and 395.

6. Kanmar, supra, footnote of p. 1319.

7. Austin v. Michigan Chamber of Commerce, 108, L.Ed.2, 652 at 670.

8. Ibid, p. 661.

9. Ibid, p. 677.

10. Ibid, p. 688.

11. Ibid, p. 687.

12. Ibid, p. 678.

13. Ibid, p. 680.

14. Ibid, p. 680.

15. Ibid, pp. 683-684.

16. Ibid, pp. 680-681.

17. Ibid.