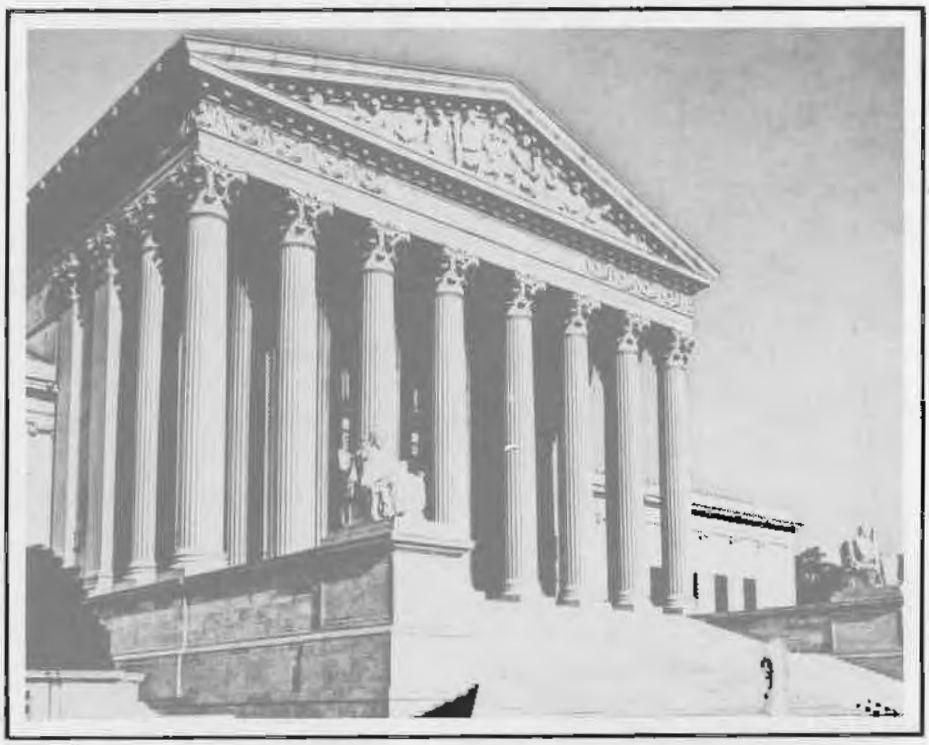
North East Journal of Legal Studies



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ARTICLES

AIDS: LEGAL AND ETHICAL IMPLICATIONS FOR HEALTH CARE PROVIDERS*

by

Audrey Wolfson Latourette**

AIDS is a tragic disease of epidemic proportions. It constitutes the most serious public health problem confronting the United States. In the 1980's human immunodeficiency virus (HIV) infection emerged as a leading cause of death in the United States. Reports emanating from the Centers for Disease Control (CDC) indicate that HIV infection/acquired immunodeficiency syndrome (AIDS) will continue to cause an increasing proportion of all deaths.[1] This contagious, devastating and fatal disease has as of September 30, 1993 heen contracted by 339,250 Americans since 1981, and of that number 204,390 AIDS patients have died.[2] The Centers for Disease Control have reported an acceleration in the number of diagnoses made; thus, while it took eight years for the first 100,000 cases to be diagnosed, it only took two years, between September 1989 and November 1991, for the second 100,000 cases to be determined. Moreover, the CDC estimates that only twenty percent of the one million Americans who have contracted the human immunodeficiency virus which causes AIDS have been diagnosed with the disease. While male homosexuals still comprise the majority of AIDS cases, the CDC has concluded that the incidence of the disease is spreading most rapidly among heterosexuals, and the percentage of AIDS cases is increasing among blacks, Hispanics and women.[3] The largest proportionate increase of AIDS cases was experienced by heterosexuals, jumping 130 percent,

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from 4,045 in 1992 to 9,288 in 1993. This dramatic rise in numbers helped boost the overall growth in AIDS cases in 1993 by 111 percent, far greater than the 75 percent increase the CDC had earlier anticipated.[4] Further, the World Health Organization, in a report assessing the future dimensions of the AIDS pandemic, stated that by early 1992 ten to twelve million people world wide had contracted HIV. The agency anticipates that by the year 2000 the number of infections will have tripled and possibly quadrupled.[5]

Scientists have indicated that AIDS is caused by infection with the human immunodeficiency virus (HIV). AIDS is transmitted through sexual contact with an infected person, exposure to tainted blood or blood products and perinatal exposure. Notwithstanding the fact that scientific evidence does not support the transmission of AIDS through casual contact or exposure to saliva, tears or other bodily fluids, the public through fear or a lack of knowledge perceives the disease as an ominous threat, and this perception has prompted numerous instances of discrimination against actual or suspected carriers of the AIDS virus.[6] Thus, HIV carriers bave been denied adequate medical care where dentists and physicians have refused to treat them.[7] Access to schools has been denied by school boards who have voted to bar any student from attending class who has AIDS or is suspected of having it.[8] Many bave been removed from employment, including a flight attendant, a university professor and a nurse.[9] Evictions or refusals to rent have occurred where landlords have regarded tenants as homosexuals or as AIDS carriers.[10] Morticians have refused to provide proper funeral services or transferred the decedent to another funeral home, upon discovering that the death was caused by AIDS.[11] Ambulance workers have refused to transport AIDS patients to hospitals.[12]

These acts of discrimination have engendered numerous lawsuits. AIDS has in fact prompted more litigation than any other disease in history. As reported by AIDS Litigation Project, an activity of the U.S. Public Health Service's AIDS program, the number of AIDS lawsuits currently pending or decided exceeds 1,000.[13] This figure reflects a far greater number of cases than can be attributable to any other public health problem. While the majority of cases involve discrimination against people with AIDS, other cases focus on the responsibility of blood banks, physicians and hospitals for AIDS tainted hlood transfusions. Commentators have noted that a significant trend in AIDS discrimination litigation is the exploration of the duty to treat issues in health care.[14] The concomitant issues of testing of patients and providers, issues of privacy and confidentiality as related to those tests, and issues of ethical duties to inform patients and providers of one's AIDS status and to warn third parties about the AIDS status of a patient or

provider, are emerging as issues of particular importance to the health care provider.

A myriad of legal issues have thus been raised by the AIDS disease; it has become as much of a legal and ethical dilemma as a medical crisis. This article will discuss those legal issues which particularly relate to the health care field, including the major pieces of pertinent federal legislation and court interpretations as to their applicability to AIDS victims; state legislative enactments regarding AIDS; and official postures of the judiciary, the CDC and the American Medical Association with regard to the ethical and legal issues raised by AIDS.

Federal Legislation Which Protects The Disabled

Section 504 of the Rehabilitation Act of 1973[15] prohibits employment discrimination against handicapped individuals who are otherwise qualified in federally funded programs. Section 504 defines as handicapped an individual who has a mental or physical impairment which substantially limits one or more major life activities, has a record of such impairment, or is perceived by others as having such an impairment. Pursuant to this statute, an "otherwise qualified" disabled employee is afforded protection if with reasonable accommodation on the part of the employer, the employee can perform the essential functions of the job. Further, the nature, severity and duration of the risk such an employee may pose to co-workers is examined. While AIDS is not specifically included within the statutory language as a handicap, the statute has been interpreted by the lower federal courts,[16] the Department of Health and Human Services and the United States Department of Justice[17] to encompass victims of contagious disease, including symptomatic and asymptomatic AIDS carriers.

It is interesting to note that the original posture of the U.S. Department of Justice with regard to whether AIDS constitutes a handicap under section 504 was that an asymptomatic carrier of HIV was not included within the purview of the statute.[18] The United States Supreme Court in School Board of Nassau County v. Arline[19] decided shortly thereafter rejected much of the Justice Department's reasoning and concluded that a contagious disease, in this instance tuberculosis, constituted a section 504 handicap. While the Court declined to address the issue of whether a carrier of AIDS could be deemed handicapped, a number of lower federal courts have relied upon the Court's reasoning in Arline to conclude that symptomatic and asymptomatic carriers of HIV are handicapped.[20] Further, the Department of Justice, citing Arline, amended its position to assert that section 504 of the Rehabilitation Act does protect both symptomatic and asymptomatic carriers

of HIV.[21] The scope of this statute is limited, however, inasmuch as it does not prohibit discrimination by private persons or entities.

The landmark civil rights legislation, Americans With Disabilities Act (ADA) of 1990[22] is far more expansive in scope, prohibiting discrimination against the disabled in employment, public services, and public accommodations which would include doctors, dentists and any health care provider. Moreover, the statute was drafted to specifically include HIV infection as a covered disability, whether it be asymptomatic or symptomatic, thus affording HIV patients support in filing discrimination lawsuits against hospitals and physicians. Pursuant to this statute an employer must make reasonable accommodations for a qualified disabled employee unless so doing would create an undue hardship for the employer. Private persons or entities are included within this act; specifically those employing 25 or more as of July 26, 1992 and those employing 15 or more as of July 26, 1994. In some cases state statutes may apply similar restrictions with respect to employers of less than 15 employees.

In accordance with the restraints imposed by ADA, queries can be made by an employer as to the ability of a job applicant to perform the essential functions of the job, but inquiries as to the nature or severity of an applicant's disability are not permitted. Once an applicant has been offered a job, but has not commenced work, an employer may require a medical examination, including an HIV test, if all applicants must take the same exam. However, the employer may not withdraw the job offer subsequent to such tests unless he or she can prove the employee is not "qualified" and cannot perform the essential functions of the job because of the disability. With respect to current employees, an employer may not require an HIV test unless he or she can prove the test is necessary for the employee to perform the job. For those who are too ill to adequately perform a job because they are afflicted with full blown AIDS or with the opportunistic diseases to which HIV victims succumb, such as the deadly, drug resistant and contagious form of tuberculosis that has recently emerged, the ADA does not afford protection from discrimination. An employer need only make reasonable accommodations for a qualified employee.[23]

State Legislative Enactments Regarding AIDS

States are confronted with a two fold problem with regard to the AIDS epidemic. On one hand they seek to stem the tide of AIDS cases and to ease public fears through a variety of public health measures which include quarantine, contact tracing (notification of sexual partners and others at risk), voluntary testing

and counseling and reporting of results. On the other hand many states have endeavored to reduce the discrimination directed towards AIDS victims by enacting statutes which parallel the federal legislation and treat AIDS and HIV infection as protected handicaps.[24] Several states have enacted legislation which prohibits discrimination against individuals with HIV infection or AIDS.[25] Other states such as New Jersey have accorded homosexuals (who are still disproportionately affected by AIDS) a protected status, barring discrimination based on affectional or sexual orientation.[26]

Historically the legislative response to other communicable diseases has entailed the use of public health measures similar to those currently being used or considered for AIDS. Every state has forms of quarantine laws that relate to communicable diseases such as smallpox, typhoid or venereal disease and their use has traditionally been upheld by the courts. Recently several states such as California, Michigan, Florida and Oklahoma have applied quarantine laws to recalcitrant AIDS carriers who pose an ominous threat to the public. In these cases the carriers engaged in repetitive unprotected sex with partners who were not forewarned of their disease.[27] The Presidential Commission on AIDS supports the use of quarantine to control harmful behavior by AIDS victims such as the selling of blood, sperm, organs and sexual services but does not support the use of quarantine to penalize a person who has AIDS or is HIV positive. The CDC presently recommends quarantine only for patients who refuse treatment for extreme cases of drug resistant tuberculosis.

Contact tracing is a public health strategy that has been utilized since the 1940's for diseases such as syphilis and tuberculosis. It endeavors to identify those persons who have been exposed to a sexually transmitted or contagious disease. The rationale supporting its use is that it is an effective control measure which treats infected third parties at risk as early as possible. The primary negative aspect to its use is that it invades the privacy of the afflicted disease carrier. With regard to AIDS the CDC has recommended that sexual partners of AIDS carriers be notified. Some states such as Colorado do engage in contact tracing on an active basis. Commentators have suggested that physicians and health care workers be mandated to engage in contact tracing in the AIDS context.[28]

Legal and Ethical Obligation To Treat AIDS Patients

Traditionally those in the health care field were free to accept or reject patients except in emergencies. Both the American Medical Association (AMA) and the Association of American Physicians and Surgeons set forth this standard in

their respective codes of ethics. This posture, however, has recently undergone marked change. The AMA has now deemed it unethical to refuse the treatment of AIDS patients even in nonemergency situations.[29] Moreover, several courts have held health care providers civilly liable in damages for refusing to treat HIV infected patients, premised on statutes prohibiting discrimination against those who are infected with AIDS.[30] Finally, pursuant to the Americans with Disabilities Act of 1990 a health care provider would be prohibited from refusing to treat an individual due to that person's HIV status.

Ethical Obligation of the HIV Positive Health Care Provider

Commentators and courts regard the provider-patient relationship as one of a fiduciary nature. The physician or provider possesses an expertise and knowledge the other party lacks, and is entrusted to utilize that expertise in the best interests of the patient. Arguably then, health care providers and institutions have an ethical responsibility to perform only those procedures which pose no risk of transmission of AIDS. Further, the argument is advanced that disclosure of the providers' HIV status should be made to the patients so that they can fully appreciate the risks inherent in a given situation and give fully informed consent for the treatment to be provided. Without such disclosure a potential cause of action for negligence or intentional infliction of emotional distress exists. Significantly, no corresponding duty to disclose one's HIV status to the health care provider exists for the patient.[31] The posture of the CDC, and the Department of Health and Human Services is that the providers' reliance on universal blood and body fluid precautions is the best defense against workplace transmission of HIV. Such precautions entail the use of gloves and protective clothing and the avoidance of skin punctures caused by needles and sharp instruments.[32]

The case of David Acer, the Florida dentist who transmitted the HIV virus to five of his patients, none of whom were aware of his AIDS, prompted calls in Congress for the mandatory AIDS testing of all health care workers engaging in invasive procedures.[33] Although the measure did not pass, the CDC issued guidelines which recommend that doctors and dentists who perform invasive medical procedures refrain from doing them if they are HIV positive. And in one case a United States Court of Appeals upheld a hospital's right to demand the results of a nurse's HIV test where a reasonable suspicion existed that the nurse had been exposed to HIV. The hospital argued that under the CDC guidelines they were required to determine the HIV status of employees potentially exposed to the virus to ascertain whether they posed a risk to the hospital community.[34] The CDC is now instructing state health departments to determine on a case by case basis whether doctors, dentists and other health care workers with AIDS, HIV

virus or hepatitis B are a threat to patients.[35] State health departments are to consider the skill and physical health of the infected workers and whether they are performing "exposure-prone" procedures where the health worker could be injured and bleed into an opening in a patient.

Health care workers who perform procedures regarded as "exposure prone" encompass a variety of positions in addition to that of doctors, dentists and nurses. Physical therapists, for example, perform the type of invasive and high risk procedures which may be deemed "exposure prone" pursuant to a state health department assessment. Physical therapists frequently treat patients with open wounds and chemical burns. The debridement and whirlpool therapies utilized expose both patient and therapist to a risk of HIV transmission. Physical therapists treating postoperative patients are exposed to many types of bodily fluids, as are cardiopulmonary therapists who are exposed to airborne particles which include blood and sputum. Moreover, in a few states needle insertion electromyography (EMG) is performed by physical therapists. These invasive procedures engaged in by physical therapists underscore the need for adherence to universal precautions and a recognition that such procedures pose a risk of HIV to either the patient or the therapist, and that an HIV infected physical therapist could potentially be regarded as a threat to patients under CDC analysis.

Mandatory HIV Testing for Patients

In addressing the question of mandatory testing of individuals for exposure to the AIDS virus, the competing interests of the health care worker's right to know of potential exposure to HIV infection and the long recognized constitutional right to privacy must be balanced. Testing at first was not encouraged due to lack of effective treatment when diagnoses were made late in the course of the disease, and due to the potential negative manner in which such test results might be utilized. Today, however, early medical intervention has produced dramatic benefits in delaying or preventing opportunistic infection, progressive immunodeficiency and neurologic disease.[36] Thus, the call for HIV testing to detect HIV in the early, asymptomatic stages becomes a more compelling issue than heretofore regarded.

The major advisory bodies, including CDC and the Presidential Commission on AIDS advise against HIV blood screening for patients (and employees).[37] Many states also prohibit testing unless the subject gives an informed consent.[38] Both federal and state statutes require that an individual's HIV status remain confidential. Although health care workers are at somewhat

higher risk of contracting AIDS in the work place than other employees, (the CDC has documented 46 cases of health care workers being infected with the AIDS virus on the job) the posture of the CDC and Department of Health and Human Services is one of strict adherence to what are deemed "universal precautions" with respect to all patients irrespective of infection status. In cases where a health worker experiences a needle stick or exposure to bodily fluids or blood, the CDC recommends seeking consent from the patient to test for HIV. Confronted with a refusal, it is suggested by the CDC that such workers seek medical evaluation and be retested at several times after exposure.[39] Some states, such as Connecticut have sought further protection for the safety of health care workers, recognizing a "right to know" among health care workers who have been potentially exposed to HIV infection. These statutes under certain circumstances, authorize the testing of patients even without their consent and disclosure of test results to those health care providers significantly exposed to the HIV infection.[40]

Mandatory Testing of Health Care Workers

While recognizing that transmission of HIV to patients can occur and has occurred in the health care setting of Dr. David Acer's Florida dental office, the official guidelines set forth by the CDC do not support mandatory HIV testing of health care workers. The risk of transmission is highest where health care workers perform invasive procedures, and in these instances the CDC recommends that the infected worker's physician and the institution's medical director determine whether changes in work assignments are advisable.[41] And, as noted earlier, the CDC is directing all state health departments to decide on a case by case basis which health care workers pose a risk to patients. Again the CDC has assumed the position that full implementation of "universal precautions" will minimize the risk of transmission of the virus to patients. The AMA has adopted a stronger stance in advocating that a physician who knows he or she is HIV positive should not engage in any activity that creates a risk of transmission of the disease to others.[42] In contrast, the Presidential Commission on AIDS asserts that there is no medical or scientific basis for restricting the practice of AIDS infected health care professionals. The Commission contends that strict adherence to infection control procedures should prevent transmission of the virus.[43] Although the law is not clear in this area, mandatory testing of health care workers will probably only be mandated where the worker has been exposed to the AIDS virus and/or if it is limited to those who engage in the type of invasive procedures where the risk of transmission is the greatest.

Duty to Warn Third Parties About the AIDS Status of a Patient

The issue is currently being debated as to whether a health care worker has a duty to warn foreseeable third parties who are engaged in high risk behavior with an AIDS patient. Many courts have imposed a duty upon physicians, psychotherapists and psychiatrists to warn family members, other health care workers and those perceived to lie within a foreseeable zone of risk about the contagious condition of a patient (such as scarlet fever or tuberculosis)[44] or of a mental condition of a patient that created a threat of physical harm to third parties.[45] In these cases the disclosure of confidential information was deemed necessary to protect the interests of innocent parties, and hence was viewed as a more significant factor than the concomitant loss of privacy of the individual patient. One court, in particular, stressed that the privacy right in an individual's medical condition is not absolute and can he invaded to satisfy compelling governmental interests.[46] The rationale for applying this legal reasoning to the AIDS epidemic would urge that such notification could prevent the transmission of the virus, and would aid the early detection, treatment and retardation of the progression of the disease, public health protections which some commentators suggest support an infringement to the right to privacy and physican-patient confidentiality.

In response to this perceived need for limited disclosure of the status of an HIV patient, and breach of the physician-patient privilege, some states have enacted laws affording immunity from liability for breach of confidentiality lawsuits, to physicians who disclose a patient's AIDS status to the patient's spouse or sexual partner.[47] In fact, some states such as Colorado, Georgia, Idaho, Illinois and Wisconsin require physicians and other health care providers to report the HIV status of their patients (with identifiers) to state health authorities within a short period after treating them. Some commentators have urged that inasmuch as AIDS is incurable, the physician's legal and ethical duty to warn foreseeable third parties of the risk of infection becomes a more compelling case than exists with other contagious or sexually transmitted diseases.[48] Such proposals invoke vehement opposition from public interest groups who argue that the institution of such a requirement will only serve to further burden and discriminate against AIDS victims.

Liability for Transmission of AIDS Through Transfusion

It has been estimated by the CDC that 29,000 transfusion recipients received HIV infected blood during the period between 1978 and 1984.[49] The 1980's witnessed but a small number of these cases being litigated; now several hundred transfusion associated AIDS cases have been filed. During that period a marked change in the posture of the courts with respect to the liability of blood banks has been observed. Historically blood banks bave been afforded virtual immunity from suit premised on the belief that the adequacy of the blood supply must be maintained and that blood donor organizations adhered to strict notions of safety precautions in screening donors and blood. Blood donor organizations were consistently construed as providing a service, and not a sale of goods, and hence theories of liability such as warranty and product liability were viewed as inapplicable. Moreover, "blood shield" statutes (which were written with liability for hepatitis in mind) codified this philosophy in every state except New Jersey.[50] Thus, the only avenue of recovery for a plaintiff was to ground its case in negligence, and under the "blood shield" statutes these were generally unsuccessful.

Today the negligence theory of recovery has been utilized successfully against blood banks wberein the blood bank failed to use surrogate tests to eliminate AIDS tainted blood prior to 1985, failed to use the ELISA test (enzyme linked immunosorbent assay) when it became available in 1985 or failed to employ an adequate screening process for donors. Plaintiffs have prevailed against physicians and hospitals where they could demonstrate that negligent treatment caused the need for transfusions (a tonsillectomy, for example, was negligently handled, prompting the need for transfusions) or that negligent failure to use the patient's blood existed (plaintiffs specifically requested that their own blood be used to avoid AIDS; tainted donor blood was used instead).[51]

Conclusion

AIDS constitutes a tragedy for those who are afflicted with this contagious, incurable and fatal disease. It further constitutes a worldwide public bealth problem which has been termed by one court as the modern day equivalent of leprosy.[52] As the rate of reported AIDS cases continues to escalate so too will the burgeoning AIDS related litigation. The unique questions that it raises for health care providers with regard to issues of ethical and legal duties, privacy, responsibility and the balancing of competing private and public interests are ones that should be of significance to all health care professionals.

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LIABILITY WITHOUT PRIVITY: DEVELOPMENTS IN THE IMPLIED WARRANTY OF HABITABILITY

by

Patricia M. Pattison*
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"The assault upon the citadel of privity is proceeding in these days apace."[1] This statement, originally made by Cardozo, has been widely quoted, especially by William Prosser. Concerning products liability, Prosser noted in 1960 that the assault was well developed;[2] in 1966 he concluded that the citadel had fallen.[3]

The citadel of privity is again under assault. This time it relates to liability for defective housing. Specifically, this paper will (I.) review the background and origin of the implied warranty of habitability, (II.) identify seven factors which court decisions have weighed and utilized in defining and refining the warranty, (III.) analyze the heart of the implied warranty development--the privity issue, (IV.) compare the application of the warranty with the development of products liability, and conclude by speculating on possible new directions for the development of the warranty.

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I. Background

The doctrine of caveat emptor in the housing industry is dying.[4] In the past twenty-five years, nearly all jurisdictions have replaced or at least minimally modified it with either an implied warranty of habitability or some modification of it.[5] Unfortunately, neither builders nor purchasers are able to predict what the court-created warranty requires or offers. The piecemeal birth of the warranty has resulted in a ghost child who assumes different shapes and names depending upon the jurisdiction of its birth. It is not the purpose of this section to closely examine each inconsistency, but merely to state the general rule or trend.

The first case directly touching upon the warranty of habitability issue in this country appears to be a 1957 case from the Ohio court of appeals.[6] The plaintiffs, in this case the homeowners (and initial-purchasers), alleged that the contractors-defendants failed to construct the home in a workmanlike manner since sewage and water flooded the home's basement. The court focused on the fact that the sale of the house took place prior to the completion of the house.

This remained an important concept since the court went to great lengths to note

> In this opinion we will not go into a discussion of the duty of the seller of a completed bouse to the buyer, with every varying circumstance surrounding such sale. Nor will we discuss the legal questions of caveat emptor and express warranty, except to say only that the vendor of a completed house, in respect of which there is no work going on and no work to be done, does not generally, in the absence of some express bargain or warranty, undertake any obligation with regard to the condition of the house...[7]

The Ohio court,stating that "...we have found but few cases bearing upon the question. We have found none in this state directly touching it",[8] cited to and focused on established English precedents holding that "...upon the sale of a bouse in the course of erection, there is an implied warranty that the house will be finished in a workmanlike manner."[9]

Seven years later the Colorado Supreme Court would wrestle with the same dearth of legal precedents as the Ohio appellate court. There the Court also relied upon established English precedent in adopting the implied warranty citing to the same

English cases explained in the Ohio decision.[10] However, the Colorado court expanded the English decisions. While the Ohio court, like the English courts, premised the implied warranty as existing in a sale occurring before the house was fully constructed, the Colorado court encompassed not only houses still under construction but also newly finished houses. The court reasoned:

> That a different rule should apply to the purchaser of a house which is near completion than would apply to one who purchases a new house seems incongruous. To say that the former may rely on an implied warranty and the latter cannot is recognizing a distinction without a reasonable basis for it.[11]

This well-reasoned Colorado opinion provides the starting point for most jurisdictions' subsequent adoption and modification of the implied warranty of habitability.

Consequently, a summary of the various court decisions reveals generally: When a builder-vendor sells a home to an initial purchaser there is created an implied warranty of habitability. However, in any specific circumstance it would be unwise to exclusively rely upon this general rule because of its many and varied exceptions. Following is a general discussion of seven factors which most courts consider in their analyses of the applicability of the implied warranty.

II. Factors

Builder-vendor

Most jurisdictions have specifically limited liability to a builder vendor.[12] A builder-vendor has been defined as "one who buys land and builds homes upon that land for purposes of sale to the general public."[13] One court explained why the builder-vendor should be the responsible party:

> The applicability of the implied warranty is based upon the premise that, with respect to the sale of new homes, the purchaser has little choice but to rely upon the integrity and professional competence of the builder vendor. The public interest dictates that if the construction of a new house is defective, its repair cost should be borne by the responsible builder-vendor who created the defect and is in a better economic position to bear the loss, rather than by the ordinary purchaser who justifiably relied upon the builder's skill.[14]

The definition of builder-vendor has been further refined by some courts to also include that the builder-vendor be engaged in that profession. Consequently, the sale is commercial rather than casual or personal in nature.[15] This limitation has been placed to protect those vendors who have no greater skill relevant to determining the quality of a house than the purchaser.[16] As with the UCC "merchant", any person who holds himself out as having particular skill and knowledge in his trade should be held to a higher degree of responsibility.

Courts in a few jurisdictions have chosen to expand the number of persons potentially liable for breach of the implied warranty. Some have held vendors, who were not also the builders, liable.[17] Vendors of the real estate were held liable although an independent contractor had constructed the defective house. One court explained its reasoning by noting that the vendor had "placed the house in the stream of commerce and had exacted a fair price for it. Its liability is not found upon fault, but because it has profited by receiving a fair price and, as between it and an innocent purchaser, the innocent purchaser should be protected from latent defects."[18]

Another court found a builder who was not the vendor liable. The court could see no difference between a builder or contractor who constructs a home and a builder-developer. It doesn't matter whether the builder constructs the residence on land he owns or land the purchaser owns. It is the structure and all its intricate components and related facilities that are the subject matter of the implied warranty. Mere builders must be as accountable for their workmanship as are builder developers.[19]

Home

Although the majority of jurisdictions agree that the implied warranty attaches to the sale of new housing,[20] some questions as to what is "new housing" have arisen. Early in the development of the implied warranty, several states, relying on the English precedents, distinguished between sales made while the homes were still under construction and sales of completed homes.[21] The earlier decisions limited recovery to cases where the home was under construction at the time of sale, following what is commonly referred to as the "Miller Rule."[22] However, as reasoned by the Colorado Supreme Court, most jurisdictions have reversed their earlier decisions,[23] finding no sound rationale for the distinction.

Some courts, however, have substituted the word "construction" for "housing" when finding an implied warranty.[24] The result is warranty protection which extends to apartment buildings,[25] grain elevators[26] and condominiums.[27] It has been argued

that the extension is unwise and unsubstantiated when considered with the purpose of the warranty itself.[28] Relatively unknowledgeable buyers are those the warranty is supposedly designed to protect. In contrast, purchasers of larger constructions should have greater expertise or the funds to purchase expert advice.

Since the imposition of the unqualified implied warranty is based upon the theory that it is the ordinary home buyer, relatively ignorant of the business of buying a home, who needs this statutory protection, the unqualified warranty is implied only in purchases of one- or two-family homes. Anything larger than a two-family dwelling is often an apartment house, and these are commonly purchased by corporations or individuals with enough wealth to afford competent inspection or knowledge of the realty business.[29]

Initial Purchaser

With a few exceptions most state courts have limited recovery to initial purchasers. A Missouri court explained that the contractual nature of the implied warranty implicitly limits the right of action to the first purchase:[30]

> Because the warranty is implied by virtue of the contemplated sale to the first purchaser and arises by reason of the purchase, it theoretically accrues in him. The practical aspects of the contractual defenses also lead to this conclusion. The first purchaser is the only one with whom the builder may negotiate an allocation of the risk. Furthermore, the builder is in a better position to know the condition of the home at the time of sale, and thus whether defects were latent. This is not true if the builder is sued by a subsequent vendee.[31]

In California a court noted that this initial purchaser is the one who most needs the warranty protection.[32] The purchaser of a new building, unlike the buyer of an older building has had "no opportunity to observe how the building has withstood the passage of time. Thus he generally relies on those in a position to know the quality of the work to be sold, and his reliance is surely evident to the construction industry."[33]

The Implied Warranty Itself

There are two general premises upon which most jurisdictions agree. First is the fact that the warranty is an implied warranty; one that is created by law and which exists regardless of the intent of the parties. Because home purchasers rely on the

knowledge and judgment of their vendors, the warranty springs from the vendors' duty not to take advantage of their superior positions.[34] Second, negligence is not a relevant issue. In one of the earlier cases holding that a new homeowner was entitled to recover on an implied warranty of fitness for habitation, the court also held that fault or negligence on the part of the defendant was not required in order for the plaintiff to recover.[35] The fact that the defendant was the vendor of the real estate was sufficient to make him liable. In a more recent decision another court agreed that "[o]n an implied warranty, one may be held liable for damages even when be has exercised all reasonable or even possible care.[36]

Some courts have described the warranty as one of "fitness for habitation"[37] while others have required "workmanlike construction."[38] The definition of "fit for habitation" has caused some concern for the courts. The most extensive discussion of habitability is found in the Illinois case Goggin v. Fox Valley Construction Company.[39] The court set down what is considered to be the basic parameters of habitability.[40] They include:

(1) It is possible for a new home to be in substantial compliance with building codes and still be uninhabitable.

(2) The primary function of a new home is to shelter its inhabitants from the elements. If a new bome does not keep out the elements because of a substantial defect of construction, such home is not habitable within the meaning of the implied warranty of habitability.

(3) Another function of a new home is to provide its inhabitants with a reasonably safe place to live, without fear of injury to person, health, safety, or property. If a new home is not structurally sound because of a substantial defect of construction, such a home is not habitable within the meaning of the implied warranty of habitability.

(4) If a new home is not aesthetically satisfying because of a defect of construction, such a defect should not be considered as making the home uninhabitable.

In another case the dispute also rested upon the determination of the type of defect wbich reuders a new home uninhabitable. The plaintiffs attempted to show that their premises were rendered uninhabitable by noise from an air conditioning system.[41] Evidently the noise was undetectable during normal conversation sounds, but

disturbed them in the still of the night. The court rejected their arguments stressing the fact that the test of breacb of the warranty is an objective one; i.e., what reasonable people would expect. If "the premises met ordinary, normal standards reasonably to be expected of living quarters of comparable kind and quality"[42] they are deemed habitable. There is no warranty to protect certain individuals who are hypersensitive.

The question "What is workmanlike construction?" has not received the same amount of attention as the issue of habitability. Evidently the courts have had little difficulty in assessing it. However, there is one noteworthy case in which a court found a breach of the "implied warranty of proper construction and sound workmanship."[43] This case is mentioned because in it the court extended the meaning of workmanship to include the concept of design. The builder had installed a septic tank which failed to function properly. Apparently there was no defect in the material or workmanship, but nevertheless the court found a breach of warranty because of a "defect in the design from the time the septic tank was being installed."[44]

A court's choice of terminology (habitability or workmanlike construction) could determine the buyer's ability to recover from his seller. A buyer who would win a suit based on habitability could lose if the court recognized only the warranty of workmanlike construction. As an illustration, consider a situation in which a builder drilled a well in a workmanlike manner, but found no water fit for human consumption.[45] In this particular case the buyer recovered damages because the court defined the warranty as fitness for habitation, but he would have lost had only workmanlike construction been required.

On the other hand, consider the situation of the home buyer who receives an improperly constructed fireplace. Obviously, he could recover damages under the warranty of workmanlike construction, but in today's homes fireplaces may be more decorative than necessary. It might appear that buyers receive the most protection in states wbere the courts say that both warranties are implied.[46] Then, however, the buyers might have the burden of proving that both warranties were breached. One plaintiff, caught in the quandary of words, lost his suit because he alleged only poor workmanship and did not also allege that the home was not fit for human habitation.[47]

Types of Defects

There has been a wide variance in the type of defect for which the courts have allowed recovery. Generally, the courts have agreed that the defect must be a latent or hidden defect which would not be apparent to the buyers upon reasonable inspection.

If the party asserting the implied warranty has a reasonable opportunity to discover the defect and did not do so, the seller has a valid defense.[48]

While some courts have allowed recovery for structural defects only, most have included site or lot defects. A Pennsylvania court, reasoning that the purchaser of real estate justifiably relies on his seller's expertise and superior opportunity to choose a suitable site, became the first to hold a builder-vendor liable for latent site defects not involving damage to a dwelling.[49] This case along with many others to follow,[50] involved a well which produced no water fit for human consumption. The Pennsylvania court found that potable water supply is within the scope of the builder-vendor's implied warranty because without it a house is rendered uninhabitable. This rule stands true even when the quality of the water is not the result of poor drilling techniques.[51] Other defects included defective septic tanks,[52] water seepage into homes,[53] cracked foundations and concrete work,[54] defective air conditioning,[55] floors,[56] fireplaces,[57] electrical systems,[58] roofs,[59] heating,[60] insulation,[61] and plumbing.[62]

Duration of the Warranty

Obviously a purchaser will not be able to discover the defects in his new home until he has occupied the house for a reasonable length of time. The difficult decision facing the courts has been "What constitutes a reasonable time?" As can be expected, the courts have been reluctant to limit the warranty to a specific period. One of the earlier decisions dealing with the duration of the builder's liability was handed down by the Supreme Court of Rhode Island. In it the court stated:

> ....where there is a sale of a new house by a vendor who is also the builder thereof, there is an implied warranty of reasonable workmanship and habitability surviving the delivery of the deed. This is not to hold that the builder is required to construct a perfect house. Whether the house is defective is determined by the test of reasonableness and not perfection, and the duration of such liability after the taking of possession is to be determined by standards of reasonableness.[63]

In this statement there are two ideas which courts have consistently agreed upon. First, the duration of liability is to be determined by standards of reasonableness[64] and second, a builder is not required to construct a perfect house.[65] Yet, the "standard of reasonableness" test doesn't really tell a builder when his liability will stop.

It has been suggested that the courts can extend the reach of Article 2 of the Uniform Commercial Code to cover the building industry.[66] Article 2, providing implied warranty protection for items such as cars, appliances and other personal property has a four year statute of limitations (which by agreement may be reduced to no less than one year).[67] When compared with a $1,000 appliance, a four-year warranty limitation on an $80,000 new home hardly seems appropriate. Not only do the personal property items cost significantly less, they also have a much shorter economic life span. In spite of this difference, at least one state has limited the warranty on new housing to a one year period.[68]

Although it is unrealistic to expect a builder to insure against defects for the total expected life of the house, it is also unrealistic to expect a new house buyer to be satisfied with a one year warranty on such a large purchase. Considering variations in weather conditions, a latent defect may take several years to become apparent. One commentator has suggested that a ten year period of liability should be more than sufficient.[69] Several courts, recognizing that the various components which go into the construction of a house have different life expectancies, refuse to set a specific time limit for a warranty on an entire house.[70]

Warranty Disclaimers

Some sophisticated builders who are aware of the doctrine of implied warranty of habitability have included warranty disclaimers in their sales contracts. Of all the issues involved in this type of litigation this is the most controversial and inconsistent. The courts don't even agree if there ever could be an effective disclaimer, much less what would be required to constitute it.

In Utah, a builder successfully disclaimed all implied warranties by including an "as is" provision in the real estate contract.[71] The provision, which specified that the purchasers "accepted the property in its present condition," was held to be controlling and precluded the purchasers from asserting that the builder had impliedly warranted that his homes were constructed in a good workmanlike manner.

In a contrasting opinion, a Rhode Island court stated that the plaintiff's agreeing to taking the premises "in the same condition in which they now are" did not constitute a disclaimer.[72] Although the wording of this attempted disclaimer was nearly the same as in the Utah case supra, the court was reluctant to accept it as an effective disclaimer because it didn't use language which specifically referred to its effect on warranties. The court said "to effectuate the policies underlying the implied warranties of habitability and reasonable workmanship, the court will construe exclusionary

provisions of doubtful meaning strictly against those parties raising such provisions as defenses.[73]

A Missouri court, in Crowder v. Vandendeale,[74] presented a good discussion of the requirements of an effective disclaimer.[75] First, it recognized the potential vitality of traditional contract defense when employed under the proper circumstances. According to the court, the parties have a right to make their own bargain as to economic risk; but since a disclaimer varies implied warranty terms, there exists a heavy burden of proof to demonstrate that in fact the bargain was actually made.

Second, the court stated that one seeking the benefit of a disclaimer must prove that there was a conspicuous provision which fully disclosed its consequences. Third, the disclaimer must have in fact been voluntarily agreed upon. The builder must bear the weight of this burden of proof because by asserting the disclaimer he is trying to show that the buyer gave up protection given to him by public policy. Courts will not imply that this protection was waived just because boilerplate clauses are included in a contract.

Courts have not been able to agree if an express warranty given by a builder automatically negates the implied warranties. The court in Richman v. Watel found it did not.[76] The court said that because the breach of an implied warranty in housing is considered to be a tort rather than a contract concept (a developing concept which will be discussed below), the express written one year warranty did not limit or exclude the implied warranty of fitness.[77]

In Colorado, a court agreed that if the express warranty contained no words of limitation, then the builder had not abrogated or limited his common law implied warranties.[78] However, in Arkansas, it was held that implied warranties are not applicable when there is an express warranty.[79] The court stated that it reached this conclusion by analogy to pre-Commercial Code sales contract cases where it was held that if an express warranty was present it was exclusive.[80]

III. The Privity Issue and Subsequent Purchasers

Prosser described a warranty as a "...freak hybrid born of the illicit intercourse of tort and contract."[81] The action for breacb of warranty was originally a tort action, closely resembling the tort of deceit. hi the late eighteenth century, courts, for procedural convenience, determined that a contract action could also be maintained.

As a result, the original tort form of the action, as well as the contract form, still survives today.

This duality is significant today because, depending upon a particular court's choice of contract or tort, several aspects of a case such as the survival of actions, the measure of damages, the statute of limitations and the requirement of privity of contract will likely vary. Prosser concluded, "...the concept of warranty has involved so many major difficulties and disadvantages that it is very questionable whether it has not become rather a burden than a boon to the courts in what they are trying to accomplish."[82]

The truth of his conclusion is revealed when one examines the warranty of habitability court decisions. As indicated earlier, in the decisions in which privity was the controlling issue, most courts viewed the warranty as sounding in contracts; therefore privity is required.[83] Moreover, in many instances the courts have also listed practical reasons for the privity requirements:

(1) The first purchaser is the only one with whom the builder may negotiate an allocation of the risk.[84] If the builder had lowered the purchase price because of defects in the structure he would have double liability if a subsequent purchaser were also permitted to recover.

(2) A builder is in a better position to know the condition of a home at the time of sale rather than at a later date.[85]

(3) Real estate transactions require a written contract or deed. Each subsequent purchaser may require from his vendor any warranties he wishes to have on improvements.[86]

(4) There are significant differences between manufactured products and homes that analogies are not appropriate.[87]

(5) There are several other means of protection for the home buyer which will enable him to enter the housing market on an equal footing with the builder.[88] Examples are: "astute consumer appraisal of potential builders, inspections where possible, support of HOW builders, and government warranties where either VA or FHA financing is utilized."[89]

In contrast, several courts have now disregarded privity arguments and extended warranty protection to subsequent purchasers.[90] In 1976 an Indiana court, with little commentary, held that a builder's implied warranty of fitness for habitation runs not only in favor of the first owner, but extends also to subsequent purchasers.[91] However, this implied warranty is limited to latent defects which are not discoverable by the subsequent purchasers by reasonable inspection and which become manifest only after the purchase.

The Wyoming Supreme Court, acknowledging that the Indiana court had furnished a "reasonably workable rule,"[92] added its own reason for extending the warranty:

> The purpose of a warranty is to protect innocent purchasers and hold builders accountable for their work. With that object in mind, any reasoning which would arbitrarily interpose a first buyer as an obstruction to someone equally as deserving of recovery is incomprehensible. Let us assume for example a person contracts construction of a home and, a month after occupying, is transferred to another locality and must sell. Or let us look at the family which contracts construction, occupies the home and the head of the household dies a year later and the residence must, for economic reasons, be sold. Further, how about the one who contracts for construction of a home, occupies it and, after a couple of years, attracted by a profit incentive caused by inflation or otherwise, sells to another. No reason has been presented to us whereby the original owner should have the benefits of an implied warranty or a recovery on a negligence theory and the next owner should not simply because there has been a transfer. Such intervening sales, standing by themselves, should not, by any standard of reasonableness, effect an end to an implied warranty or, in that matter, a right of recovery on any other ground, upon manifestation of a defect. The builder always has available the defense that the defects are not attributable to him.[93]

Also relying upon the Indiana decision, the South Carolina Supreme Court abolished the privity requirement for liability.[94] The rule it created was essentially identical to those in Indiana and Wyoming. Three justifications for its decision were set forth:

(1) Because latent construction defects can surface several years after the initial sale, there is no sound basis for the reasoning that only first owners need warranty protection.

(2) Prospective purchasers rely on the builder's expertise.

(3) Because of their limited knowledge purchasers cannot discover latent construction defects.[95]

Mississippi has also experienced a transformation in overruling well-established precedents in abolishing the privity requirement. In a lengthy, well-reasoned decision, the Mississippi Supreme Court has ruled

> The current trend in other jurisdictions extends protection to remote purchasers who have no contractual relationship or privity with the builder-vendor. For example, where a remote purchaser can prove negligence on the part of the builder vendor which results in foreseeable injury or loss to the remote purchaser, a remote purchaser has been entitled to recovery for damages. (citations omitted) And, the privity barrier has also been removed in recent cases based on the implied warranty theory. (citations omitted) In light of this new substantial trend of authority, we think it worthwhile to reexamine our past rulings on this issue.[96]

In reexamining its position, the Mississippi Court opined that there is no reasonable justification not to extend the same protection to a subsequent purchaser as to the initial purchaser; consequently, the Court abolished the privity requirement.[97]

Although privity was not the central issue, in a Texas Court of Civil Appeals decision,[98] dicta indicated that privity requirements also have been eliminated. The court made it clear that the sale of a house carries with it an implied warranty of habitability, and that a breach of such warranty gives rise to a cause of action in tort rather than contract. Since privity of contract is not relevant in a tort action, warranties should extend to subsequent purchasers. Along this same line, the Supreme Court of Arkansas has found that a house is a "product" for purposes of the Arkansas strict liability statute and the District of Columbia District Court has not precluded condominiums from falling under the same analysis.[99] Therefore the implied warranty of habitability was extended to subsequent purchasers for a reasonable length of time. The Arkansas court, quoting another case in justifying its decision, succinctly stated,

> In this era of complex marketing practices and assembly line manufacturing conditions, restrictive notions of privity of contract between manufacturer and consumer must be put aside and the realistic view of strict liability adopted.[100]

IV. Products Liability Compared

Several courts which have extended the warranty protection to subsequent purchasers indicated that they did so because they could see no significant reason to differentiate between strict liability for manufactured products and real estate improvements. This section of the paper will first review the policy reasons for creating strict liability and then discuss whether the same reasoning is applicable to improved real estate.

Prosser listed three reasons why courts have accepted strict liability for products.

(1) The public interest in human life, health and safety demands the maximum possible protection that the law can give against dangerous defects in products which consumers must buy, and against which they are helpless to protect themselves; and it justifies the imposition, upon all suppliers of such products, of full responsibility for the harm they cause, even though the supplier has not been negligent.

(2) The supplier, by placing the goods upon the market, represent to the public that they are suitable and safe for use; and by packaging, advertising or otherwise, he does everything he can to induce that belief. He intends and expects that the product will be purchased and used in reliance upon this assurance of safety, and it is in fact so purchased and used. The supplier has invited and solicited the use; and when it leads to disaster, he should not be permitted to avoid the responsibility by saying that be has made no contract with the consumer.

(3) It is already possible to enforce strict liability by resort to a series of actions, in which the retailer is first held liable on a warranty to his purchaser, and indemnity on a warranty is then sought successively from other suppliers, until the manufacturer finally pays the damages, with the added cost of repeated litigation. This is an expensive, time consuming and wasteful process, and it may be interrupted by insolvency, lack of jurisdiction, disclaimer, or the statute of limitations, anywhere along the line. What is needed is a blanket rule which makes any supplier in the chain directly liable to the ultimate user and so short-circuits the whole unwieldy procedure.[101]

A comparison of these reasons (for establishing strict liability for defective products) and the reasons the courts have stated for creating implied warranties of habitability reveals no substantial differences. As with products, there is certainly a public interest in protecting consumers from defects in housing. Consumers are certainly no less helpless when buying a house than when buying a product.

California very early recognized the application of strict liability concepts within the pruview of the implied warranty of habitability. Applying dicta from the landmark California strict liability case of *Greenman v. Yuba Power Products, Inc.*,[102] the California court reasoned that if injury results from defective workmanship, then strict liability may apply even though the "product" is a home.[103]

The builder, much like the supplier, places his housing upon the market and represents that it is suitable and safe for use. Why should he be permitted to avoid responsibility just because he had no contact with a subsequent purchaser? Also, as with product liability, what is the sense in requiring a subsequent purchaser to sue his vendor, and on up the line, if the defect is ultimately the responsibility of the builder? As Prosser stated, it is "an expensive, time consuming and wasteful process..."[104]

There are a few weak arguments set forth attempting to show why strict liability is appropriate for products, but not housing. One argument is that products are mass marketed, housing is not.[105] Through mass-marketing it is argued that suppliers attempt to insulate themselves behind a wall of intermediaries. In contrast, builders contract directly with the original purchaser. The argument concludes with the statement that a builder-vendor may not have been reasonably expected to anticipate a change in ownership.

This argument is simply untenable. Reasonable builders would anticipate change in ownership. Anyway, what difference does it make? If the home has a latent defect which eventually manifests itself, why should it matter who the builder expected to own it? It is the latent defect which gives rise to the liability, not the status of the owner. Moreover what difference should it make if a builder attempts to insulate himself from liability by a wall of intermediaries or first purchasers? Again, the liability arises from the builder's defect/negligence, not the status of the owner.

Other attempted distinctions have no more strength than the argument above. For example, one court emphasized that material and workmanship which may go into a home are of infinite variety.[106] An original purchaser may have negotiated for lesser quality. That is true; but isn't this also true of products? Some products sell for lower

prices because of inferior materials or workmanship. But, manufacturers are still potentially liable for latent defects.

By way of illustration: would a consumer reasonably expect his new mower to explode just because it was the less expensive model? Obviously not. Would a subsequent purchaser of a home expect his walls to cave in because his home was the less expensive model? Again, obviously not.

V. Conclusion

Courts have recognized that the purchase of a home is usually the largest single purchase of a lifetime. Purchasers are generally helpless in the transaction because they lack the training and experience to recognize the possible latent defects. To remedy the situation, in the past twenty years forty-one jurisdictions have court-created warranties of habitability. Generally, the warranties state that when a builder-vendor sells a home to an initial purchaser there exists an implied warranty of habitability. Because it is court created, the rule varies quite extensively from jurisdiction to jurisdiction. Consequently, many courts have placed artificial limitations upon the warranty.

One such limitation is the requirement that a plaintiff must be an initial purchaser in order to recover. However, this limitation has come under rigorous scrutiny; states such as Mississippi, South Carolina, and Wyoming have reviewed this limitation and have found it wanting. As the Mississippi Supreme Court noted, it seems that the trend has shifted. When scrutinized under a reasonableness test, there can be no justification to preclude a subsequent purchaser from a cause of action; the privity requirement serves no purpose. There appears to be no sound reasoning for the limitation other than the fact that many courts see the warranty as one based on contract.[107]

Yet, some courts, like the District of Columbia, have moved the area of implied warranty of habitability out of contract law and into the tort area; thus, rules governing tort actions, including strict liability,[108] become applicable. Consequently, a comparison of the development of strict products liability and the development of the warranty of habitability reveals that the policy considerations for both are very similar. If the similarity in development continues, courts may follow the D.C. example and soon discard the privity requirements, thus allowing recovery to subsequent purchasers.

ENDNOTES

1. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 180, 174 N.E. 441, 445 (1931).

2. Prosser, The Assault Upon the Citadel (Strict Liability to the Consumer) 69 YALE L.J. 1099 (1960).

3. Prosser, The Fall of the Citadel (Strict Liability to the Consumer) 50 MINN. L. R. 791 (1966).

4. For an exhaustive history of and the rationale behind the doctrine of caveat emptor see *Cochran v. Keeton* 47 Ala. App. 194, 252 So. 2d 307 (1970); Hamilton, The Ancient Maxim - Caveat Emptor, 40 YALE L. J. 133 (1931); Bearman, Caveat Emptor in Sales of Realty: Recent Assaults Upon the Rule, 14 VAND. L. REV. 769, fn. 2.

5. Comment, Peterson v. Hubschman Construction Company: The Implied Warranty Comes of Age in Illinois New Housing, 13 JOHN MARSHALL L. REV. 769, fn. 2.

6. *Vanderschrier v. Aaron*, 140 N.E.2d 819 (Ohio App., 1957)

7. *Id.* 821

8. *Id.*

9. *Id.*, citing to *Perry v. Sharon Development Co., Ltd.*, 4 All. E.L.R. (1937); see generally, also, "Right of the Purchaser in Sale of Defective House," 4 WESTERN RESERVE LAW REV. 357 (Summer 1953).

10. *Carpenter v. Donohue*, 388 P.2d 402 (Colorado Sup. Ct., 1964) citing to *Miller v. Cannon Hill Estates*, Ltd., 2 K.B. 113 (1931) and *Perry v. Sharon Development Co., Ltd., supra.*

11. *Id.* 402.

12. Annot., 25 *A.L.R.* 3d 383, 413-419 (1969).

13. *Elderkin v. Gaster*, 447 Pa. 118, 288 A. 2d 771, 774 (1972); followed, *Philadelphia Electric Company v. Hercules, Inc.*, 762 F.2d 303 (3d Cir. 1985) stating

> ...In *Elderkin* the court abolished the rule of caveat emptor as to the sale of new homes by a builder-vendor and, in accordance with a national trend, adopted a theory of implied warranties. See generally 6A Powell on Real Property chap. 84A..Id. 312

For a judicial discussion of Pennsylvania's Implied Warranty of Habitability, see *Pugh v. Holmes*, 405 A.2d 903-910 (1979).

14. *Sousa v. Albino*, 388 A. 2d 804, 805 (R.I. 1978).

15.*Klos v. Gockel*, 87 Wash 2d 567, 554 P. 2d 1349, 1352 (1976). Also see *Hartley v. Ballou*, 286 N.C. 51, 62, 209 S.E. 2d 776, 783 (1974). Courts have been reluctant to extend the implied warranty beyond the scope of the building itself, *e.g.*, a septic tank system has been included within the warranty's embrace (see *Tavares v. Horstman*, 542 P.2d 1275 (Wyo. 1975) and *Arvai v. Shaw*, 345 S.E. 2d 715 (So. Car. 1986) as well as the settling of a basement (see *Brown v. Fowler*, 269 N.W.2d 907 (S.D. 1979); yet, a seawall has not (see *Conklin v. Hurley*, 428 So.2d 654 (Fla. 1983).

16.*Sousa v. Albino, supra* 388 A. 2d at 805.

17.*Smith v. Old Warsaw Dev. Co*, 479 S.W. 2d 795, (Mo. 1972); *Lane v. Trenholm*, 267 S.C. 497, 229 S.E. 2d 728, 731 (1976).

18.*Id.*

19.*Moxley v. Laramie Builders, Inc.*, 600 P. 2d 733 (Wyo. 1979).

20.*Tavares v. Horstman*, 542 P. 2d 1275, 1276 (Wyo. 1975). See also *Columbia Western Corporation v. Vela*, 592 P.2d 1294 (Ariz. 1979)

21.See *Jeanguneat v. Jackie Hames Constr. Co.*, 576 P. 2d 761, 763-64 (Okl. 1978); *Elden v. Simmons*, 631 P. 2d 739 (Okla. 1981); *Bridges v. Ferrell*, 685 P. 2d 409 (Okla. App. 1984).

22.*Miller v. Cannon Hill Estates, Ltd.* 2 K.B. 113 (1931); *cf.* fn.10 *supra*.

23.*Jeanguneat v. Jackie Hames Constr. Co., supra* 576 P. 2d at 763-64.

24.*Pollard v. Saxe & Yalles Dev. Co.*, 12 Cal. 3d 347, 115 Cal. Rptr. 648, 525 P. 2d 88 (1974); *Carpenter v. Donohoe*, 154 Colo. at 78, 388 P. 2d at 399; however, see *East Hilton Drive Homeowners' Assoc. v Western Real Estate Exchange, Inc.*, 186 Cal. Rptr. 267 (App. 1982) which basically held that since the homes in question (condominiums) had been built four years prior to the vendor purchasing them for resale and that despite the homes having been unoccupied for the previous four years, the vendor could not be considered a vendor of "new" construction and thus no warranty would be implied.

25.*Pollard v. Saxe & Yalles Dev. Co.*, 12 Cal. 3rd at 347, 115 Cal. Rptr. 648, 525 P. 2d at 88.

26.*Robertson Lumber Co. v. Stephen Farmers Cooperative Elevator Co.*, 247 Minn. 17, 143 N.W. 2d 622 (1966).

27.*David v. B & J Holding Corp.* 349 So. 2d at 676 (Fla. 1977); *Gable v. Silver*, 258 So. 2d 11 (Fla. 1972).

28.Comment, *supra* note 5, at 788.

29.Bearman, Caveat Emptor in Sales of Realty-Recent Assaults Upon the Rule, 14 VAND. L. REV. 541, 575 (1961).

30.*Crowder v. Vandendeale*, 564 S.W. 2d 879 881 (Mo. 1978) modified on other grounds in *Sharp Brothers Contracting Company v. American Hoist and Derrick Co.*, 703 S.W. 2d 901 (Mo. 1986). See also: *R.W. Murray Co. v. Shatterproof Glass Corporation*, 697 F. 2d 818, 824-825 (8th Cir. 1983); *San Francisco Real Esate Investors v. J. A. Jones Construction Company*, 524 F. Supp. 768 (S.D. Ohio 1981 citing to *Mitchem v. Johnson*, 218 N.E. 2d 594 Ohio (1966)) stating that Ohio requires that privity of contract must exist before an action based on the implied warranty will lie.

31.*Id.*, 564 S.W. 2d 879, 881.

32.*Pollard v. Saxe & Yalles Development Co., supra* 112 Cal. 3d 347, 115 Cal. Rptr. 648, 525 P. 2d at 91.

33.*Id.*

34.*David v. B & J Holding Corp., supra* 349 So. 2d at 678.

35.*Smith v. Old Warsaw Development Company, supra* 479 S.W. 2d at 795.

36.*Chandler v. Bunick*, 279 Or. 353, 569 P. 2d 1037, 1039 (1977).

37.*Shannar v. Butler Homes, Inc.*, 102 Ariz. 312 428 P. 2d 990 (1967); *Gable v. Silver*, 258 So. 2d 11, 18 (Fla. 1972); *Bethlahmy v. Bechtel*, 91 Idaho 55 (1966) 415 P. 2d at 704; *Theis v. Heuer*, 289 N.W. 2d 303, 304 (Ind. 1972); *Weeks v. Slavick*, 180 N.W. 2d 503, 504, 24 Mich. App. 621 (1970); *Robertson Lumber Co. v. Stephen Farmers Cooperative Elevator Co.*, 143 N.W. 2d 622, 625, 274 Minn. 17 (1966); *Smith v. Old Warsaw Development Co.*, 479 S.W. at 416; *Garcia v. Hynes & Howes Real Estate, Inc.*, 331 N.E. 2d 634 637 (1975); *Harris v. Buckeye Irrigation Co.*, 642 P. 2d 885, 888 (Ariz. App. 1982).

38.*Pollard v. Saxe & Yalles Development Company, supra* 525 P. 2d at 90-91; *Crawley v. Terhune*, 437 S.W. 2d 743, 745 (Ky. 1969); *Norton v. Burleaud*, 342 A. 2d 629, 630 (N.H. 1975); *Centrella v. Holland Construction Corp.*, 370 N.Y.S. 932, 875 (1975); *Hartley v. Ballou*, 209 S.E. 2d at 783; *Mitchell v. Johnson*, 218 N.E. 2d 594, 599 (1966); *Rothberg v. Olemeh*, 262 A. 2d 461 (Vt. 1970); *San Francisco Real Estate Investors v. J.A. Jones Construction Company*, 524 F. Supp. 768 (S.D. Ohio 1981).

39.*Goggen v. Fox Valley Construction*, 48 Ill. App. 3d 193, 654 N.E. 510 2d (1977).

40.*Id.* at 511.

41.*Putnam v. Roudenbush*, 352 So. 2d 908 (Fla. 1977).

42.*Id.* at 910.

43.*Coney v. Steward*, 562 S.W. 2d 619 (Ark. 1978).

44.*Id.* at 620.

45.*Elderkin v. Gaster*, 447 Pa 118, 121-122, 288 A. 2d 771, 773 (1972).

46.*Cochran v. Keeton*, 252 So. 2d 313 (Ala. 1971); *Carpenter v. Donohoe*, 388 P. 2d at 402; *Vernali v. Centraella*, 266 A. 2d 200, 201 (Conn. 1970); *Jones v. Gatewood*, 381 P. 2d 158 (Okla. 1973); *Yepsen v. Burgess*, 525 P. 2d 1019, 1022 (Ariz. 2974); *Elderkin v. Gaster*, *supra* 288 A. 2d at 772; *Paudla v. J.J. Deb-Cin. Homes*, Inc., 298 A. 2d 529-531 (R.I. 1973): *Casavant v. Campopiano*, 327 A. 2d 831, 833 (R.I. 1974); *Rutledge v. Dodenhoff*, 175 S.E. 2d 793-795 (1970); *Waggoner v. Midwestern Development, Inc.*, 154 N.W. 2d 803-809 (1967); *Number v. Morton*, 426 S.W. 2d 554, 555 (Tex. 1968); *House v. Thorton*, 457 P. 2d 99-204 (Wash. 1969); *Tavares v. Horstman*, *supra* 542 P. 2d at 1282.

47.*Goggen v. Fox Valley Construction*, *supra* 654 N.E. 2d 511.

48.*Putnam v. Roudenbush*, *supra* 352 So. 2d at 771.

49.*Elderkin v. Gaster*, *supra* 288 A. 2d at 771.

50.*Forbes v. Mercado*, 283 Or. 291, 583 P. 2d 552 (1978); *Jeanguneat v. Jackie Hames Construction Co.*, 576 P. 2d 761 (Okl. 1978); *Krol v. York Terrace Building, Inc.*, 35 Md. App. 321, 370 A. 2d 589 (1977); *McDonald v. Mianecki*, 159 N.J. Super 1, 386 A. 2d 1325 (1978).

51.*Elderkin v. Gaster*, *supra* 288 A. 2d at 773.

52.*Theis v. Heuer*, 289 N.E. 2d at 301; *Norton v. Burleaud*, 342 A. 2d at 630; *Yepsen v. Burgess*, 525 P. 2d at 1022; *Rutledge v. Dodenhoff*, 175 S.E. 2d at 793; *Tavares v. Horstman*, 542 P. 2d at 1277; *Chandler v. Bunick*, 279 Or. 353, 569 P. 2d 1037 (1977); *Coney v. Steward*, 562 S.W. 2d 619 (Ark. 1978); *Lane v. Trenholm Building Co.*, 229 S.E. 2d (S.C. 1976); *Arvai v. Shaw*, 345 S.E. 2d 715 (So. Car. 1986).

53.*Wawak v. Steward*, 449 S.W. 2d at 923; *Bethlahmy v. Bechtel*, 415 P. 2d at 700-701; *Garcia v. Hunes & Howes Real Estate, Inc.*, 331 N.E. 2d at 635; *Hanavan v. Dye*, 4 Ill., App. 3rd 576, 281 N.E. 2d 398 (1972); *Crawley v. Terhune*, 437 S.W. 2d at 745; *Norton v. Burleaud*, 342 A. 2d at 630; *Hartley v. Ballow*, 209 S.E. 2d at 595; *Jones v. Gatewood*, 381, P. 2d at 158; *Waggoner v. Midwestern Development, Inc.*, 154 N.W. 2d at 809.

54.*Carpenter v. Donohoe*, 388 P. 2d at 402; *Barnes v. MacBrown and Company, Inc.*, 342 N.E. 2d at 621; *Smith v. Old Warsaw Development Co.*, 479 S.W. 2d at 799; *House v. Thornton*, 457 P. 2d at 203; *Belt v. Spencer*, 585 P. 2d 922 (Colo. 1978); *Crowder v. Vandendeale*, 564 S.W. 2d 879 (Mo. 1978) (see also fn. 25 re: this case).

55.*Putnam v. Roudenbush*, 352 So. 2d at 908; *Gable v. Silver*, 258 So. 2d at 11.

56.*Centrella v. Holland Construction Corp.*, 370 N.Y.S. at 832; *House v. Thorton*, 457 P. 2d at 199; *Matuhunas v. Baker*, 569 S.W. 2d 791, (Mo. 1978); *Richman v. Watel*, 565 S.W. 2d 101 (Tex. 1978).

57.*Vernali v. Centraella*, 266 A. 2d at 200; *Humber v. Morton*, 426 S.W. 2d at 554.

58.*Cochran v. Ketton*, 252 So. 2d at 307; *Padula v. J.J. Deb-Cin. Homes, Inc.*, 298 A. 2d 529.

59.*Casavant v. Campopiano*, 327 A. 2d at 831; *Weeks v. Slavick*, 180 N.W. 2d at 503.

60.*Sousa v. Albino*, 288 A. 2d 804 (R.I. 1978).

61.*David v. B & J Holding Corporation*, 349 So. 2d at 676.

62.*Schipper v. Levitt & Sons, Inc.* 208 A. 2d at 314.

63.*Padula v. J.J. Deb-Cin. Homes, Inc.*, 298 A. 2d 529, 532 (R.I. 1973).

64.*Smith v. Old Warsaw Development Co.*, 479 S.W. 2d at 801; *Mautlunas v. Baker*, 569 S.W. 2d at 791; *Jeanguneat v. Jackie Hames Construction Co.*, 576 P. 2d at 764; *Waggoner v. Midwestern Development, Inc.*, 154 N.W. 2d at 809.

65.*Smith v. Old Warsaw Development Co.*, 479 S.W. 2d at 801; *Mautlunas v. Baker*, 569 S.W. 2d at 791; *Jeanguneat v. Jackie Hames Construction Co.*, 576 P. 2d at 764; *Waggoner v. Midwestern Development, Inc.*, 154 N.W. 2d at 809.

66.Murray, Under the Spreading Analogy of Article 2 of the Uniform Commercial Code, 39 FORDHAM L. REV. 447, 454 (1971).

67.U.C.C. Section 2-725.

68.Md. Code Art. 21, Section 10-203.

69.McNamara, supra note 96 at 142.

70.*Tavares v. Horstman*, 542 P. 2d at 1282; *McDonald v. Mianecki*, 386 A. 2d at 1335-1336; *Carey v. Steward*, 562 S.W. 2d at 620.

71.*Tibbitts v. Openshaw*, 18 Utah 2d 442, 415 P. 2d 160 (1967); this approach, i.e. "'as is", which may effectively waive the implied warranty, has been supported in Wyoming by *Schepps v. Howe*, 665 P. 2d 504 (Wyo. 1983) and in Texas by *Diamond v. Meacham*, 699 S.W. 2d 950 (Tex. App. 1985).

72.*Casavant v. Campopiano*, 327 A. 2d at 833-834.

73.*Id.*

74.*Crowder v. Vandendeale*, 564 S.W. 2d at 879 (modified on other grounds in *Sharp Brothers Contracting Company v. American Hoist and Derrick Company*, 703 S.W. 2d 901 (Mo. 1986).

75.*Id.* at 881.

76.*Richman v. Watel*, 565 S.W. 2d at 102.

77.*Id.*

78.*Hoagland v. Celebrity Homes, Inc.*, 572 P. 2d 493, 494 (Colo. 1977); *Nastri v. Wood Bros. Homes, Inc.*, 690 P. 2d 158 (Ariz. 1984).

79.*Carter v. Quick*, 563 S.W. 2d at 463.

80.*Id.*

81.Prosser, *supra* note 2.

82.*Id.* 1127.

83.*Miles v. Love*, Kan. App. 2d 630, 573 P. 2d 622 (Kan. 1977); *San Francisco Real Estate Investors v. J.A. Jones Construction Company*, 524 F. Supp. 768 (S.D. Ohio 1981), *Mitchem v. Johnson*, 218 N.E. 2d 594 (Ohio 1966).

84.*Crowder v. Vandendeale*, 564 S.W. 2d 879, 882 (Mo. 1978) modified on other grounds in *Sharp Brothers Contracting Company v. American Hoist and Derrick Company*, 703 S.W. 2d 901 (Mo. 1986).

85.*Id.*

86.*Oliver v. City Builders, Inc.*, 303 So. 29 466, 469 (Miss. 1974) (see fn. 96 below; while this case has effectively been overruled by subsequent action in the Mississippi Supreme Court, its rationale still holds for the sake of illustration only).

87.*Coburn v. Lenox Homes, Inc.*, 173 Conn. 567, 378 A. 2d 599, 601 (1977).

88.Comment, The Case Against Strict Liability Protection for New Home Buyers in Ohio, 14 AKRON L. REV. 103, 106 (1980).

89.*Id.* 118.

90.The first case to consider the issue of a builder's liability to a second owner is *Steinberg v. Coda Roberson Construction Co.*, 79 N.M. 123, 440 P.2d 798 (1968), a 1968 New Mexico case which held that since the cause of action sounded in the tort of negligence, then the issue of privity was immaterial.

91.*Barnes v. Mac Brown and Co. Inc.*, 342 N.E. 2d 611 (1976).

92.*Moxley v. Laramie Builders, Inc.*, 600 P. 2d 733, 737 (Wyo. 1979).

93.*Id.*; see also *Western Equipment Co., Inc. v. Sheridan Iron Works, Inc.*, 605 P. 2d 806 (Wyo 1980) and *Phillips v. ABC Builders, Inc.*, 611 P. 2d 821 (Wyo. 1980).

94.*Terlinde v. Neely*, 721 S.E. 2d 768 (1980); see also *Arvai v. Shaw*, 345 S.E. 2d 715 (So. Car. 1986).

95.*Id.*, 721 S.E. 2d 768.

96.*Keyes v. Guy Bailey Homes, Inc.*, 439 So. 2d 670, 671 (Miss. 1983); the court used the following rationale in its decision:

> ...The purchase of a home is quite frequently the most important and expensive investment that a family makes. Yet, most purchasers simply do not have the knowledge of expertise necessary to discover many defects. Tcts. They must instead rely upon the honesty and expertise of the builder...
>
> Under such a scenerio, it is rather obvious that the courts must fashion some legal framework in which to protect innocent purchasers. Accordingly, we have already recognized that a first purchaser should be able to recover damages from the builder...
>
> But, our past decisions have unfortunately denied this same protection to second or subsequent purchasers. Yet, we know of no reasonable justification for this distinction. The existing law permits a wrong without a remedy... *Id.* 671-672.

With this opinion, the Mississippi Court effectively overruled *Brown v. Elton Chalk, Inc.*, 358 So.2d 721 (Miss. 1978), *Hicks v. Grenville Lumber Company, Inc.*, 387 So. 29 94 (Miss. 1980), and *Oliver v. City Builders, Inc.*, 303 So. 2d 466 (Miss. 1974). See also Justice Walker's strongly-worded dissent in the Keyes case.

97.For similar arguments establishing the standing of subsequent purchasers to sue the builder based on negligence, see *Elden v. Simmons*, 631 P.2d 739 (Okla. 1979); *Hermes v. Staiano*, 437 A.2d 925 (App. Div. 1981); *Redarowicz v. Ohlendorf*, 441 N.E.2d 324 (Ill. 1982); *Cosmopolitan Homes, Inc. v. Weller*, 663 p.2d 1041 (Colo. 1983). One of the most

wide-sweeping cases is *Oates v. Jag, Inc.* 311 S.E.2d 369 (1984), rev'd, 333 S.E.2d 222 (North Car. 1985) holding that the tort of negligence will lie for the third owners of a house when shown that the builder failed to comply with building code provisions and used inferior building materials. The North Carolina Supreme Court relied extensively on a pair of Florida cases recognizing the right of remote purchasers of condominiums to sue the builder for defects; see, *Simmons v. Owens*, 363 So.2d 142 (Fla. App. 1978) and *Navajo Circle, Inc., v. Development Concepts Corp.*, 373 So.2d 689 (Fla. App. 1979).

98.*Richman v. Watel*, 565 S.W.2d 101 (Tex. Civ. App. 1978); *Blagg v. Fred Hunt Co., Inc.*, 612 S.W.2d 321 (Ark. 1981); *Towers Tenant Association, Inc., v. Towers Limited Partnership*, 563 F. Supp. 566 (D.C. 1983).

99.*Richman v. Watel*, 565 S.W. 2d 101 (Tex. Civ. App. 1978); *Blagg v. Fred Hunt Co., Inc.* 612 S.W. 2d 321 (Ark. 1981); *Towers Tenant Association, Inc., v. Towers Limited Partnership*, 563 F.Supp. 566 (D.C. 1983). The D.C. Court relies upon *Berman v. Watergate West, Inc.*, 391 A.2d 1351 (D.C. 1978) which held "...the District of Columbia Court of Appeals concluded that products liability principles apply to the sale of newly constructed homes and cooperative units. As a result, the Court held that plaintiff had a viable cause of action grounded in breach of implied warranty/strict liability in tort." *Towers Tenant Assoc., supra* at 574.

100.*Blagg, supra*, at 323-324.

101.Prosser, *supra* note 2 at 1122-1124.

102.377 P.2d 897 (1963); this case lays out the prototypical strict liability standards using the facts of an injury resulting from an allegedly faulty power tool; these standards were later codified in Section 402A of the Second Restatement of Torts.

103.*Kriegler v. Eichler Homes, Inc.*, 73 Cal. Rptr. 749 (1969).

104.Prosser, *supra* p. 1124.

105.*Coburn v. Lenox Homes, Inc.*, 173 Conn. 567, 378A. 2d 599, 601 (1977).

106.*Oliver v. City Builders, Inc.*, 303 So. 2d 466, 468 (Miss. 1974); (see fn. 96 *infra*; while this case has been overruled, it is used here for illustrative purposes only).

107.For a detailed listing of jurisdictions recognizing negligence as a remedy, see Robert L. Cherry, *Builder Liability for Used Homes Defects*, 18 REAL ESTATE LAW JOURNAL 115-141 (1989).

108.See, California: *Kriegler v. Eichler Homes, Inc., supra*; District of Columbia: *Berman v. Watergate West, Inc., supra*; New Jersey: *Hermes v. Staiano, supra*; Arkansas: *Blagg v. Fred Hunt Co., supra*.

FOR LOVE OR MONEY: NONPROFIT SURVIVAL IN A FOR PROFIT WORLD

by

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> Once upon a time, the process of budgeting for most nonprofit organizations was very simple. My favorite illustration is the story of how one Ivy League university set its budget in the years right after World War II. The university was run by one vice-president and two deans...The vice-president and senior deans would meet with the president early in the summer at his summer home... Somewhere between the first and second martini, the president and his two chief administrators would settle the budget for the year and decide on the amount of any tuition increase needed to keep the university happily in the black.

Times, of course, have changed.[1]

Variously known as charitable, eleemosynary or nonprofit associations, small community based organizations whose mission it is "to help the less fortunate" are deeply imbedded in the American psyche. Such organizations sprang up fast and furiously as the Industrial Revolution sped forward in this

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country, providing some relief (usually minimal) from the economic dislocation caused by the shift from an agrarian to an urban economy.[2]

Many of these organizations, direct descendants of those founded in the late nineteenth and early twentieth centuries, still exist today. Frequently, these small nonprofits share similar origins: the community's wealthiest and most influential people came together and formed an organization to fill a need in their community. These early charities would spout such values as sobriety and hard work and only provide assistance to those deemed "deserving". Of course,as is the case today, there was probably far more need in these towns than there was relief available. One wonders if the community leaders were motivated more by altruism or by the desire to get the "riffraff" off the streets. Funding was provided by the wealthy themselves, both by start up donations and annual charity balls. Social prestige, and not business acumen, was the driving force.

The Great Depression of the 1930's actually brought little change to this small, community-based nonprofit model. Even though the government ultimately provided a "safety net" of sorts - unemployment compensation and social security insurance - somehow there were those who slipped through the net and had only community relief efforts on which to rely. These local relief societies were still coordinated and largely funded by the local leading citizens--those with wealth, power and prestige. A charity's primary mission might change with the times, but its major source of funding was still found in the local leadership with their yearly charitable and social events.

For the wealthy, charitable work provided a social outlet. The business principals that formed the basis of their professional successes were not applied to their volunteer organizations. Long-range planning was minimal. Even well endowed organizations were to suffer erosions of their asset bases caused by the inflation and recessions which have become typical since the early 1970's. The innovation and creativity that is characteristic of American entrepreneurship were sorely lacking in the nonprofit sector of the economy.

> The board of a not-for-profit institution, with its traditional bnsiness membership, ought to be well-positioned to press management to think and act in a businesslike fashion as well as to insist that the staff of the organization has the professional competence to conduct the business of the enterprise. But business executives serving on such boards are often hesitant in their roles as trustees to be assertive in suggesting that business practices have a place in the management of not-for-profit organizations. As the general manager of a major public broadcasting station put it, "When my business trustees come to a board meeting, they seem to check all their business expertise at the door."[3]
>
> Corporate types...leave their corporate brains outside the door.[4]

At a time when the demand and need for nonprofit services far outstrips the supply, it is obvious that the time has come to put the old fashioned "charity model" to rest. Assertive and aggressive approaches must be taken to stimulate this sector of the economy; in fact, the law demands of nonprofit directors no less than it demands of directors of for profit corporations.

Specific sections of nonprofit corporate codes will be discussed *infra.* Auditing standards for nonprofit corporations also merit mention. Certified public accountants who specialize in nonprofit audits follow Generally Accepted Auditing Standards (GAAS), and also Office of Management and Budget Circular A133. Additionally, a particular funding source may have its own guidelines that must be followed as well.

In an audit of a for profit corporation, an auditor will check to see whether the financial statements fairly reflect the corporation's transactions during the prior year, and also whether reliable internal controls are in place. In a nonprofit audit, the additional issue of compliance is key: whether monies received were spent for the designated programs. Ultimate accountability is to the public, an onerous burden for any board of directors.[5] Thus a nonprofit corporation today is no place for a sleepy board. The failure to recognize the need for change jeopardizes the very survival of these organizations since the future has arrived for nonprofits. This $500 billion dollar per year sector of the American economy[6] must make hard decisions if it is to remain viable in the face of continued recession, government funding cuts, implementation of programs such as United Way Donor Choice,[7] and a lack of health insurance to cover services such as mental health counseling.[8]

Professionalization of management is rapidly becoming the rule. Executive director positions are being retitled "President" and "CEO" to reflect this changing reality.[9] State organizations such as Family Service Association of New Jersey and national organizations such as Family Service America provide expertise and training to their member agencies. Agency heads form consortiums to gain a

competitive edge when seeking grants from government agencies. Some agencies merge as a way to combine strengths while better ensuring survival.

Efficiency and results are stressed in today's nonprofit world. More and more government agencies are demanding quantifiable results as a condition of awarding grants. "Having quantifiable goals is an essential starting point if managers are to measure the results of their organizations activities. It is difficult to quantify the output of social programs, but if managers define their goals well, it can be done."[10]However, long term survival for these organizations will depend on more than operating in a "leaner and meaner" fashion. By their nature, nonprofits have tended to operate on a shoestring all along such that when cutbacks are suggested, there is little if anything to cut.

Until recently, the answer to the problem of nonprofit financial woes was thought to be fund development - more creative and aggressive fund raising. In fact, since the beginning of modern nonprofits, directors were often selected because of their potential as a funding source (whether personally or via corporate connection). While the role of fundraising should not be diminished, it should no longer be overemphasized as the great panacea. Fundraising has serious limits; among them are state regulations[11] and increasing competition for the charitable dollar.

Greater emphasis should be placed on making nonprofits partially self-funding by having certain successful operations which can help to underwrite those services which lose money or for which adequate funding is not available. Clearly, nonprofits should think in terms of income generation. As this paper's discussion of the law will emphasize, the law does not say that nonprofits must operate in the red; it only says that excessive salaries can't be paid and that profits cannot be distributed to shareholders.

Family Service Association of Atlantic County has begun to generate income via its sister corporation Family Service Enterprise. Both of these organizations are subsidiaries of a holding company formed to provide management services including long range planning and investment guidance. Family Service Enterprise runs only programs which pay for themselves out of program fees such as its highly successful Consumer Credit Counseling Service. No public money is involved. Right now this entity represents only a small percentage of Family Service Association of Atlantic County's business. However, it is clearly understood that should there be a "profit" the decision of how to best utilize this positive return will be made at the holding company level

for the good of the organization as a whole, in a way which furthers the overall aims and goals of this Atlantic County, New Jersey nonprofit. The board of directors of the holding company is made up of members of the boards of the various constituent organizations. Jerome Johnson, President and CEO of this $4.5 million dollar per year Family Service Association (which has on its payroll 130 employees) stresses the importance of recognizing change and modifying operations as required.[12]

Any discussion of the adaptations to be made by not-for-profit corporations in recognition of the changing economic and regulatory climates must, of necessity, revolve about the relevant statutory framework. After all, compliance with state and federal statutes and regulations is the minimum level of acceptable behavior. Therefore, this Article will examine the Revised Model Nonprofit Corporation Act (with a glance at its predecessor), the New Jersey statute known as Corporations and Associations Not for Profit[13], and the New York Not-for-Profit Corporation Law[14]- one of the pioneering legislative schemes.[15]

The New York legislature in 1969 enacted the current statute which repealed the former Membership Corporation Law[16] and which draws a significant number of provisions from the state's General Corporation Law.[17] The law, which became effective on September 1, 1970, was the result of a Joint Legislative Committee which was formed in 1956 to plan "for the revision of the corporation laws of New York."[18] The drafters of the statute felt that not-for-profit organizations were sufficiently unique so as to warrant legislation distinct from the Business Corporation Law, a product of the same committee. The separate law also gives the legislature additional flexibility to deal with issues peculiar to not-for-profit corporations.[19]

It is of interest to note that the committee members specifically rejected the nomenclature "Non-profit Corporation Law" in favor of the Not-for-Profit Corporation Law. Their reasoning was that the latter more accurately reflected the reality of such organizations. While not organized for profit, they may in fact show a surplus of revenues over expenses in connection with their operations.[20]

For a not-for-profit corporation to carry out its (usually)[21] admirable functions and to allow for long term planning, it must attempt to maintain a surplus to cover periodic negative cash flow periods. Since they cannot reach out to the equity markets, not-for-profit's also require a surplus to finance the maintenance, replacement and expansion of its capital plant.[22] New York specifically grants a not-for-profit the right to make "an incidental profit" so long as it is used for the

"maintenance, expansion or operation of ... the corporation."[23] However to avoid being in violation of the statute, as interpreted by the courts, profits may not inure to the benefit of any members of the corporation.[24]

The New Jersey act[25], while referring to "Corporations and Associations Not for Profit" nevertheless inferentially recognizes the possibility that such an organization may, in fact, show a surplus. Though it provides that "a corporation may be organized .. for any lawful purpose other than for a pecuniary profit ..."[26], it further requires that "... no part of the income or profit of a corporation organized under this act shall be distributed to its members, trustees or officers... ."[27] Similarly, the Revised Model Nonprofit Corporation Act specifies that no distributions can be made[28], with distributions defined as the "payment of a dividend or any part of the income or profit of a corporation to its members, directors or officers."[29] The Model Nonprofit Corporation Act had a virtually identical provision.[30]

Like the New York law, the current New Jersey statute can trace its history to late in the last century. The predecessor legislation, identically named, has roots in 1875[31]with a codification enacted in 1898.[32] However, it wasn't until 1975 that a major revision was contemplated. The Nonprofit Law Revision Committee of the Corporate and Business Law Section of the New Jersey State Bar Association issued its report in 1980.

The Committee sought to provide a uniform regulatory scheme applicable to all nonprofit corporations, regardless of their purpose. [33] It also attempted, and to a great extent succeeded, to "track" the New Jersey Business Corporation Act.[34] while recognizing their inherent differences.[35] By so doing, the drafters hoped "that the similarity between the two acts will lead to a body of case law in which the interpretation of either act may be used as a guide in interpreting the parallel section of the other ... ."[36] The very first provision of the legislation sets forth as one of its "Underlying purposes and policies ... to make the law governing nonprofit corporations as nearly compatible with the New Jersey Business Corporation Act ... as may be practicable, subject to the particular requirements of nonprofit corporations." [37]The law became effective October 1, 1983.

The Revised Model Nonprofit Corporation Act also explicitly notes the utility of recognizing the connection between itself and the Model Business Corporation Act. The Subcommittee on the Model Nonprofit Corporation Act stated, "Shortly after the project (to revise the Model Nonprofit Corporation Act) began, the Committee on Corporate Laws decided to completely revise the Model

Business Corporation Act ('MBCA'). The Subcommittee decided to track the MBCA in form and substance wherever appropriate ... ."[38]

Thus, even this brief look at these various statutes leads to the conclusion that the decision of a not-for-profit corporation to organize its activities to provide for a cash surplus is consistent with a structure envisioned by the regulatory framers. The prudent and forward looking executive director *must* plan for an operating surplus in at least some of the group's activities to allow for long range planning and its very existence.

Acting within the legal constraints imposed, some of the best known not-for-profits have long had profit making ventures. New York's Metropolitan Museum of Art began selling photographs of its collection in 1874 and opened a sales shop in 1908.[39] Girl Scout cookies and P.T.A. bake sales are part of our culture and additional examples of not-for-profit earned income ventures. For these and similar activities to be successful, the not-for-profit corporation administrators must have a strictly businesslike approach to the activities.[40] As we have seen in the example of the Family Service Association of Atlantic County, the foresight, talent and perseverance of an executive director can make the difference between success or failure of these ventures.

As noted by Brooke W. Mahoney, executive director of Volunteer Consulting Group, Inc., "nonprofits are starved for the skills and perspectives of financial executives from the profit-making realm."[41] Merely having the right to engage in profit making activities is no guarantee that they will be successful. All of the abilities needed by the managers and owners of profit making entities are required by their not-for-profit colleagues.

Attracting and retaining directors or trustees[42] with the skills and desires necessary to assist a not-for-profit corporation can be greatly enhanced if the statute regulating the operation provides sufficient flexibility in appointing, protecting, retaining and dismissing those persons.

The Revised Model Nonprofit Corporation Act requires that each corporation formed under it must have a board of directors[43] consisting of at least three members.[44] Similarly, New Jersey mandates a board consisting of not fewer than three members.[45] New York presumes that a not-for-profit corporation will operate through a board of directors consisting of three member "except as otherwise provided in the certificate of incorporation."[46]

The not-for-profit corporation hoping to tune up its operations may seek to "clean up" its board. As noted above, for decades the board of directors of the local not-for-profit has been considered the fiefdom of those people (and their descendants) who bad the money, name and clout to form and fund such organizations. Though needs and funding methods have changed, board membership may not reflect such transition. Reelection as a director was usually a formality satisfied at the brief business meeting which preceded the annual dinner dance.

The Revised Model Nonprofit Corporation Act deals with the issue of director tenure by holding that if the bylaws do not provide otherwise, the term of a director shall be one year. In no event may a term exceed five years.[47]The Act does allow for successive terms.[48] New York has a virtually identical section[49], while New Jersey requires terms which vary from one to six years.[50] Though reelection is permitted, the existence of statutory limitations on term length at least gives the activists on the board and among the membership a basis for suggesting to the "dead wood" that while their service has been greatly appreciated, it is time for them to move on to the category of (non-voting) directors *emeriti*.

Of course, the changes planned by a newly hired executive director and partially reconstituted board may require the removal of obstinate directors. As expected, the statutes deal with this rather unpleasant subject. Because of the various methods of electing directors under it, the Revised Model Nonprofit Corporation Act sets forth a number of ways to remove a director without specific cause.[51] Essentially, if the number of members needed to elect a director decide to remove him or her, that director is off the board. New York[52]and New Jersey[53] deal with the subject in a similar manner. A hanging-on director, facing certain removal once the required number of votes are assembled, is likely to resign. Failure to do so only validates the decision to seek that person's removal.

While monetary compensation is not likely to be the incentive to join the board of directors of a not-for-profit corporation, the acts examined all permit reasonable compensation.[54] The fact is, few nonprofits pay their directors though many will reimburse them for their actual out of pocket expenses.

Though most directors have altruistic motives and are not interested in payment for their services, they are concerned about their being exposed to liability based upon their actions. For these volunteers, even the smallest possibility of being found liable is unacceptable.[55]That issue is directly dealt with by several statutes contained in the various codes we have examined.

Before considering methods of reducing the risk to directors, we will first look at the standard of care imposed upon them. The Revised Model Nonprofit Corporation Act sets forth "General Standards for Directors."[56] The standard is not extraordinarily stringent. Discharging a director's obligation is satisfied by acting "in good faith"[57] and "with the care of an ordinarily prudent person in a like position... ."[58] This level of accountability is certainly no higher than common sense dictates as the minimum standard required of a director.

While a stricter standard of care, such as holding a director liable for simple negligence, may have certain appeal, it would undoubtedly have the effect of discouraging volunteers.[59] Since the commonly accepted standard requires that the director act in good faith, it strikes an appropriate balance between the conflicting concerns. Conforming to that standard will address the issues raised by the recent problems encountered by the United Way of America in connection with allegations of lavish compensation and nepotism attributed to their president.[60]

In addition, a director is permitted to rely, unless the facts require otherwise, upon reports, statements, opinions, etc. of corporate officers, counsel, employees, committees, etc. in determining the propriety of their actions.

The New Jersey act contains provisions quite similar.[61] That statute goes even further by permitting a not-for-profit corporation to eliminate all director liability by so providing in the certificate of incorporation.[62] New York also imposes a standard of good faith and prudence[63] and allows directors to rely upon financial statements found in a report prepared by a certified public accountant or represented to them as accurate by the president of the organization. [64]

Of course, however lenient a statute may be concerning the level of care required of a director, an action may be brought seeking to hold the director liable based upon his conduct as a director. To that end, the codes also address the issue of indemnification of those directors who are sued. The Revised Model Nonprofit Corporation Act takes the straight-forward position that a not-for-profit corporation may indemnify a director so long as that director's conduct comported with the standards of conduct specified in the Act[65], and, in the case of a criminal proceeding, the director had no reasonable cause to believe that the conduct was unlawful.[66]

The Act requires mandatory indemnification when a director is wholly successful in defending an action[67], allows for the corporation to advance defense

costs[68], and, unless prohibited by the articles of incorporation, authorizes a court to grant a director's application to have the court order indemnification.[69]

The New Jersey provision dealing with indemnification gathers all of the components found in the Revised Model Nonprofit Corporation Act.[70] In 1987, New York reorganized, and to some extent expanded its statutes dealing with permitted and mandatory indemnification of directors.[71]

The states have recognized the necessity of protecting directors of nonprofits from litigation other than in cases of self-dealing and bad faith. The statutory provisions examined allow the organizations to recruit directors who might otherwise decline the honor due to their concern of being caught up in a lawsuit brought by an unhappy member or client.

For smaller not-for-profit corporations to succeed, they must break away from traditional notions of funding, organization and the role of their directors. Much of their business operations have been based upon the "myth" that operating efficiently and showing a "profit" is improper. They have treated their directors either with utmost reverence or merely as rubber stamps, and have failed to utilize the business talents possessed by many of them.

As this paper has shown, the law has not imposed these results upon nonprofits, in fact, the law grants to those groups the latitude to adopt operating methods appropriate for now and in the future.

ENDNOTES

[1] PAUL B. FIRSTENBERG, MANAGING FOR PROFIT IN THE NONPROFIT WORLD 143 (1986).

[2] Much of the historical information for this paper is from Nancy Ilyse Lasher, *The Power Network of the New Brunswick Elite: 1870-1905*, unpublished thesis, Alexander Library, Rutgers University, 1982. Significant primary sources include: *Constitution of the Children's Industrial Home*, Special Collections, Alexander Library, New Brunswick, New Jersey; Records of the Children's Industrial Home, 1903, Special Collections, Alexander Library, New Brunswick, New Jersey; Reports of the Children's Industrial Home, 1883--1903, Special Collections, Alexander Library, New Brunswick, New Jersey; Collection of Annual Reports, Charity Organization Society, Special Collections, Alexander Library, New Brunswick, New Jersey.

[3] Firstenberg, *supra* note 1, at 205.

[4] Interview with Andrea Krich, Executive Director, Family Service Association of Middlesex County (February 11, 1994). Much of the information concerning the operation of Family Service Associations came from this interview as well as from the experiences of one of the authors who serves as a director of one of the New Jersey Family Service Association agencies.

[5] Interview with Brian D. Levine, CPA (March 23, 1994).

[6] Ann Monroe, *A World of Difference*, CFO, September 1993 at 34. About half of the organizations and enterprises in the United States are now nonprofit in nature. Currently, there are nearly one million of these organizations in the United States. The numerical significance of nonprofits cannot be disputed. Gordon Dabbs, *Nonprofit Businesses in the 1990s: Models for Success*, Business Horizons, September/October, 1991 at 68.

[7] This procedure allows a donor to specify which of the United Way recipients will receive a portion of his or her contribution. This clearly gives an advantage to larger, better known organizations.

[8] It is not clear that all nonprofits that currently provide mental health counseling would be considered "providers" under the Clinton health plan. Obviously, exclusion from the plan would have disastrous consequences for those nonprofits. Additionally, to the extent that the Clinton health plan may limit the number of therapy sessions, alternate funding would need to be provided for long-term counseling.

[9] Interview with Jerome Johnson, President and CEO, Family Service Association of Atlantic County (March 30, 1994).

[10] Philip D. Harvey and James D. Snyder, *Charities need a bottom line too*, Harvard Business Review, January/February 1987 at 14.

[11] *See, e.g* Assembly, No. 839, 1994 New Jersey Laws which would create a "Charitable Registration and Investigation Act."

[12] Interview with Jerome Johnson, President and CEO, Family Service Association of Atlantic County (March 30, 1994).

[13] N.J. Stat. Ann. §15A:1-1 *et seq. (West 1993).*

[14] N. Y. Not-For-Profit Corporation Law § 101 *et seq.* (McKinney 1993).

[15] These statutes are as broad as their business corporation counterparts. We will examine only a few of the provisions which directly impact upon the ability, and the need, of not-for-profit corporations to "modernize" to the extent necessary to survive and flourish.

[16] The Membership Corporation Law can be traced to portions of the Gen. Corp. Law of 1890 and various amendments and additions in 1909, 1929, 1941 and 1962.

[17] N. Y. Gen. Corp. Law § 1 *et seq. (McKinney 1993).*

[18] Forward to the Committee's Thirteenth Interim Report.

[19] *Id.*

[20] Memorandum No. 1 of the Joint Legislative Committee.

[21] At least at the formation stage , the statutes examined do not differentiate between "good" and "bad" organizations. "The revised Act (The Revised Model Nonprofit Corporation Act) does not deal with the question of whether the activities of a ... nonprofit corporation can be so offensive to public policy that its existence can be challenged by the state in a quo warranto or other proceeding. The matter is left to judicial development on a state by state basis. Michael C. Hone, *Introduction to the Revised Model Nonprofit Corporation Act*, Prentice Hall Law & Business, 1988.

[22] Robert P. Fallon, *Not-for-profit?No Profit: Profitability planning in not-for-profit organizations*, Health Care Management Rev., Summer 1991, at 47.

[23] N. Y. Not-For-Profit Corporation Law § 508 (McKinney 1993).

[24] *New York State Liquor Authority v. Salem Social Club, Inc.*, 76 A.D.2d 908, 429 N.Y.S.2d 235 (1980). The prohibition against "distribution of profits" encompasses any division or sharing of surplus before dissolution. Also included is payment of excess salaries or fees. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835, 838 (1980).

[25] N.J. Stat. Ann. § 15A:1-1 *et seq. (West 1993).*

[26] *Id.* at § 15A:2-1.

[27] *Id* at § 15A:2-1 (d).

[28] Revised Model Nonprofit Corporation Act §13.01 (1988).

[29] *Id. at* §1.40(10).

[30] *Id.* at §26.

[31] Act of April 9, 1875.

[32] P.L. 1898, c.79.

[33] Report of the Nonprofit Law Revision Committee. Though there are obvious differences between the traditional not-for-profit models - Public Benefit Corporations, Mutual Benefit Corporations and Religious Corporations - they have much in common when it comes to regulation of their formation and operation. The constitutional protections granted religious organizations frequently leads to a separate statute dealing with their special needs. *See, e.g.*, N.J. Stat. Ann. § 16:1-1 *et seq. (West 1993).*

[34] N.J. Stat. Ann. § 15A:1-1 *et seq. (West 1993)*

[35] Report of the Nonprofit Law Revision Committee.

[36] *Id.*

[37] N.J. Stat. Ann. § 15A:1-1.c(1) *(West 1993).*

[38] MICHAEL C. HONE, INTRODUCTION TO THE REVISED MODEL NONPROFIT CORPORATION ACT, 1988.

[39] Edward Skloot, *Should not-for-profits go into business?*, Harvard Business Review, January/February, 1983 at 20.

[40] *Id.* at 22.

[41] Ann Monroe, *A World of Difference*, CFO, September 1993 at 36.

[42] For the sake of simplicity we will use the term "director" to cover all of the possible names for those who are given the task of setting policy for a not-for-profit corporation.

[43] Revised Model Nonprofit Corporation Act §8.01 (1988).

[44] *Id.* at § 8.03.

[45] N.J. Stat. Ann. § 15A:2-8(9) *(West 1993).*

[46] N. Y. Not-For-Profit Corporation Law § 701(McKinney 1993).

[47] Revised Model Nonprofit Corporation Act §8.05 (1988).

[48] *Id.*

[49] N. Y. Not-For-Profit Corporation Law § 703(b) (McKinney 1993).

[50] N.J. Stat. Ann. §§15A:6-3, 15A:6-4(a) *(West 1993).*

[51] Revised Model Nonprofit Corporation Act §8.08 (1988).

[52] N. Y. Not-For-Profit Corporation Law § 706 (McKinney 1993).

[53] N.J. Stat. Ann. §15A:6-6 *(West 1993).*

[54] Revised Model Nonprofit Corporation Act §8.12 (1988); N. Y. Not-For-Profit Corporation Law § 715 (McKinney 1993); N.J. Stat. Ann. §§15A:6-8(c) *(West 1993).* Case law provides some guidance in determining the reasonableness of compensation paid to director. In addition to the quantity and quality of services rendered, the financial condition of the organization must be considered. *See, e.g. Baker v. Cohn,* 292 N.Y. 570, 54 N.E.2d 689 (1950).

[55] Louis S. Harrison and Eric L. Marhoun, *Protection for Unpaid Directors and Officers of Illinois Not-for-profits: Fact or Fiction?,* Illinois Bar Journal, April, 1991 at 172.

[56] Revised Model Nonprofit Corporation Act §8.30 (1988).

[57] *Id.* at 8.30 (a)(1).

[58] *Id* at §8.30(a)(2).

[59] *Developments - Nonprofit Corporations*, 105 Harvard Law Review 1578, 1602 (1992).

[60] *See*, Felicity Barringer, *United Way Head is Forced Out in a Furor Over His Lavish Style*, N.Y. Times, February 28, 1992 and note 24 *supra*.

[61] N.J. Stat. Ann. §15A:6-14 *(West 1993).*

[62] *Id.* In addition, in the case of many religious, charitable, educational and hospital nonprofits, there is mandated charitable immunity for non-compensated directors, officers and members. N.J. Stat. Ann. §2A:53A-7 *(West 1993).*

[63] N. Y. Not-For-Profit Corporation Law § 717(a) (McKinney 1993).

[64] N. Y. Not-For-Profit Corporation Law § 717(b) (McKinney 1993).

[65] *See,* Notes, 56, 57 and 58, supra.

[66] Revised Model Nonprofit Corporation Act §8.51 (1988).

[67] *Id. at* § 8.52.

[68] *Id* at § 8.53. This section requires a writing from the director that he or she has met the required standard of conduct and an agreement to reimburse the organization to repay the advance if it is determined that the director did not meet that standard.

[69] *Id at § 8.54.*

[70] N.J. Stat. Ann. §15A:3-4 *(West 1993).* N.J. Stat. Ann. §15A:2-8 *(West 1993)* dealing with the Certificate of Incorporation of a nonprofit specifies indemnification language which may appear in that document.

[71] N. Y. Not-For-Profit Corporation Law §§ 721-726 (McKinney 1993).

DISPUTE SETTLEMENT UNDER NAFTA: DO THE PARTIES HAVE THE WILL TO MAKE IT WORK?

by

Mary Jo Nicholson*

I. Introduction

The Canada - United States Free Trade Agreement (CFTA)[1] has now been in effect for over five years with the result that we have relevant experience to apply to the more recent North American Free Trade Agreement (NAFTA)[2] which replicates many of the provisions of the CFTA. This is particularly true in the area of dispute settlement. There are three categories of dispute settlement under NAFTA. The general dispute settlement provisions are found in Chapter 20 and are available only to the contracting parties or governments.[3] These provisions extend to "all disputes between the Parties regarding the interpretation or application" of the agreement or situations where "a Party considers that an actual or proposed measure of another Party is or would be inconsistent with the obligations of the agreement or cause nullification or impairment" of the agreement.[4] The antidumping (AD) and countervailing duty (CVD) dispute provisions are found in Chapter 19, and the provisions relating to investor disputes are found in Chapter 11.

This article will outline the AD and CVD dispute provisions of the NAFTA which are similar to those of the CFTA. The experience under the CFTA provisions will be reviewed paying particular attention to the cases affecting the pork and softwood lumber industries. The article will conclude with a view forward towards the operation of the provisions of Chapter 19 of NAFTA.

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This is an important topic relating directly to prospects for the ultimate success of the new agreement. While the CFTA and NAFTA are largely about the reduction of tariffs, many domestic industries are affected by their provisions and will look for any means available to protect themselves from the effects of global competition. The long-term viability of NAFTA may well depend upon the willingness of the domestic governments of each Party[5] to adhere to the spirit of the dispute settlement provisions. Manifestations of respect and acceptance by the governments of the Parties of the decisions made under the AD and CVD provisions carry a great deal of weight in the formative stages of the new relationship of the Parties. One writer has described the situation, stating," The binational panel process of Chapter 19 will in many respects be the crucible of the NAFTA. As the vehicle for resolving AD and CVD cases brought in any of the three contracting countries, Chapter 19 panels will be required to deal with the types of trade conflicts that have historically generated intense, sometimes passionate controversy."[6]

II. Chapter 19 of NAFTA: the AD and CVD Dispute Settlement Provisions

AD and CVD dispute procedures were included in the CFTA at the insistence of Canada where there was at the time of the negotiation of that agreement, a perception that American contingent protection laws were applied subjectively. What Canada really wanted from the AD and CVD negotiations was agreement by the Parties on a set of common rules on subsidies and dumping, however the two countries were unable to agree on a bilateral regime providing for uniform provisions. It was agreed instead,that each Party would reserve the right to apply its own AD and CVD law to goods imported from the territory of any other Party.[7] With the proviso that binding binational panel proceedings would be substituted for appeals to the courts of either country. This was an important compromise on the part of the two Parties to the CFTA and these provisions have been incorporated substantially unchanged into the NAFTA.

A. Binational Panel Review Replaces Judicial Review

Each country has promised to replace judicial review of final AD and CVD duty determinations with binational panel review.[8] Under the GATT, and under U.S. and Canadian law AD and CVD duties cannot be imposed unless there is a finding of dumping or subsidy *and* a finding of material injury or threat of material injury to a domestic industry. The CFTA provides that review based upon the administrative record, a final AD or CVD determination of a competent investigating authority may be requested in order to determine whether such determination was in accordance with the AD or CVD law of the importing Party.[9] "Competent investigating authority is defined in Canada as the Canadian International Trade Tribunal (CITT) or the Deputy

Minister of National Revenue for Customs and Excise (MNR); in the United States as the International Trade Administration of the U.S. Department of Commerce (Commerce) or the U.S. International Trade Commission (ITC); and in Mexico as the designated authority within the Secretariat of Trade and Industrial Development (SCFI).[10] The panel appointed to review may then uphold a final determination, or remand it for action not inconsistent with the panel's decision.[11] Panels must apply the same domestic substantive law that the administering agency in the importing country must apply. This law is defined as "relevant statutes, legislative history, regulations, administrative practice and judicial precedents".[12] The standard of review has been defined by reference to specific legislation in each of the three countries with the intention that it be the same as would be applied by the reviewing court of the importing country.[13]

It is interesting to note the comment by one observer, "At the time (that panels were introduced in the CFTA) some regarded them as insubstantial innovations: the Chapter 19 provisions creating panels neither adopted new substantive law nor established a right of review that would not otherwise exist. Rather, those provisions provided that Chapter 19 panels would serve simply as surrogates for reviewing courts and decide cases in accordance with the same legal standards that courts would apply."[14]

B. Composition of the Panels

The panels will be made up of five members, who "shall be of good character, high standing and repute, and shall be chosen strictly on the basis of objectivity, reliability, sound judgment and general familiarity with international trade law. The Parties will maintain separate rosters of potential panelists, composed of sitting or retired judges "to the fullest extent practicable.[15] It is interesting to note that the CFTA did not include this specific preference for sitting or retired judges.[16] Panel members must be citizens of one of the Parties but there is no requirement of proportional representation on the basis of nationality. A majority of the panelists on each panel shall be lawyers in good standing. Within 30 days of a request for a panel, each involved Party shall appoint two panelists from the roster. Within 55 days of the request for the panel, the involved Parties shall agree on the selection of a fifth panelist.[17]

C. Individuals May Access Proceedings

Unlike Chapter 20 proceedings, Chapter 19 panels are accessible by private parties.[18] This is consistent with Chapter 19 review as an extension of domestic proceedings and with the fact that the involvement of government is generally less

with Chapter 19 review than is the case with Chapter 20 review. It has been observed that "though the language attempts to preserve the state-to-state nature of Agreement by requiring that the formal request for a panel come from a government Party, the clear implication is that governments must comply with the requests of individuals."[19] In Chapter 19 reviews, decisions are binding upon the Parties and there is no provision for political negotiations, as is the case with Chapter 20 review. The fact that individuals have standing in this review process also contributes to some of the intensive lobbying in this area that will be referred to later in this paper.

D. Allowable Time Limits for Panel Decisions

One of the objectives of the Parties is to see disputes resolved in a timely fashion. For this reason, strict time limits have been imposed, the effect of which is to result in final decisions within 315 days of the date on which a request for a panel is made.[20] Generally panels have met these time limits, although there have been exceptions due to panelists having stepped down to avoid any appearance of conflict and also due to the remand process[21] which can result in substantial delays before a final determination is made.

E. Effect of Chapter 19 Panel Decisions

The decision of a panel is binding upon the Parties with respect to the particular matter that is before the panel.[22] The finality of the panel's decision is further emphasized by the provision which states that a final determination by a panel may not be reviewed under the judicial review procedures of the importing Party provided that the panel determination was requested within the time limits set out in NAFTA. Thus, there can be no appeal from a panel decision to domestic courts.[23] A casual observer of this process, especially in recent cases could be forgiven for questioning the finality of panel decisions. Most of this uncertainty is due to the provisions that the "panel may uphold a final determination *or remand it for action not inconsistent with the panel's decision*. Some of the recent cases involving multiple remands resemble nothing so much as a ping-pong game between the panel and the determining agency. The question of the effect of successive remands to the determining agency was addressed by a panel in the first pork case when it concluded that it was required by Article 1904 (8) of the CFTA to issue a "final decision", i.e. that the Agreement did not contemplate or permit successive remands.[24]

So far the history of the CFTA reveals several cases that demonstrate agency reluctance to comply with panel decisions. In these cases, the panels have included increasingly specific instructions to the agencies on remand and the tone of the decisions of the agencies and the panels has become somewhat antagonistic.

F. The Extraordinary Challenge Committee - An Exception to the Rule of Finality of Chapter 19 Panel Decisions?

The only exception to the rule of finality of Chapter 19 panel decisions is a limited one and it is found in the provision for the extraordinary challenge procedure which provides for the establishment of an extraordinary challenge committee (ECC) comprising three members which are selected from a joint roster comprised of judges or former judges.[25] This provision reads as follows:

Where, within a reasonable time after the panel decision is issued, an involved Party alleges that:

(a) (i) a member of the panel was guilty of gross misconduct, bias, or a serious conflict of interest, or otherwise materially violated the rules of conduct,

(ii) the panel seriously departed from a fundamental rule of procedure, or

(iii) the panel manifestly exceeded its powers, authority or jurisdiction set out in this Article, for example by failing to apply the appropriate standard of review, and

(b) any of the actions set out in subparagraph (a) has materially affected the panel's decision and threatens the integrity of the binational panel review process,that party may avail itself of the extraordinary challenge procedure set out in Annex 1904.13 [26].

If an ECC finds that the narrow grounds for an extraordinary challenge have been established, the ECC may vacate or remand the binational panel decision.[27] The drafters of the extraordinary challenge process expected that it would be used infrequently.[28] There are, at present, significant tensions between the Parties with respect to the proper role of an ECC. "Thus far, these challengers have arisen solely with respect to panel reviews of U.S. cases. At least in that context the initial tension has been between a U.S. desire for broader appellate recourse in cases it believes were wrongly decided by a panel and a Canadian desire to restrict extraordinary challenges to rare instances of systemic abuse, such as gross misconduct or ultra vires action."[29] This issue has been addressed in each of the ECC decisions to date. In the first ECC, In the Matter of Fresh Chilled, or Frozen Pork from Canada[30], the Committee stated: "As its name suggests, the extraordinary challenge procedure is not intended to function as a routine appeal. Rather the decision of a binational panel may be challenged and reviewed only in "extraordinary" circumstances. While the legislative

history of the extraordinary challenge committee mechanism is lacking in specifics, it is clear that the extraordinary challenge procedure is intended solely as a safeguard against an impropriety or gross panel error that could threaten the integrity of the binational panel review process...Notably, the legislative history states that an extraordinary challenge committee is intended as a review mechanism for "aberrant panel decisions" and that "the availability of or resort to extraordinary challenge committees should act to cure aberrant behavior by panelists".[31] The Committee gave further reasons, "As the procedural rules state, an extraordinary challenge committee is composed of three judges or former judges of a federal court of the United States or of a court of superior jurisdiction of Canada. The challenge committee's function is to determine whether a panel or panel member violated the three-prong standard of the extraordinary challenge procedure. In contrast, a binational panel is composed of five individuals with expertise in international trade law. The panel members' function is to review the record evidence and the trade law issues that have been raised before the competent investigating authority. The committee and the panel have separate roles and different expertise; it is not the function of a committee to conduct a traditional appellate review regarding the merits of a panel decision. Another important procedural distinction and indicator of differences in review functions between the panel review mechanism and the extraordinary challenge mechanism is the disparate amount of time allotted to the two tribunals for review. Under the procedural rules, an extraordinary challenge committee typically is given only 30 days to issue a written decision, whereas a binational panel generally is given 315 days to issue a decision."[32] The issue was also addressed by the second ECC in the Live Swine case: "The ECC should be perceived as a safety valve in those extraordinary circumstances where a challenge is warranted to maintain the integrity of the binational panel process....The ECC should address systemic problems and not mere legal issues that do not threaten the integrity of the FTA's dispute resolution mechanism itself. A systemic problem arises whenever the binational panel process itself is tainted by failure on the part of a panel or a panellist to follow their mandate under the FTA."[33]

III. The Pork Cases

The "pork cases" actually include a number of panel determinations, the specific details of which will not be outlined in this article. These cases can be divided for our purposes into two categories,the Fresh Chilled and Frozen Pork from Canada (Fresh Pork Case), and the Live Swine from Canada (Live Swine Case). Each of these cases involved panel reviews of CVD determinations by Commerce as well as findings of material injury by the ITC. Each of the cases involved multiple remands, and each of the cases resulted in an appeal to the ECC.

These cases have exposed possible weaknesses in the AD and CVD dispute settlement provisions, and have exerted considerable pressure on the system, severely

testing the commitment of the Parties to it. They have received a great deal of publicity especially in Canada, where the analogy of the "mouse in bed with the elephant' still strikes a resonant chord. To be fair, we may attach too much significance to the events in the pork cases. It has been stated of these cases, "the issues were complicated, even for experts: the texts were lengthy; the proceedings were confusing; and the mix of economics, politics, and law are difficult to sort out."[34]

A. The Fresh Pork Injury Case

"This case was the first in which a panel established under the CFTA had to construe a U.S. statute that had not been construed previously."[35]

The facts of the Fresh Pork (Injury) Case may be summarized as follows:

1. The ITC determined that the U.S. industry was threatened with material injury by reason of subsidized pork imports from Canada.
2. This decision was appealed by Canadian producers and provincial governments.
3. The Chapter 19 panel unanimously found that several of the ITC's findings "rely heavily or flow directly from faulty use of statistics".[36] The Panel remanded the determination to the agency, which re-opened its record, and "attempted to strengthen the basis for its findings and then re-issued the same decision".[37]
4. The Canadian parties requested another panel review. This panel decision stated "the ITC's record has been combed not once but twice in the search for substantial evidence of material injury". The panel found that a threat of material injury was not supported by substantial evidence. The case was once again remanded to the ITC.
5. The ITC then reversed its decision, stating that it was required to do so by the panel decision.

In the final stages of this case it became apparent that "the traditional courtesies of international dispute settlement, which had on the whole been observed in the earlier phases of the pork case and in all of the other cases under Chapter 19 were beginning to wear thin."[38] The situation continued to deteriorate. Professor Lowenfeld describes the acrimonious tone of the Commissioners of the ITC in the remand from the second panel decision as follows: "...And so on for more than thirty pages, full of statements referring to the panel's "preordained outcome," "counter-intuitive, counterfactual, and illogical, but legally binding conclusion," "deliberate misunderstanding of the Commission's view," "woeful lack of knowledge", "egregious intrusion into the factual decision-making authority of the Commission"

"impermissible reweighing of the evidence etc."[39] It must be observed, however, that these views were limited to two commissioners and for this reason may not represent an on-going problem provided that this attitude is not take up by their fellow Commissioners. Informed observers, however, view these developments with concern. "Although the ITC reversal in the Pork (injury) case indicates that the U.S. government honoured its commitment under FTA article 1904.9 to be bound by the decisions of Chapter 19 panels, its statements and actions suggest that it was doing so reluctantly. In the majority opinion on the second remand, Commissioners Ruhr and Newquist repeatedly criticized the "panel's decision and warned that the decision would not impact their future practice. The U.S. Government, at the urging of the ITC, requested an extraordinary challenge committee to review the panel's second remand to the ITC."[40]

B. The ECC Decision in the Fresh Pork (Injury) Case

The ECC, comprising two retired Canadian judges and one retired United States judge, made a unanimous decision that the three-pronged requirement for review "provides explicit, narrow grounds for extraordinary challenges and makes clear that an extraordinary challenge is not intended to function as a routine appeal."[41] The ECC stated that "the allegations do not meet the threshold for an extraordinary challenge."

It is generally acknowledged that political pressure was a factor in the decision to bring an extraordinary challenge in this case. Consider the comments of Horlick & deBusk writing in 1992: "Political pressure played a major role in the Pork Case because the deadline for the U.S. Trade Representative's decision to invoke the ECC process fell at the same time Congress was deciding whether to extend fast-track legislation for an additional two years."[42] At the relevant time, the US Trade Representative received a number of multiple signature letters from "approximately 90 members of Congress encouraging her to request an ECC. The implicit message of the letters was that support for fast-track extension was dependent on a request for an ECC".[43]

A Canadian perspective is provided by Professor William Graham, who wrote,"an examination of the recent Pork cases sends out conflicting signals, some worrisome, some encouraging, about the way the system is working. Dissatisfaction in the U.S. led to the use of an ECC procedure..." There are several concerns about the use of the procedure in this case. As there was no suggestion of corruption or bias or a failure to observe natural justice before the tribunal, there is a real fear in Canadian quarters that the use of the procedure in these circumstances, relying on the excess of jurisdiction test, is an attempt by Americans to have an appeal procedure

introduced into the system. Lawyers familiar with arbitration will know all too well how attempts are made to challenge arbitration awards before the courts when the real motive is that one does not like the result. If there is regular recourse to such a procedure it will introduce expense, complexity and delay, which will in themselves, constitute non-tariff barriers which the agreement sought to eliminate.... It also politicizes an area which was suppose to be depoliticized."[44]

C. The Live Swine (Subsidy) Case

Canadians, lulled into thinking that the extraordinary challenge issue may have been settled by the Fresh Pork Case had a sudden awakening brought on by the Live Swine affair. In this case Canadian and provincial governments and producers brought a Chapter 19 appeal against a finding by Commerce of subsidies on Canadian live swine exported to the U.S. The first panel decision was released May 19, 1992 and affirmed the agency in part and remanded the case in part. The agency confirmed its prior decision and a second panel review was held. In its second decision, released October 30, 1992 the panel again affirmed Commerce's determination in part and remanded in part. In response to the second determination on remand in which Commerce continued to find subsidies, the panel issued an order on December 27, 1992 affirming its second determination on remand. In the final remand, the Commerce Department criticized the panel reviewing its final decision in the fourth administrative review of Live Swine from Canada and announced that Commerce would not adhere to it in any other cases.[45]

On January 21, 1993, in the very early weeks of the Clinton administration, the USTR filed a request for an ECC.[46] Again political pressure, this time, the need to satisfy powerful critics who might unpede the passage of implementing legislation for NAFTA was, certainly from the Canadian perspective, a factor in the decision to bring the challenge.

D. The Decision of the ECC in the Live Swine (Subsidy) Case

Once again, the ECC upheld the decision of the panel. The ECC stated in its reasons,"The FTA provides a three-prong test....A panel decision must reflect gross misconduct or bias, a serious departure from fundamental rules, and manifest excess of a panel's authority and jurisdiction to be over turned. The ECC cannot become an appeal forum for every frustrated participant in the binational panel process" the Committee stated. The ECC described the task before it;" to determine whether the panel accurately articulated the scope of review and... whether it has been conscientiously applied." The ECC found that the binational panel had correctly cited

the standard of review and that the USTR had not persuaded it "that the panel failed to apply the properly articulated standard of review".[47]

The result of the second ECC decision was to encourage those who thought that the strongly worded decision would convince American pork producers and other like-minded industry associations that a Chapter 19 panel decision properly arrived at is final and binding upon the parties. Sanguine comments were written, e.g. "Most commentators agree that the outcome of the *Pork* case has strengthened the integrity of the binational panel system. In precluding the use of the extraordinary challenge procedure as a means of "routine appeal" the decision both reinforced the authority of the panels and limited the potential for political interference in the panel process. Given this strong precedent, there is no reason to suspect that the procedure will be employed any differently under NAFTA.[48]

IV. The Softwood Lumber Cases

Although the writer would like to echo this optimism expressed after the second pork ECC, recent developments in the trade relations between the two contracting parties to the CFTA raise serious questions. Will the dispute resolution settlement provisions receive sufficient support to ensure their efficacy at times when they are most needed? An affirmative answer is fundamental to the long-term viability of the any trade agreement. Perhaps the optimism voiced after the ECC decision in the first pork case is premature. Are we now in a period in which patience alone is required or do we also require vigilance (on the part of those familiar with the process)? Can we provide more effective education of the general public as to the so-called "arcane" intricacies of international dispute settlement? It is this writer's opinion that all three are necessary: patience to allow for the industries most affected by liberalization of trade rules to come to terms with change; vigilance to ensure that permanent damage is not inflicted on the new institutions in the interests of short-term political gains; and education of legislators, lobbyists and lay people through a wider dissemination of approachable information as to the dispute settlement provisions of the CFTA/NAFTA and their place in developing global trade agreements.

A. The History of U.S.-Canada Softwood Lumber Controversy

This has been a troublesome area for the two Parties to the CFTA for several decades, largely due to the difference in the two countries' methods of assessing timber cutting costs which in the U.S. are established in advance by bidding on timber rights and in Canada by payment of stumpage fees to the provincial governments which own the timber rights. The situation was particularly volatile in the 80's. In 1986 the two countries entered into a Memorandum of Understanding (MOU) in which Canada

(under threat of countervailing duties) agreed to impose a 15% export levy on its own industry.

"In 1991, the Government of Canada in conjunction with four provincial governments,[49] undertook a joint study of the provincial stumpage systems, applying a methodology employed in certain instances by the U.S. Forest Service. The Joint Study was said to have demonstrated that stumpage revenues in all four of these provinces exceeded the provinces' costs of administering their stumpage systems. On this basis, Canada concluded that the MOU had served its purpose and gave notice to the United States on September 3, 1991 that it intended to exercise its right to terminate the MOU effective October 4, 1991. On October 4, Canada ceased to collect the export charges provided for in the MOU."[50] The result was the current spate of softwood lumber cases, which like the Pork cases can be divided into a subsidy phase and an injury phase.

B. The Softwood Lumber (Injury) Case

A final injury determination in this case was made by the ITC on August 5, 1992. Canadian and provincial governments and Canadian producers requested a review of the determination. The panel's unanimous decision released on July 26, 1993, found fault with the ITC's conclusions and remanded the determination to the agency for further action.[51]

The ITC filed its second determination on October 25, 1993 and the panel having reviewed it, again remanded the matter to the ITC on January 28,1994.[52] On March, 14, 1994, the ITC released its decision in which the five commissioners divided 3:2, the majority affirming that the U.S. softwood industry is materially injured by imports from Canada. Chairman Newquist and Commissioner Ruhr "levelled a critique of the binational panel's remand determination. They found the record was sufficient to conclude that the domestic industry is currently experiencing material injury, *even if forced to concede that the evidence on the record did not indicate a cause and effect relationship between the Canadian imports and the price of softwood lumber in the United States*. On the basis of their conclusion that no cause other than the Canadian imports fully explains the injury to the industry, they affirmed the commission's previous material injury finding."[53] This sort of reasoning in the absence of adequate supportive evidence does not bode well for the future of the Ch. 19 dispute settlement system, although once again, it is Commissioners Ruhr and Newquist who express these views so vehemently. The two dissenting members of the ITC, Commissioners Watson and Nuzum did not find sufficient evidence to support a material injury finding.[54] The panel will now have up to 90 days to review the ITC's determination. The scenario is depressingly similar to that of the pork cases. This

similarity is carried still further when we observe the situation with respect to the Softwood Lumber, Subsidy Phase.

C. The Softwood Lumber (Subsidy) Case

On May 28, 1992, Commerce published its Final Determination that the stumpage systems of the four provinces in question had conferred a subsidy on softwood lumber exports...and assessed a "country-wide" weighted average rate of 6.51% on softwood lumber exports from all provinces and territories under investigation.[55] A panel was convened pursuant to the CFTA on July 29, 1992 and on May 6, 1993 the panel unanimously issued remand instructions to the agency (Commerce).[56] Commerce issued its Determination on Remand on September 17, 1993, in which it affirmed its previous determinations concerning both stumpage and log export restraints, and increased the applicable country wide rate from 6.51% to 11.54% ad valorem.[57] The panel's decision of December 17, 1993 raises some interesting issues. The majority of the panel, the three Canadians, concluded the following:

1. That Commerce has failed to provide a rational basis for its conclusion that provincial stumpage programs are specific.[58]
2. That Commerce's finding that provincial stumpage programs distort the normal competitive markets for softwood lumber is not supported by substantial evidence.
3. That Commerce's determination that the log export restraints imposed by British Columbia confer a benefit on a specific industry is unsupported by evidence on the record.

The minority, which dissented from all three conclusions, comprised the two American members of the panel. Perhaps the most important observation about this decision is that it represents the first time that the decision of a panel has split clearly along national lines. This is particularly significant given the comment of the two dissenting American panelists that , "We believe that the Majority's formulation of the standard of review is incorrect in a number of critical points and that it leads the Majority into a misconceived exercise that clearly exceeds its jurisdiction."[59] The dissenting panelists, Pomeranz and Reisman, go further and state, "the Majority has failed to keep that second prong, viz. United States law governing this matter, in focus and as a result has conducted a defective review: the Majority has applied review standards not to U.S. law, but to what the Majority believes U.S. law should be. In our view, the governing legislation and rules in this case, the Tariff Act and the Proposed Regulations, are clear in their terms and their proper application to this case, but they have been materially misconstrued by the Majority of the Panel.[60]

Commerce issued its determination after this remand on January 6, 1994, "grudgingly accepting a Canada-U.S. Trade Panel decision that punitive tariffs... be removed."[61]

On April 7, 1994, the United States announced an extraordinary challenge against the ruling on the grounds that the three Canadian members of the panel had exceeded the bounds of the panel's authority by deciding that neither of the subsidy programs...at issue were countervailable, and also that two of the three Canadians failed to disclose that they worked for legal firms whose clients included lumber companies and the Canadian government.[62]

Many Canadians have seen this action as yet another attempt to convert the extraordinary challenge provisions into a normal appellate forum. Before joining in this conclusion too hastily, there are several factors which must be considered. The first is the actual wording of the provision for the extraordinary challenge. *"Where,... an involved Party alleges that"....that party may avail itself of the extraordinary challenge procedure set out in Annex 1904.13.* Note that the wording is not "where it can be demonstrated that", or "where there is evidence of" or other wording that would suggest an objective test as to whether the extraordinary challenge procedure is available. Instead we have a clearly subjective test, which imposes no limitation upon the circumstances in which a Party may make an allegation under these provisions. Thus Canadian observers should not be so surprised when extraordinary challenges are brought, even in circumstances which do not appear to meet the three-pronged test which will be applied by the ECC.

Also worth noting is the fact that a private party cannot itself invoke the ECC process. It must be a Party which makes the allegations. This provision should result in some control over the frequency of extraordinary challenges as a party cannot initiate a challenge but is required to convince its own government of the appropriateness of a challenge. In the case of the Softwood Lumber (Subsidy) Case these private interests have been armed with potent ammunition in the remarks of the two American panelists.[63]

V. Conclusion

An assessment of the success of the AD and CVD dispute settlement provisions of Chapter 19 of the CFTA provides some cause for optimism together with some misgivings.Does our experience so far augur well for the similar provisions of NAFTA? On the positive side there is considerable agreement that the panels have performed well, viz,"...CFTA Chapter 19 panels , on the whole , have demonstrated a

high degree of conscientiousness and professionalism. Counsel appearing before Chapter 19 panels routinely face panelists who are exceptionally well prepared. Panel decisions frequently include detailed analyses of the relevant law of the importing Party and careful discussions of the facts. Opinions typically reflect a diligent effort on the part of the panelists to apply the law fairly and correctly. Indeed, some of the most thoughtful discussions of difficult issues to appear anywhere–for example, specificity–are found in opinions of CFTA binational panels."[64] These comments are echoed by Professor Huntington. "Experience under the Canada-U.S. FTA suggests that panels will function effectively in resolving particular disputes. The Canada-U.S. panels have generally issued their decisions in a timely fashion, and as Professor Lowenfeld points out, these decisions have been of high quality..."[65] Professor Huntington reiterates the comments of Professor Lowenfeld, who wrote in 1991, " The panelists have been thoughtful; their opinions have been thorough and articulate, and their conclusions on the whole persuasive....One could not detect a bias in favor of protectionism or unrestricted trade. While the panels have differed from one another, no "Canadian approach" or "American approach" has emerged."[66]

To these hopeful comments must be added, some cautionary remarks. One concern relates to the conclusion that there does not appear to be any bias based upon the nationality of the panelists. Professor Lowenfeld's remarks were accurate at the time they were made. It is only recently, in the Softwood Lumber (Subsidy) Case, that a "national" split has been discernible. As recently as February of 1993, commentators Horlick & deBusk could state, "Moreover, there has been no correlation between the nationality of the FTA panelists and the result. In the Fresh Chilled or Frozen Pork from Canada decision on injury, U.S. panelists sided with Canadian panelists in reaching a unanimous decision against the ITC."[67]

Professor Huntington echoes this opinion, stating "(e)xperience under chapter 19 of the Canada-U.S. FTA suggests that the citizenship of panelists will not pose a problem of partiality."[68] He cites a study of chapter 19 cases between January 1989 and July 1991 which found no discernable correlation between the nationality of panelists and the result.[69] It is too early to say whether the Softwood Lumber (Subsidy) Case is an exception to the many cases which have preceded it or whether it signifies the beginning of a new acrimony to be reflected in Chapter 19 decisions.

The other factor which must concern the observer of the Chapter 19 process is the possibility of too frequent resort to an extraordinary challenge to prevent or postpone acceptance of unpalatable decisions. It may be prudent in this context to heed the remarks of Professor Lowenfeld, "I was worried that Chapter 19 of the FTA might go the way of the World Bank *Convention on the Settlement of Investment Disputes between States and Nationals of Other States*-- which has been seriously undermined by repeated resort to a procedure for annulment of arbitral awards that

was intended as a safety valve for gross violations of due process but has come to be used by dissatisfied litigants as a device for delay and repeated appeals."[70] "On the other hand, the issue may well dissipate as Chapter 19 proceedings become more routine and the jurisprudence of extraordinary challenge committees is established. Agency resistance to Chapter 19 panel review may prove to have been an unsurprising growing pain occasioned by a significant innovation in bilateral dispute resolution. If such growing pains persist, however,they will present an issue that goes to the heart of the Chapter 19 binational panel process."[71] The same author states further, "One of the dramas of the NAFTA will be played out on this stage of extraordinary challenge provisions. Unlike Chapter 19 panels themselves, which must operate within the general confines of the existing, applicable domestic law, challenge committees construing and applying article 1904(13) are fashioning a new jurisprudence. That strain of case law will undoubtedly affect how the Chapter 19 panel process will function. If extraordinary challenge committee decisions continue to limit recourse to extraordinary challenges to truly extraordinary abuses of the Chapter 19 panel process, then the arbitral model of nonreviewable dispute resolution will remain intact."[72] The writer agrees with these remarks. This is why the upcoming decision of the ECC in the Softwood Lumber (Subsidy) Case is so important and why a possible challenge in the other phase of the Softwood Lumber case is of such concern to Canadians.

It is not surprising that Canadians appear to be more concerned about any indications that the dispute settlement provisions of Chapter 19 might breakdown. As the much smaller Party to the CFTA, Canada viewed the Chapter 19 dispute settlement provisions as fundamental to its participation in the agreement. It has been said of NAFTA that there is a need for candour in assessing the pros and cons of the agreement.[73] Such candour should also be applied to dispute settlement under Chapter 19. The Parties have established a regime where the final say on AD and CVD duties now lies with a supra-national body. Are the citizens of the Parties able to accept this or have national policy makers moved too far down the path of international agreement with its concomitant limitation of sovereignty? This can result in the Parties creating a situation where they cannot honour their international commitments without losing too much political support domestically. The tensions which are created and the inconsistency of statements and actions are all too understandable in this context.

This situation will only be exacerbated under NAFTA. "...(P)anel members will be navigating the jurisprudence of another country and possible relying on their host country colleagues on the panel...In the case of the NAFTA panels involving Mexico, panelists will be required to bridge even wider cultural and legal gaps. Unlike both Canada and the United States, Mexico is a civil law country, not a common law country. In addition, Mexico does not have the trade law history and experience of either the United States or Canada. Language differences will present new challenges

generally not encountered in CFTA proceeding. In these respects NAFTA panels will face new complications."[74]

It is interesting to note that the Joint Working Group on Dispute Settlement established by the American Bar Association, the Canadian Bar Association and the Barra Mexicana do not appear to have any serious concerns with respect to Chapter 19 Procedures. "A major recommendation of the Joint Working Group was the maintenance of the FTA Chapter 19 procedures in relation to antidumping and countervail measures. These have, in fact, been retained and expanded to deal with the three party format. This system is well known and need not be reviewed here. The Working Group was strongly of the opinion that this mechanism be retained and is most content that this has been done."[75]

In appraising the success or failure of these provisions, we should not lose sight of the fact that Chapter 19 was drafted as an interim measure for the period in which the Parties were negotiating common rules for governing dumping subsidies.[76] We are also dealing with the legal systems of three different countries. It is important that we do not judge these provisions too harshly. What is most important at this stage, is that interested observers in all three Parties are convinced on balance, that the system is operating fairly and that "justice is seen to be done". If this is the case the system should survive and support the ongoing trading relationship of the Parties.

ENDNOTES

1. Canada - United States Free Trade Agreement, entered into force January 1, 1989. H.R. Doc. No 216, 100th Cong., 2d Sess. 2977 (1988), reprinted in 27 I.L.M. 281 (hereinafter CFTA).

2. North American Free Trade Agreement, entered into force January 1, 1994, reprinted 32 I.L.M.605 (hereinafter NAFTA).

3. Id. Chapter 20.

4. Id. Article 2004.

5. The NAFTA refers to the three contracting countries as "Parties", whereas participants in a Chapter 19 panel proceeding are "parties".

6. Moyer, *Chapter 19 of the NAFTA: Binational Panels as the Trade Courts of Last Resort*, 27 INT'L LAW 707,707 (1993).

7. NAFTA, supra note 2, Article 1902(1).

8. Id., Article 1904 (1).

9. Id., Article 1904(2).

10. Id., Annex 1911.

11. Id., Article 1904(8).

12. Id., Article 1904 (2).

13. Id., Article 1904(3).

14. Moyer, supra note 6, at 707.

15. NAFTA, supra note 2, Annex 1901.2.

16. CFTA, supra note 1, Annex 1901.2(1).

17. NAFTA, supra note 2, Article 1901.2(2)(3).

18. Id., Article 1904(5).

19. Huntington, *Settling Disputes under the North American Free Trade Agreement*, 34 HARV. INT'L J. 407,431 (1993).

20. NAFTA, supra NOTE 2, Article 1904(14).

21. Moyer, supra note 6 at 717, notes 46 and 47.

22. NAFTA, supra note 2, Article 1904(9).

23. Id., supra, Article 1904(11).

24. Lowenfeld, The Free Trade Agreement Meets its First Challenge: Dispute Settlement and the Pork Case, 37 McGill L.J. 597,613 (1992).

25. NAFTA, supra note 2, Annex 1904.13.

26. Id., Article 1904(13).

27. Id., Article 1904(13).

28. Testimony of M.J. Anderson, chief counsel for International Trade, U.S. Dept. of Commerce Subcommittee on Courts, Civil Liberties and the Administration of Justice of the Committee on the Judiciary, U.S. H.R., 100th Cong., 2d Sess. 69 at 75(1988).

29. Moyer, supra note 6 at 724.

30. ECC-91-1904-01 USA.

31. Ibid. at 8.

32. Ibid. at 12.

33. In the Matter of Live Swine from Canada, ECC-93-1904-01 USA at 7.

34. Lowenfeld, supra note 24 at 599.

35. Id., at 602.

36. USA-89-1904-11.

37. Horlick & deBusk, Dispute Resolution Panels of the U.S. - Canada Free Trade Agreement: The First Two and One-Half Years, 37 McGill L.J. 574,586 (1992).

38. Lowenfeld,supra note 24, at 617.

39. Id., at 616.

40. Horlick & deBusk, supra note 37 at 587.

41. ECC-91-1904-01 USA.

42. Horlick & deBusk, supra note 37 at 588.

43. Id., at 588.

44. Graham, *Dispute Resolution in the Canada-United States Free Trade Agreement: One Element of a Complex Relationship*, 37 McGill L.J. 544,571 (1992).

45. Moyer, supra note 6 at 720.

46. USA-91-1904-03.

47. Id.

48. Huntington, supra note 19 at 437.

49. Alberta, British Columbia, Ontario and Quebec.

50. USA-92-1904-01, Decision of the Panel, May 6, 1993, at 5.

51. USA-92-1904-02, Decision of the Panel, July 26, 1993.

52. USA-92-1904-02, Decision of the Panel, Jan.28, 1994.

53. CCH NAFTA Watch, Vol.1, No.5, Mar. 30, 1994 at 3.

54. Id. at 3.

55. USA-92-1904-01, Decision of the Panel, May 6, 1993 at 10.

56. USA-92-1904-01, Decision of the Panel, Dec. 17, 1993 at 11.

57. Id., at 6.

58. *Specificity* is one of the tests applied by the Department of Commerce. Once a determination of subsidy is made, it must then be determined whether the subsidy meets the specificity test. This occurs only where the preference is granted to a group narrower than the whole population.

59. USA 92-1904-01, Dissent at 6.

60. Id., at 7.

61. Toronto Globe & Mail, Jan. 8, 1994 at 10, col. 1.

62. Financial Post, April 7, 1994 at 1, col. 2.

63. Id. at 12.

64. Moyer, supra note 6 at 722.

65. Huntington, supra note 19 at 435.

66. Lowenfeld, *Binational Dispute Settlement Under Chapter 19 of the Canada-United States Free Trade Agreement: An Interim Appraisal*, 24 Int'l L. & Pol. 269, 334 (1991)

67. Horlick & deBusk, *Dispute Resolution Under NAFTA*, 27 J. WORLD TRADE 21,31 (1993).

68. Huntington, supra note 19 at 432.

69. Id., see note 177.

70. Lowenfeld, supra note 24 at 620.

71. Moyer, supra note 6 at 721.

72. Id., at 724.

73. Alford, *Introduction: The North American Free Trade Agreement and the Need for Candor* 34 HARV. INT'L L.J. 293 (1993).

74. Moyer, supra note 6 at 714.

75. Report of Joint Working Group of the American Bar Association et al, 34 HARV. INT'L L.J. 831,834 (1993).

76. The CFTA required the Parties to establish a formal Working Group to address the issue of harmonization and provided that failure to implement a new regime within seven years would allow either Party to terminate the Agreement. (CFTA Article 1906) NAFTA is less stringent, simply requiring the Parties to consider the "potential" to develop substitute measures. (NAFTA Article 1907-2).

RELIEF FOR MINORITY SHAREHOLDERS- THE NEW YORK SOLUTION*

by

Peter M. Edelstein**

Introduction

When teaching "corporations," have you ever felt that there was a larger than usual disparity between the subject as taught and the probable future experiences of our students? The classic features of a corporation--limited liability, perpetual duration, ease of transferability of interest, and centralized management, seem so remote from the intimate, close corporations many of our students are likely to deal with.

After graduation, A. Abbie, in the front row, B. Benny, who sits behind her and C. Cindy in the back, may form "ABC Cookie Corp.", to exploit C. Cindy's recipe for chocolate chip cookies. They will invest their life's savings, devote all of their time and efforts to the success of the venture, and dream of lifetimes of happy employment including handsome compensation packages, bonuses and benefits. They may even look forward to the day they will sell their interests, retire to Hawaii and be remembered as the latest incarnations of "Famous Amos."

They will each be shareholders, board members, and officers. They will probably not conduct regular board meetings, have annual shareholder's meetings,

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keep minutes, nor observe any but the minimum corporate formalities; and those only when threatened by their lawyer or accountant.

To these three individuals, the classic corporate features we taught them are mostly irrelevant. As to perpetual duration, they know that they can dissolve the corporation at any time and, if they are not good corporate citizens, the state may dissolve it for them. As to ease of transferability of their interests, they are concerned with the opposite--restricting the transfer of shares, and they will probably execute a shareholder's agreement to that effect. As to centralized management, they each have the powers and rights of shareholders, officers and directors, but are not really sure what the differences are, or why they exist, because they do everything together anyway.

A. Abbie, B. Benny and C. Cindy probably consider themselves to be "partners." The corporate form of business may have been selected only for its supposed insulation from personal liability. But even that attribute is mostly imaginary today in matters of contract liability to lending institutions, landlords and major vendors, due to the routine requirement of personal guarantees.

ABC Cookie Corp. may operate harmoniously for years, with the individuals making all business decisions by persuasion of the majority. When, however, A. Abbie and B. Benny get married, and pool their interests to consistently polarize the two of them on one side of each issue and C. Cindy on the other, C. Cindy could suffer dramatically. Now, governance by the majority means that C. Cindy has no effective voice. If the relationship deteriorates to the point that C. Cindy is no longer able or allowed to participate in the business of the corporation, she may experience the loss of her employment, the loss of her compensation, the loss of any return on her investment and the loss of all of her reasonable expectations for her future. A bad novelist might say that "all of her dreams were shattered."

Just as we, as instructors, sense that most of our students will not become CEO's of large, publicly traded corporations (and that, therefore, lectures relating exclusively to such corporations may not be entirely relevant to their business future), the legislature and the courts of the State of New York have acknowledged that shareholders in close corporations have special needs.[1]

New York recognizes the practical difference between being a shareholder in a large publicly held corporation and being a shareholder in a close corporation, particularly in instances of shareholder oppression. All shareholders may pursue the traditional remedies of direct or derivative actions against the corporation and the

board of directors to remedy perceived wrongs. Shareholders in publicly traded corporations also have the ability to become instantly liquid. The aggrieved shareholder can dispose of his or her shares by selling them for market value through a stock exchange or stock market transaction. To shareholders in a close corporation, instant liquidity may not be available and the other remedies may not be practical. This paper discusses the statutory cause of action for "oppression" by the corporate majority against the minority, what behaviors constitute oppression and two defenses recently raised by a defendant-majority shareholder in an oppression case in New York County.

A Cause Of Action For Oppression

The New York legislature, in 1979, reacting to section 97 of the ABA-ALI Model Business Corporation Act (1972 ed.) and to the statutes already passed in twelve other states,[2] adopted Business Corporation Law section 1104-a[3] to afford certain protections to minority shareholders, in closely held corporations, who were oppressed by the majority.

BCL section 1104-a (and its corollary, BCL section 1118)[4]."... created remedies for minority shareholders of close corporations and may be considered legislative recognition of the fact that the relationships among shareholders of such corporations closely approximated that among partners."[5] Section 1104-a(a) offers to minority shareholders of close corporations the weighty remedy of involuntary dissolution. It provides, in relevant part:

> "The holders of twenty percent or more of all outstanding shares of a corporation...no shares of which are listed on a national securities exchange or regularly quoted in an over-the-counter market...who are entitled to vote in an election of directors may present a petition of dissolution on one or more of the following grounds: (1) The directors or those in control of the corporation may have been guilty of illegal, fraudulent or oppressive actions toward the minority shareholders..."[6]

"Oppression" is not defined in the BCL. Professor F. Hodge O'Neal, an authority on "squeeze-outs" of minority shareholders, formulated a test for "oppression" which was included in the legislative materials of the statute's cosponsors in 1979.[7] In describing the need for such a test, Professor O'Neal stated:

> "Many participants in closely held corporations are `little people,' unsophisticated in business and financial matters. Not uncommonly a participant in a closely held enterprise invests all his assets in the business with an expectation, often reasonable under the circumstances even in the absence of an express contract, that he will be a key employee in the company and will have a voice in business decisions."[8]

The "reasonable expectations" test has been the benchmark for determining oppressive actions from the first New York case, in 1980, to deal with BCL section 1104-a,[9] and has been described as follows: A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there is no effective means of salvaging the investment.[10]

In the seminal case of In the Matter of Topper,[11] the Court found "oppression" by the controlling shareholder, based on the following facts: "...[B]usiness...flourished in the brief one-year period during most of which Petitioner Topper has actively participated," [12] "...Petitioner Topper associated himself with [the other two shareholders and the corporations] in the expectation of being an active participant...,"[13] "Petitioner put his life savings into the venture."[14] [Petitioner] executed personal guaranties..."[15] "...[T]he majority shareholders...discharged petitioner as an employee, terminated his salary...removed him as an officer...and changed the locks on the corporate offices to exclude him."[16]

The Court held, based on the foregoing facts: "...[R]espondent's actions have severely damaged petitioner's reasonable expectations and constitute a freeze-out of petitioner's interest; consequently, they are deemed to be `oppressive' within the statutory framework."[17]

Since the Topper decision, the courts of New York have consistently found "oppression" within the meaning of BCL section 1104-a by application of the "reasonable expectations" test. Minority shareholders have been granted relief from the oppression of the majority in the following circumstances:

• Petitioner, a thirty-five percent shareholder, was expelled from any role in the corporation and removed as an officer and a director.[18]

• Petitioner, a one-third shareholder with two other shareholders, was frozen out of active operations of the corporation. There existed no shareholder's or any other written agreement with respect to the operation of the corporation, there were no bylaws and many organizational formalities were ignored.[19]

• Petitioners, both long term employees (one for forty-two years, the other for thirty-six years) had invested capital in the corporation. After leaving, they were "frozen out." Their experience had been that when with the company they received distributions of the company's earnings. After they left, they received nothing. The court held: " When the majority shareholders of a close corporation award *de facto* dividends to all shareholders except a class of minority shareholders, such a policy may constitute `oppressive actions' ..."[20]

• Petitioner, actively engaged in family business, was discharged as an officer and employee (of all the family corporations), locked out of the building and threatened with criminal prosecution if he trespassed on any of the corporate properties.[21]

• Petitioner joined the corporate venture pursuant to an understanding that he would be provided with salaried employment to continue as long as the corporation existed; his salary was terminated.[22]

• Petitioner-employee, a twenty-five percent shareholder and employee of a family-owned corporation was terminated, was denied entry to the corporate office by use of a padlock and was denied further salary and dividends.[23]

• Petitioner, a one-third shareholder and employee, was suspected of: expense account irregularities, making generous "gifts" to clients, double-billing the corporation for the same expense, holding himself out to be the president (which he was not), and engaging in a side business (which may or may not have been in competition with the corporation). He was terminated, the locks were changed, he was removed as an officer and director.[24]

In all of the foregoing illustrations, the common theme was the conduct of the majority that substantially defeated the expectations of the minority that were reasonable under the circumstances. The disappointment of the minority shareholders constituted oppression.[25]

Dissolution Or Buy-out

Section 1104-a, by its terms, affords the "oppressed" shareholder with a cause of action for involuntary dissolution. This may or may not be a satisfactory remedy under the particular circumstances. However, when the oppressed minority shareholder combines the threat of dissolution with BCL section 1118, a weapon of substantial practical utility is created.[26] That section provides a court sanctioned mechanism for dispute resolution far broader than an order for dissolution alone. In all but the most unusual circumstances, the minority shareholder wants to be free from the oppressive majority, to cash out, and to be able to invest and work elsewhere. The statutory remedy of dissolution under section 1104-a alone, may not provide the shareholder with the means or the opportunity to pursue his or her chosen career. The lawsuit may continue for years, and the book value of the shares may decrease during the process of litigation due to the distraction of management and the costs involved.[27]

Section 1118, entitled "Purchase of petitioner's shares; valuation.", provides in relevant part:

> "(a) In any proceeding brought pursuant to section eleven hundred four-a of this chapter, any other shareholder or shareholders or the corporation may, at any time within ninety days after the filing of such petition or at such later time as the court in its discretion may allow, elect to purchase the shares owned by the petitioners at their fair value and upon such terms and conditions as may be approved by the court. (b) If one or more shareholders or the corporation elect to purchase the shares owned by the petitioner but are unable to agree with the petitioner upon the fair value of such shares, the court, upon the application of such prospective purchaser or purchasers, or the petitioner may stay the proceedings brought by pursuant to section 1104-a of this chapter and determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed, exclusive of any element of value arising from such filing..."

The result of these two sections, 1104-a and 1118, is to provide the oppressed minority shareholder with more than just a remedy for involuntary dissolution. Together, they give the shareholder the power to negotiate, with judicial imprimatur, to cause the majority to seriously consider buying out the minority. Failure to do so raises the possibility of forced dissolution or forced purchase of the minority shares, with the court determining the value *as of the date of the petition.*

This additional statutory remedy not only broadens the scope of 1104-a, but effectively changes its nature from a rifle approach to dissolution to a shotgun approach to dispute resolution, which can be used to effectuate settlement of a myriad of shareholder questions.

No Conflict With The Employment At-Will Doctrine

New York retains the doctrine of employment at-will by which an employer, in the absence of an agreement to the contrary, may terminate an employee at any time for cause or for no cause.[28]

An imaginative defendant-majority shareholder, in a case now before the Supreme Court, New York County, In the Matter of The Application of Michael P. Lyons,[29] asserted as a defense, that the existence of the employment at-will doctrine precluded the plaintiff-minority shareholder from alleging "oppression" under section 1104-a. In that case, the controlling shareholder summarily dismissed the petitioner-minority shareholder as an employee and removed him as an officer and director, all without prior notice or warning. The locks on the doors of the corporation were changed and the petitioner-minority shareholder was denied compensation. The theory of the defendant-majority shareholder amounted to an argument that because under New York law, an employee at-will can be terminated at any time, any termination cannot amount to oppression. This defense ignores the gravamen of section 1104-a. The section does not prohibit the termination of the shareholder-employee, but rather, it provides a remedy for the oppression of that shareholder-employee. It is not the loss of the employment *per se* that is central to the spirit of the statute, but the loss of one's reasonable expectations for one's future under the totality of the circumstances.

The courts in New York, weighing the right to terminate an employee against the right of that employee to be free from oppression, have addressed the issue in the form of the relevance of the conduct of the terminated minority shareholder, and have held: "Whether the Controlling Shareholder discharged petitioner for cause or in their good business judgment is irrelevant."[30]

In one case,[31] the petitioner-minority shareholder had stolen from the corporation. The court, in applying BCL section 1104-a, went as far as to pronounce: "Even Cain was granted protection from the perpetual vengefulness of his fellow man (Genesis 4:12-15)... The Court is not without jurisdiction to fashion a remedy here."[32]

In a similar case, the court, applying BCL section 1104-a, cited Topper[33] and held: "...'unclean hands' is not an automatic bar..." to relief under BCL section 1104-a. [34] "Only when a 'minority shareholder whose own acts, made in bad faith and undertaken with a view toward forcing involuntary dissolution, give rise to the complained-of oppression' should relief be barred."[35]

In a recent Putnam County case, referred to above, Judge Dickinson was faced with a petitioner-minority shareholder about whom the controlling shareholder alleged expense account irregularities, the giving of unauthorized "gifts," double-billing, holding himself out as president of the corporation, (which he was not), conducting a "side business" with his brother-in-law and theft of business. The Court citing Topper[36] and similar cases, held: "The...Petitioner may not be prevented from seeking dissolution merely because he is guilty of one or more of the charges made against him."[37]

Corporate Informality Is Not Inconsistent With The Application Of Bcl Section 1104-a

The defendant-majority shareholder, in the Lyons[38] case, also defended on the grounds that the minority shareholder did not have a written employment agreement, nor did there exist records of the corporation to support the claim of oppression; presumably on the theory that a corporation operated in less than text book fashion should be free to oppress its minority shareholders.

The informality with which closely held corporations operate, has long been held not to bar application of BCL section 1104-a. On the issue of formality, as on the issue of oppression, the nature of close corporations has been recognized to be substantially different from large or publicly held corporations.

Professor O'Neal commenting on the application of BCL section 1104-a states: "Not uncommonly a participant in a closely held enterprise invests all his assets in the business with an expectation, often reasonable under the circumstances *even in the absence of express contract*, that he will he a key employee in the company and will have a voice in business decisions"[39] (emphasis added).

The courts in New York have recognized that corporate formalities are frequently ignored in close corporations. In finding for the petitioner, it has been held: "The parties did not enter into any shareholders' or any other written agreement with respect to the operation of the Corporation and many organizational

formalities...do not seem to have taken place prior to the institution of this proceeding."[40]

"The failure to make [the petitioner] a shareholder until April 1974, merely reflects *the informality with which close corporations are frequently run and the informality which [BCL] section 1104-a is intended to* remedy[41] (emphasis added).

Conclusion

The promulgation of BCL sections 1104-a and 1118, and court decisions thereunder, are legislative and judicial recognition that participants in close corporations should not be governed by the classic rules applicable to large publicly traded corporations. Special rules apply to shareholders in close corporations, many of whom view themselves as partners for the purpose of governance, and as shareholders for the purpose of enjoying the real or imagined benefits of limited liability.

Section 1104-a has provided minority shareholders with a serious weapon--the threat of involuntary dissolution. In practice, section 1118 has converted section 1104-a into a powerful tool to provide an equitable resolution to fundamental problems between or among shareholders. By application of the two sections, a negotiated settlement between the minority and the majority is likely to result.

ENDNOTES

[1] National recognition of the disparity between the classic corporate norms and the perceived relationship between or among shareholders in a closely held corporation is evidenced by the recent trend by many states to adopt enabling legislation for a business entity known as the *limited liability company*. This new business unit offers the members a partnership atmosphere in daily operations together with the corporate feature of limited liability. As of this writing, legislation authorizing this modern business creature has been adopted in about twenty states. *See* Jerome Kurtz, The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan, 47 The New York University Tax Law Review 815, (1992).

[2] 2. *See* In the Matter of Myron F. Topper, *et al.*, Petitioner, v. Park Sheraton Pharmacy, Inc., Respondent, 107 Misc. 2d 25; 433 N.Y.S. 2d 359 (1980); *See* Report for the Joint Legislative Committee to Study Revision of the Corporation Laws (Consultant Report, No. RR-70, Joint Legis. Comm. to Study Rev. of Corporation Laws)(1958).

[3] Effective June 11, 1979, pursuant to L. 1979, c. 217, §4.

[4] BCL §1118 "Purchase of petitioner's shares; valuation." Effective June 11, 1979, pursuant to L. 1979, c. 217, §4.

[5] See InThe Matter of Gordon & Weiss, 32 A.D. 2d 279; 301 N.Y.S. 2d 839. The First Department noted "It is being increasingly realized that the relationship between stockholders in a close corporation vis-a-vis each other in practice closely approximated the relationship between partners...," at 281, 842.

[6] BCL 1104-a(a).

[7] See In the Matter of Topper, supra at p. 32, 364 for a discussion of the background of the "reasonable expectations test."; *See* O'Neal, 33 The Business Lawyer 884.

[8] O'Neal, 33 The Business Lawyer 884; *See also* In the Matter of Topper, at page 33, 365.

[9] In the Matter of Myron F. Topper, et al., Petitioners, v. Park Sheraton Pharmacy, Inc., Respondent, 107 Misc. 2d 25; 433 N.Y.S. 2d 359 (1980).

[10] In the Matter of the Judicial Dissolution of Kemp & Beatley, Inc. Seymour Gardstein *et al.*, Respondents; Kemp & Beatley, Inc. Appellant, 64 N.Y. 2d 63; 473 N.E. 2d 1173; 484 N.Y.S. 2d 799 (1984), at p. 72, 1179, 805.

[11] Topper, 107 Misc. 2d 25; 433 N.Y.S. 2d 359 (1980).

[12] *Id* at p. 27, 361.

[13] *Id* at p. 27, 361.

[14] *Id* at p. 27, 362.

[15] *Id* at p. 27, 362.

[16] *Id* at p. 27, 362.

[17] *Id* at p. 27, 362.

[18] O'Donnel v. Marine Repair Services, Inc., 530 F. Supp. 1199 (1982).

[19] Gene Barry One Hour Photo Process, 111 Misc. 2d 559; 444 N.Y.S. 2d 540, (1981)

[20] Kemp & Beatley, at p. 67, 1175, 801.

[21] In the Matter of the Dissolution of Wiedy's Furniture Clearance Center, 108 A.D. 2d 81; 487 N.Y.S. 2d 901 (1985).

[22] In the Matter of John Imperatore, 128 A.D. 2d 707; 512 N.Y.S. 2d 904 (1987).

[23] In the Matter of Robert H. Burack, 137 A.D. 2d 523; 524 N.Y.S. 2d 457 (1988).

[24] Matter of Kupersmith (Caduceus Medical Publishers, Inc. , Supreme Court, Putnam County, NYLJ, Aug. 22, 1991, p.21.

[25] *See* Robert B. Thompson, The Shareholders' Cause of Action for Oppression, 48 The Business Lawyer 699 (1993), for an excellent review of the evolution of the cause of action.

[26] BCL section 1118. Buy-out may be considered a less harsh remedy; *See* Davis v. Sheerin, 754 S.W. 2d 375 (Tex CT. App. 1988).

[27] Not to be taken lightly, as to cost to the minority shareholder, in terms of time and money.

[28] *See* Martin v. New York Life Insurance Co., 148 N.Y. 117, 42 N.E. 416 (1895); for a full discussion of the development of the employment at-will doctrine in New York; *See* Minda, The Common Law of Employment At-Will in New York: The Paralysis of Nineteenth Century Doctrine, 36 Syracuse L. Rev. 939 (1985).

[29] In the Matter of the Application of Michael P. Lyons, a Holder of Forty Percent of All the Outstanding Shares of Elmrich Enterprises, Inc., d/b/a/ The Personnel Source, Petitioner, For the Dissolution of Elmrich Enterprises, Inc. d/b/a The Personnel Source, a Domestic Corporation, Supreme Court, New York County, Index Number 114991/93.

[30] In the Matter of Topper, at p.28, 362.

[31] Robert Gimpel, Plaintiff, v. Moe Bolstein et. al., Defendants; In the Matter of Dissolution of Gimpel Farms, Inc. Robert Gimpel, Petitioner; Moe Bolstein et al., Respondents, 125 Misc. 2d 45; 477 N.Y.S. 2d 1014 (1984).

[32] *Id.* at p. 55, 1021.

[33] In the Matter of Topper, 107 Misc. 2d 25; 433 N.Y.S. 2d 359 (1980).

[34] In the Matter of Fred Gunzberg et al., Respondents, v. Art-Lloyd Metal Products Corp., Appellant, 112 A.D. 2d 423, 424; 492 N.Y.S. 2d 83, 85 (1985).

[35] *Id.* at p. 424, 85, citing Kemp v. Beatley, 64 N.Y. 2d 63, 74. *See* In the Matter of Robert H. Burack 137 A.D. 2d 523, 524 N.Y.S. 2d 457 (1988), at p. 527, 460.

[36] In the Matter of Topper, 107 Misc. 2d 25; 433 N.Y.S. 2d 359 (1980); In the Matter of Kemp v. Beatley, 64 N.Y. 2d 63; 473 N.E. 2d 1173; 484 N.Y.S. 2d 799 (1984); In the Matter of Robert H. Burack, 137 A.D. 2d 523; 524 N.Y.S. 2d 457 (1988); In the Matter of Gunzberg, 112 A.D. 2d 423; 492 N.Y.S. 2d 83 (1985).

[37] Matter of Kupersmith (Caduceus Medical Publishers, Inc.), Supreme Court Putnam County, NYLJ, Aug. 22, 1991, p. 21.

[38] *See* Lyons, supra.

[39] *See* O'Neal, 33 The Business Lawyer, at p. 488.

[40] *See* Gene Barry, supra., at p. 559, 541.

[41] *See* O'Donnel, supra, at p. 1207.

FRONT PAY: AN INAPPROPRIATE REMEDY FOR AGE DISCRIMINATION

by

John McGee*

Successful plaintiffs under the Age Discrimination in Employment Act of 1976 (hereafter referred to as the ADEA)[1] may recover lost pay from the date of termination until trial (back pay) plus the pay they would have received from the date of trial until retirement age (front pay). While courts can easily calculate back pay, including fringe benefits and interest, it has proven far more difficult to accurately calculate front pay. A typical description of front pay as "a lump sum representing the discounted present value of the difference between the earnings an employee would have received in his old employment and the earnings he can be expected to receive in his present and future, and by hypothesis inferior, employment"[2] requires the court to speculate about the amount an employee would have received in the future until some hypothetical retirement date. The difficulty of calculating front pay with any degree of certainty makes such damages an inappropriate remedy in age discrimination cases.

The concept of front pay does not appear in the ADEA itself. The remedies section simply says that civil actions may be brought "for such legal or equitable relief as will effectuate the purposes of this chapter," and "legal and equitable relief ... includes ... without limitation judgments compelling employment, reinstatement or promotion".[3] Thus, Congress has given the courts broad authority to fashion remedies and front pay is the innovative remedial scheme that has emerged. Front pay was first proposed in law review articles which suggested that the usual remedies were insufficient to make whole certain workers who had been victims of discrimination. One author even argued that when reinstatement is not appropriate, the *only* way to make a plaintiff whole is with a front pay award.[4]

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So long as the "normal" retirement age was 65, there were various approaches to implementing front pay that minimized the speculative nature of the calculations. However, in 1986 the ADEA was amended to prohibit mandatory retirement and to eliminate any reference to a "normal" retirement age[5]. With the demise of a fixed retirement age, calculating the proper amount of front pay to award has become a more difficult task for courts and juries and the result has been some very speculative awards.

Reinstatement or Front Pay?

Reinstatement is the preferred remedy in discrimination cases. Courts often state the "rule" that reinstatement should suffice unless there are special factors involved which dictate a resort to front pay, described as a "special" remedy, warranted only by "egregious circumstances."[6] Therefore, it could be expected that front pay awards would be limited to situations involving discord or antagonism in the workplace that would render reinstatement ineffective. Trial courts must consider reinstatement before submitting the issue of front pay to the jury. The trial record in Walther v. Lone Star Gas Co.[7] did not indicate why the district court considered reinstatement impossible and the only evidence was the employer's testimony that it considered the employee a qualified and competent employee capable of resuming work. The Fifth Circuit found the district court's statement that the litigation was "protracted and necessarily vexing" to be insufficient to support an award of front pay.[8]

However, ordering reinstatement forces judges to supervise a coerced employment relationship. As a result, the use of front pay has become more and more common. Front pay instead of reinstatement has been ordered where 1) "discord, tension, suspicion, antagonism and sensitivity among (employees) would be productive of a very difficnlt employment environment"[9], 2) the employee's former job "required a close working relationship (with) top executives of defendant"[10], and 3) the claimant is "nearing" the normal retirement age anyway.[11] Even plaintiffs who request reinstatement sometimes end up with front pay instead, the court having found reinstatement "impracticable". The jury in Price v. Marshall Erdman & Associates, Inc.[12] awarded Price $750,000 in front pay, but he wanted to be reinstated instead. The court refused to order reinstatement because of "mutual dislike and defendants' continued opinion that plaintiff is incompetent", reasoning that "if the employee dislikes the idea of working for the employer or the employer dislikes the idea of having the employee work for him, reinstatement should not be ordered."[13] Price was a salesman who spent much of his working time away from the office and so was not constantly in touch with his enemies; nevertheless, the judge noted that

> "it is one thing to order the reinstatement of low-level employees performing routine tasks, or higher-level employees after the supervisors involved in the unlawful employment action have left the company or been transferred to another division, but to order reinstatement of a high-level employee performing discretionary functions into the division from which he was fired and which remains under the management of the person who fired him is a formula for continuous judicial intervention in the employment relation. If Price is reinstated, every time he is denied credit for a sale, or denied a raise or a bonus, or has a squabble with (the supervisor), he will be tempted to run to the district court".[14]

In Lewis v. Federal Prison Industries, Inc.[15] the court found it reasonable for Lewis to refuse reinstatement after a psychiatrist testified that Lewis experienced a " reactive depression" in response to the discriminatory acts that occurred at the company and that, although Lewis' health had improved since he left, his symptoms would return if he went back to work at the company. There was also evidence that Lewis had only four years until the date of his mandatory retirement[16]. In an earlier case[17] the employee, a lawyer, was awarded front pay because the animosity between employee and employer was so intense that reinstatement was impossible. The court specifically noted that the time period in this case was relatively short, approximately four years, and thus did not involve some of the uncertainties which might surround a front pay award to a younger worker.

Although the trial court ordered reinstatement in U.S. Equal Employment Opportunity Comm'n v. Century Broadcasting Corp.,[18] it was reversed because the judge had not given a sufficient rationale for withholding front pay. The case involved a radio station which had terminated all announcers over the age of 40. The trial court ordered that the announcers be rehired but the Court of Appeals would not allow this because "reinstatement would disrupt the operation of the station and would displace announcers currently employed" and "station management does not have confidence (in) these announcers...".[19]

The case that best illustrates the willingness of the courts to substitute front pay for reinstatement is Buckley v. Reynolds Metals Co.[20] The judge had ordered that Buckley be reinstated immediately to his old position or to a substantially equivalent position. However, after eight months of fruitless negotiations, the parties stipulated that Buckley would seek an award of front pay instead. The court agreed, concluding that reinstatement was impossible or impracticable because the parties said it was!

Calculating the Amount of Front Pay

If the trial court determines that a plaintiff is entitled to front pay, then the jury must determine the amount of damages. Factors to be considered are the employee's work and life expectancy, discount tables to determine the present value of future damages, the choice of an appropriate discount rate, and other factors that are pertinent to all types of prospective damage awards.[21] Some of this evidence, like the discount tables, is objective; but how is a judge or jury to know how long the plaintiff actually would have remained working at the job, whether he soon would have left for a different, perhaps better-paying job, or whether the plaintiff soon would have been dismissed for legitimate reasons?[22] Often the only source of such data, which is necessary to calculate a reasonably certain front pay award, is the testimony of the parties and their experts.

In Forest Electric Corp. v. Murtha[23] the employee testified that he was in excellent physical condition and enjoyed working with the people at Forest Electric so much that he would have worked until he was seventy-three to seventy-five years old. He also testified that he was earning $49,406 per year at the time he was terminated at age 66. Based on this evidence, and on evidence of earning history and fringe benefits, and based on reasonable assumptions about increases in earnings due to economic conditions, Murtha's expert economist declared that Murtha would have earned approximately $377,000 in the period from his termination until age seventy-three, if he worked to that age. The expert stated that work life was a fact which varied too much from person to person to use general tables to estimate it.[24] The company countered with the testimony of a statistician rather than an economist. He testified that Murtha would probably have worked until age seventy, based on what the typical man who was working at age sixty-six would do. Assuming he retired at age seventy, Murtha's economic loss until retirement would have been $69,713.[25] The jury accepted Murtha's expert and concluded that he would have worked to the age of seventy-one to seventy-three. The front pay award was $200,000.

In Doyne v. Union Electric Co.[26] the employee testified that he planned to work until age 70 and that he had so informed Union Electric. One of Union Electric's own witnesses testified that prior to Doyne's termination he told another employee that he intended to work until age 70. The jury awarded $273,993.00 in front pay based on this testimony but the trial judge reduced the amount to $19,610.66 after declaring that there was insufficient evidence to support the jury's finding that Doyne would have remained employed with UE until age seventy and that the front pay award should be based on retirement at the age of 65.[27] The Court of Appeals sided with the jury and reinstated the $273,993.00 award.[28]

The longer a proposed front pay period the more speculative the damages become.[29] Awards have been allowed involving as much as four years between the trial date and the date when compulsory retirement could have been imposed[30] but it is the total circumstances, not merely the length of time until retirement, that determines whether a particular award is too speculative. Mr. Buckley, for example, sought an award to cover a nine year period, which under other circumstances might exceed the limits of permissible speculation. However, Buckley had worked for Reynolds for more than twenty-five years when he was fired; he had nine years to work before retirement. There was no reason to reject his assertion that he intended to remain at Reynolds until he reached the regular retirement age of sixty-five. It was also reasonable to assume that absent the illegal discharge he would have been able to remain at Reynolds until he planned to retire. In view of his age, it was unlikely that Buckley would voluntarily switch jobs again or embark on a new career path. Finally, the industry where Buckley was employed provided relatively steady and dependable employment. Under these circumstances nine years did not seem unduly speculative.[31]

Awards that have been considered unduly speculative have arisen in situations where the discharged employee is only forty years old or so, or where the award might encompass ten years or more during which the employee, had he not been unlawfully discharged but continued in his employment, might or might not get raises, reductions, fired or become incapacitated.[32] For example, the employees in Rengers v. WCLR Radio Station[33] requested nine years of front pay but the evidence indicated that in a fickle industry like radio, job security for disk jockeys is quite tenuous and so the court refused to speculate that the employees would have remained employed at the station until retirement. In Price[34], the employee's expert witness estimated damages ranging from $1.2 million if Price retired at the age of 65 to $2.1 million if he retired at 75 but failed to discount each year's projected earnings loss by the probability that Price would have lived long enough to obtain those earnings. The court thought that since the probability was not a hundred percent the estimate of lost earnings should have been scaled down accordingly. The court decided a bigger problem was the expert's failure to take into account the high volatility of a salesman's earnings:

> "the figures the expert projected may be the best possible estimate of ... mean expected earnings had (the employee) remained with (the employer), but the variance around that mean must be considerable. Risk- averse persons--and most people are assumed to be risk-averse in their serious financial affairs--will pay a premium, often a very large one, to avoid risk ... (A) person who did not mind risk would not be willing to pay a loading charge--he would prefer to take his

> chances on the loss's occurring or not ... The award in effect enabled (the employee) to exchange his risky expectations ... for a risk- free asset having the same expected value but, assuming (the employee) is risk averse, a substantially higher utility."[35]

Front pay awards will not be upbeld if there is no evidence in the record to support the calculations. For example, in Hybert v. Hearst[36] the court had assumed that 1) the employee would continue to work at his present rate of productivity until the age of 72 (he was 67 when the trial ended); 2) the employer would have continued to employ the employee in his last-held position until he retired at the age of 72; and 3) that the employer would have continued to employ the employee at his last-held salary level for five more years until he retired at 72.[37] Since there was no evidence to support any of these assumptions, the front pay award was reversed.

The Duty to Mitigate

To be entitled to an award of front pay a plaintiff must make reasonable attempts at mitigation. The employer can avoid liability by showing that there were suitable positions available elsewhere and that the employee failed to use reasonable care in seeking them. For example, in Leeds v. Sexson[38] the employee was not entitled to an award of front pay because he failed to remain in the labor market and failed to diligently search for alternative work. The employee in Rodgers v. Western-Southern Life Insurance Co.[39] was not entitled to a front pay award because he declined an offer of reinstatement and failed to show that it would have been infeasible or inappropriate for him to return. The jury instructions in Gries v. Zimmer, Inc.[40] offer a concise statement of the duty to mitigate: the judge told the jury that if the plaintiff "failed to make reasonable efforts to find a new job, you should subtract from his damages any amount that he could have earned in a new job after his discharge".[41]

How long does an employee have to find comparable employment? The answer depends on the circumstances. In Fite v. First Tennessee Production Credit Ass'n[42] the employee postponed seeking other employment for a year in the expectation that he would be reinstated. When it became apparent that this would not happen, he vigorously sought other employment. Given these circumstances, the court gave him more than three years to find comparable employment before subtracting from his damages.[43]

Should Front Pay be Doubled?

The ADEA calls for the doubling of damages in the case of a willful violation. Should this doubling apply to front pay awards? In Olitsky v. Spencer Gifts, Inc.[44], the employee argued that the court should have doubled the jury's award of $400,000 front pay after finding that Spencer Gifts acted willfully and the Fifth Circuit agreed: " ... to exclude front pay would make no sense, for an award of double damages might well fall short of compensation and thus contain no punitive component at all (in fact contain a negative punitive component). In such a case the plaintiff might be better off if the violation were adjudged not willful".[45]

On the other hand, several courts have held that the liquidated damages provision of ADEA does not apply to front pay awards.[46] If front pay is exclusively an equitable award it is not subject to doubling. One court has even considered double back pay and front pay as mutually exclusive[47]. Clearly, the availability of double damages is one of the circumstances that courts look at when deciding whether to award front pay at all. In Lee v. Rapid City Area Sch. Dist.[48] the court entered judgment for $22,140 for back pay, $39,664.85 for front pay, and $10,000 for double damages, citing its "discretionary" authority regarding double damages while noting that the plaintiff had already received an award of front pay.[49] Even more courts are likely to multiply speculative front pay awards since the Supreme Court's recent decision in *Hazen Paper*[50] that broadly defines the term willful.

Summary and Conclusions

The phrase "without limitation" in the damages section of the ADEA invites federal courts to be imaginative in devising alternative remedies and front pay bas been one result. Initially, front pay was said to be appropriate only when the other damages awarded did not fully compensate the plaintiff for his injuries; subsequently, it has become the remedy of choice where reinstatement is not feasible in a wide range of cases. Front pay is being used to compensate employees until retirement even though the discrimination has ceased. This is a windfall, not restitution, says the Lewis dissent,[51] and it creates an incentive for the discharged employee to remain unemployed and for the employer to settle the case without addressing the possible age discrimination in the workplace. If front pay was not available, the employee would have little incentive to prosecute a frivolous claim.[52]

Congress did not include front pay as a remedy in the ADEA. It was incorporated by the federal district courts from other civil rights and labor laws. There

is no need for such a liberal construction of the act and, given the difficulties of calculation of front pay and the resulting speculative nature of the award, it is time to consider the wisdom of the widespread use of this remedy. There is no evidence in the case law that companies are so hostile to fired workers that it is impossible for them to return and reinstatement should be the remedy in all but the most exceptional cases. Front pay damages were originally allowed only in such exceptional cases and there may still be such a use for them, but the widespread use of front pay is inconsistent with the purposes of the ADEA and valid social policy.

ENDNOTES

1. 29 U.S.C. secs. 621-34 (1988 ed., Supp. III).

2. McKnight v. General Motors Corp., 908 F.2d 104, 116 (7th Cir. 1990) *cert. denied 499 US.* 919, 111 S.Ct. 1306, 113 L. Ed. 2d 241 (1991).

3. 29 U.S.C. sec. 626(b) (1988 ed., Supp. III).

4. See, *e.g.* Peter Janovsky, *Front Pay: A Necessary Alternative to Reinstatement Under the Age Discrimination in Employment Act*, 53 Fordham L. Rev. 579 (1984).

5. Age Discrimination in Employment Amendments of 1986, Pub. L. No. 99-592, 100 Stat. 3342 (October 31, 1986).

6. Goldstein v. Manhattan Indus., Inc, 758 F.2d 1435, 1449 (11th Cir.), *cert.denied*, 474 U.S. 1005, 106 S.Ct. 1005, 88 L.Ed.2d 457 (1985).

7. 952 F.2d 119 (5th Cir. 1992).

8. *Id.* at 126.

9. Combes v. Griffin Television, Inc., 421 F. Supp. 841, 846 (W.D. Okl. 1976) The plaintiff had formerly held the job of news anchorman with defendant television station, a position which involved a unique relationship with other employees.

10. EEOC v. Kallir, Phillips, Ross, Inc., 420 F. Supp. 919, 926-27 (S.D.N.Y. 1976), aff'd 559 F.2d 1203 (2d Cir.), *cert. denied*, 434 U.S. 920, 98 S. Ct. 395, 54 L. Ed.2d 277 (1977). The plaintiff's former job involved frequent personal contact with defendant's clients, with plaintiff acting as defendant's representative.

11. Eivens v. Adventist Health System, 660 F.Supp. 1255, 1264 (D. Kan. 1987). The plaintiff was 57 years old and the court found that he had altered his situation so completely that reinstatement would be a "huge burden".

12. 966 F.2d 320 (7th Cir. 1992).

13. *Id.* at 329.

14. *Id.* at 338.

15. 953 F.2d 1277 (11th Cir. 1992).

16. *Id.* at 1284.

17. Whittlesey v. Union Carbide Corp., 742 F.2d 724, 729 (2nd Cir. 1984).

18. 957 F.2d 1446 (7th Cir. 1992).

19. *Id.* at 1453.

20. 690 F. Supp. 211 (S.D.N.Y. 1988).

21. Roush v. KFC National Mgt. Co., 10 F.3d 392 (6th Cir. 1993).

22. Standley v. Chilhowee R-IV School Dist., 5 F.3d 319 (8th Cir. 1993).

23. No. 90-3259 (E.D. Pa. July 14, 1992) (Westlaw, Allfeds library).

24. *Id.*

25. *Id.*

26. 953 F.2d 447 (8th Cir. 1992).

27. *Id.* at 454.

28. Buckley was not allowed to recover his lost salary because the amount was too "speculative". He was allowed, however, to recover lost pension benefits because, said the court, a determination of lost pension benefits is "less sensitive to future salary fluctuations than is a calculation of the lost salary itself".

29. The cut-off date for the award is within the discretion of the district court, but some evidence must be submitted from which a reasonable projection can be made. Goss v. Exxon Office Systems, Inc., 747 F.2d 885 (3rd Cir. 1984).

30. Doyne v. Union Electric Co., 953 F.2d 447 (8th Cir. 1992).

31. Buckley v. Reynolds Metals Co., 690 F. Supp. 211 (S.D.N.Y. 1988).

32. Bonura v. Chase Manhattan Bank, N.A., 629 F.Supp. 353, 362 (S.D.N.Y), *aff'd on other grounds*, 795 F.2d 276 (2nd Cir. 1986).

33. 661 F.Supp. 649, 651 (N.D.Ill. 1986).

34. 966 F.2d 320 (7th Cir. 1992).

35. *Id.* at 345.

36. 900 F.2d 1050 (7th Cir. 1990).

37. *Id.* at 1055.

38. 1 F.3d 1246 (9th Cir. 1993).

39. 12 F.3d 668 (7th Cir. 1993).

40. 742 F.Supp. 1309 (W.D.N.C. 1990).

41. *Id.* at 1316.

42. Fite v. First Tennessee Prod. Credit Ass'n, 861 F.2d 884 (6th Cir. 1988).

43. *Id.* at 891.

44. 964 F.2d 1471 (5th Cir. 1992).

45. *Id.* at 1478.

46. Wheeler v. McKinley Enters., 937 F.2d 1163 n.2 (6th Cir. 1991); Graefenhain v. Pabst Brewing Co., 870 F.2d 1198, 1210 (7th Cir. 1989); Cooper v. Asplundh Tree Expert Co., 836 F.2d 1544, 1556 - 57 (10th Cir. 1988); Blum v. Witco Chem. Corp., 829 F.2d 367, 382-83 (3rd Cir. 1987); Dominic v. Consolidated Edison Co. of New York, Inc., 822 F.2d 1249, 1258-59 (2nd Cir. 1987).

47. Cancellier v. Federated Dep't Stores, 672 F.2d 1312, 1320 (9th Cir.), *cert. denied* 459 U.S. 859, 103 S.Ct. 131, 74 L.Ed. 2d 113 (1982).

48. 981 F.2d 316 (8th Cir. 1992).

49. *Id.* at 323.

50. Hazen Paper Co. v. Biggins, ___ U.S. ___, 113 S. Ct. 1701, 123 L. Ed. 2d 338 (1993).

51. Lewis v. Federal Prison Industries, Inc., 953 F.2d 1277 (11th Cir. 1992).

52. *Id.* at 1284.

WEIGHT DISCRIMINATION: SHOULD IT BE A BARRIER TO EMPLOYMENT?

by

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

Introduction

Obesity is the stigma of the nineties. Imagine the following situations! You receive your employment check and included amongst your usual deductions is a $5 deduction because you are overweight. Or your spouse arrives at the house and says, "Honey, there's $5 less in my pay envelope because you haven't stuck to your diet." Sounds incredible? Not to U-Haul International, Inc., employees who experienced this employment policy firsthand. U-Haul International requires employees and their spouses to acknowledge in writing that they fall within the company's acceptable weight guidelines. If employees lie about their weight, it becomes grounds for termination.[1]

For years, overweight and obese people have complained of unfair treatment by employers, and weight-based employment discrimination has been a frequent subject of newspaper and magazine articles. Yet, the employment problems of the overweight have been sorely neglected.

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This article will examine the definition and causes of obesity and the biases that exist toward overweight people in the workplace. It will show how these biases have led to negative social and economic consequences for these individuals. Next, it will explore the judicial developments as they relate to the increasing number of employees seeking redress for weight discrimination. Most notably, it will analyze the leading United States Circuit Court of Appeals weight-discrimination case *Bonnie Cook v. State of Rhode Island Department of Mental Health, Retardation, and Hospitals*[2], a decision that may affect future weight-discrimination cases and potential "size" legislation. The article will also describe the responses of various state and local legislative bodies to the growth of employment-related obesity lawsuits. Finally, the recommendations from various experts in job-related weight- discrimination matters are discussed, with a brief commentary on possible solutions to this troubling issue in the workplace.

Obesity And Its Stigma

Obesity is defined as an excessive storage of fat by the body. It may be mild (20% to 40% overweight), moderate (41%-100% overweight), or severe (>100% overweight), as classified in standard height-weight tables based on "ideal weight."[3] The "ideal weight" measurement is not always a good measurement of obesity, however. For example, athletes may exceed their "ideal weight" as determined by insurance company charts and still be lean because muscle weighs more than fat.

Although obesity is often considered to be a voluntary condition, there is ample evidence to the contrary. According to recent studies, as much as 50% to 75% of obesity is attributed to genetic influences.[4] Social factors are also believed to play an important role, especially among women.[5] Various endocrine, metabolic, developmental, and psychologic factors, as well as decreased physical activity, also are believed to contribute to obesity.[6] Frequently, however, the underlying cause of the obesity is not understood or explainable. Some medical experts believe that body weight is subject to physiologic regulation and that elevation of the regulatory level is responsible for obesity.[7]

At an International Conference on Obesity Management held in Antwerp in late 1993, Dr. Marian Apfelbaum, Professor of Nutrition at the University of Paris, revealed that his own protein-based diet, which he had been administering for the past twenty-five years, failed to produce long-term weight loss. Apfelbaum stated that genetic considerations determine one's weight, and oftentimes this creates an immutable condition. It is wrong, he said, to assume that individuals are obese due to overeating.[8]

Obesity is associated with various medical disorders such as diabetes, hypertension, and coronary artery disease.[9] However, a causal relationship between the obesity and the medical condition has not been established.

Even though about 25% of Americans are overweight,[10] obesity is an unacceptable condition in our thin-obsessed society. Overweight people are ridiculed without remorse or apology on television, in cartoons, by newspaper columnists, by employers, and employees. In a study of overweight people conducted at the University of Florida, researchers found that most of the overweight people surveyed felt that blindness, deafness, or leg amputation was a far better condition to have than being overweight.[11]

The obese also are often depicted as "lazy," "stupid," "ugly," and "cheats" by children at a very early age.[12] Obesity is not tolerated in our society. Unlike the blind or the deaf, overweight individuals are told that they could lose weight if they really made an effort. This creates a kind of double punishment in which individuals are discriminated against for being obese and criticized for lack of control over their situation.

The overweight also face discrimination in airline accommodations and educational opportunities as well as in their treatment by the medical profession, life insurance companies, and retailers. Sally Smith, Executive Director of the National Association to Advance Fat Acceptance (NAAFA)[13], complained that because of her weight she is required to buy two seats when she flies and does not receive double frequent-flyer miles. She believes employers eventually may be required to obtain first-class accommodations or purchase two coach seats for their obese employees who travel, just as they make special provisions for the handicapped.[14] The medical profession also illustrates the prejudices that exist toward the overweight. An editorial in the *New England Journal of Medicine* criticized doctors and medical students for their insensitivity and prejudice toward overweight or obese patients. Medical education, according to the authors, has done nothing to alleviate this problem.[15]

Obesity In The Workplace

Obesity has economic as well as social consequences. A study of 10,039 randomly selected adolescents and young adults in the United States, published recently in the *New England Journal of Medicine*, showed that overweight in adolescents, particularly women, may have significant social and economic consequences.[16] This seven-year prospective study conducted by the Harvard School of Public Health, New England Medical Center, and Harvard Medical School, found

that young, overweight women--those with weight above the 95th percentile for sex and age--had higher rates of household poverty, completed fewer years of school, had lower household incomes, and were less likely to be married than were women who were of normal weight.[17] Overweight men also were affected, but not as strongly.[18]

The study also compared the characteristics of overweight adolescents with those of adolescents who had chronic conditions such as asthma, diabetes, and arthritis. The study found that, unlike obesity, other chronic physical conditions had no significant effects on a person's later socioeconomic conditions, marital status, or self-esteem.[19] This supported the study's findings that discrimination, not health issues, causes overweight women and men to achieve less.

The results of the *New England Journal of Medicine* study are consistent with those of prior studies, which also show evidence of weight-based employment-discrimination. In a 1987 survey conducted by Esther Rothblum, a psychologist at the University of Vermont, a close correlation was also found between overweight and employment discrimination. Dr. Rothblum surveyed 367 obese women and 78 obese men on job-related issues and found that more than 40% of the obese men surveyed and 60% of the obese women surveyed had been refused employment because of their weight.[20]

Respondents stated that many job interviews focused almost entirely on their weight. Moreover, if they were hired, they were subject to continued humiliation. For example, they were told not to sit on new office furniture for fear of breaking it or were intentionally excluded from company activities.[21] One women surveyed was told that she would never be promoted until she lost weight; her humiliation was heightened when the union took management's side.[22] The survey also showed why obese women in particular so often are poor. The National Center for Health Statistics reports that 29.2% of women with incomes below $10,000 per year are obese, while only 12.7% of those with incomes above $50,000 per year are obese.[23] According to Dr. Rothblum's study, obese women are less likely than thinner women to be hired, and if they are hired, they are less likely to be promoted. Further, obese women are much more likely than thinner women to marry men lower on the social or economic ladder.[24]

Two other studies are consistent with the findings of the *New England Journal of Medicine's* study. In one study, more than 24% of executives said that employment opportunities for employees who are 15 pounds over their "ideal weight" would be somewhat negative. Approximately 70% of the executives interviewed indicated that

employment opportunities for employees who are 50 pounds over their "ideal weight" would be somewhat negative to very negative.[25]

The second study, conducted by the Maryland Commission on Human Relations, analyzed various employment practices by employment agencies in the State of Maryland. The study found that the employment agencies discriminated against overweight applicants by failing to recommend them or rarely recommending them for job opportunities because the applicants were perceived as lethargic, not motivated, and unenthusiastic.[26]

Judicial Developments

Pre-Cook v. Rhode Island

Employers and overweight prospective employees have been embroiled in a legal debate over discrimination due to obesity since the late seventies. This debate has raised such issues as: Is obesity a handicap? Should an obese person be classified as a "qualified individual with a disability?"[27] Does the employer's perception that an obese person is unable to perform the job qualify him or her as handicapped?

The following cases are illustrative of the treatment afforded the morbidly obese by the various state and federal courts that refused to consider obesity as a handicap from the late 1970s to the early 1990s.[28] In *Philadelphia Electric Company v. Pennsylvania*,[29] Joyce English pioneered the issue of weight-based employment discrimination in the state courts. In 1977 she was denied employment by the Philadelphia Electric Company(PECO) on the grounds that she was unsuitable for work because she weighed 341 pounds. Subsequently, she filed a complaint with the Pennsylvania Human Relations Commission claiming that PECO "refused to hire her because of her handicap/disability, obesity, which does not substantially interfere with her ability to perform the essential functions of the job."[30] The Commission ruled in favor of English, awarding her $20,000 and an opportunity to apply for the next available position.[31] PECO appealed to the Commonwealth Court of Pennsylvania, which overruled the Commission, holding "a morbidly obese person is not handicapped or disabled within the meaning of the Pennsylvania Human Relations Act when there is no evidence that she had any of the diseases, physical restrictions, psychological characteristics or breathing difficulties to which she was potentially susceptible."[32] In addition, the Court held that PECO did not illegally discriminate against English. The court concluded that the "employer has an inherent right to discriminate among applicants for employment and to eliminate those who have a high potential for absenteeism and low productivity."[33]

In *Greene v. Union Pacific Railroad*,[34] the federal court for the first time heard a weight-based employment- discrimination case. In *Greene*, the United States District Court for the Western District of Washington held that morbid obesity is not a handicap. Richard Greene commenced a lawsuit against Union Pacific Railroad for denying his transfer to fireman job category because of his morbid obesity. The court, in dismissing Greene's complaint, explained that the railroad through its medical director exhibited reasonable behavior in promulgating systemwide medical standards for prospective or existing employees. The standards, the court reasoned, were determined to be bona fide occupational qualifications justified by business necessity and "did not have a disparate impact upon a protected class."[35] The court held that Greene was not handicapped within the meaning of the Washington statutes because Greene's weight fluctuated from being obese to morbidly obese. The court concluded that his morbid obesity was not an immutable condition such as blindness or lameness, but rather a condition that could be controlled.[36]

In 1993, the California Supreme Court in *Cassista v. Community Foods, Inc.*[37] reversed the California Court of Appeal when it held that the California antidiscrimination law protects obese people only if their weight stems from a medical disorder. In *Cassista*, the plaintiff applied for a job as a cashier and stock clerk with Community Foods. At the time she applied for the position, she was 5'4" tall and weighed 305 pounds. The position required her to move 35- to 50-pound sacks of grain, 50-pound boxes of produce, and 55-gallon drums of honey.[38] During her interview, she was asked if she had any physical limitations that would prevent her from doing the job. She assured the interviewer that she was capable of handling the position. Subsequently, she was not hired for the position.[39] Upon inquiring as to the reasons for not being hired, she was informed by the personnel manager that the company believed that she was incapable of handling the job because of her weight.

Cassista sued Community Foods in the California Superior Court for violating the California Fair Employment and Housing Act, claiming the defendant regarded her as having a pbysical handicap (i.e., too much weight). The jury found for the employer, Community Foods. Cassista appealed, and the California Court of Appeal overturned the verdict, stating evidence establishing that Community Foods had considered ber weight to be a physical handicap as defined by state law.[40] Community Foods, therefore, should have been required to prove that Cassista's weight was not a determining factor in refusing to hire her.[41]

Subsequently, the California Supreme Court reversed the Court of Appeal ruling.[42] The court held that weight may qualify for protection as a "handicap" or "disability" under the California Fair Employment and Housing Act (FEHA) only if

the claimant can provide medical evidence to prove that the claimant's obesity is the result of a physiological condition that affects at least one basic bodily system and limits a major life activity, or that she was perceived as having such a condition.[43]

Cassista lost her case because she was unable to show that her obesity was caused by a medical condition. In its opinion, the California Supreme Court stressed that it was not at liberty to define "physical handicap" in its broadest terms to include what was morally just or socially desirable. The court continued that it was constrained to begin with the statute, apply ordinary meanings to the words, and then examine the legislative history.[44]

The California Supreme Court criticized the Court of Appeal for ignoring the statutory language and the relevant legislative history in analyzing the evolution of the term "physical handicap" since its initial adoption by the California legislature in the 1973-1974 session. The court stressed that even though the legislature made a sweeping change when it modeled its amendment to the FEHA in 1992 after the Federal ADA statute by replacing the term "physical handicap" with "physical disability," nevertheless the claimant "must have, or (be) perceived as having, a "physiological" disorder that affects one or more of the basic bodily "systems" and limits the claimant's ability to "participate in major life activities."[45] The Supreme Court stated that it was still the intention of the legislature that "physical disability" be interpreted in the same manner as "physical handicap."[46] The court again referred to the legislative history, emphasizing that it was the assembly bill, which defined handicap in a narrower way, that passed, not the senate bill, which did not limit the definition of the term "physical handicap." [47]

In considering the "perceived disability" theory the court concluded that the "perceived disability" must be in the nature of a physiological disorder as set forth in the FEHA, not just be a condition of overweight.[48] The court refused to accept the plaintiff's argument that her prospective employer's "perceived disability" of her overweight condition was enough to qualify as a disability under the state law.[49]

Therefore, the "perceived disability" conclusion has very limited use becanse the claimant still must show that the overweight condition, perceived by the employer as the reason for the employee's inability to perform the job, is medically related. In essence, the law does not protect an overweight prospective employee if the prospective employer makes a judgment that the applicant cannot do the job because of weight.

Did the court in the *Cassista* case fail to understand the causes of obesity? Laura Eljaieh criticized one of the California Supreme Court Judges because the judge's questions were based on the stereotype that overweight people overeat and if they diet they can lose the excess weight.[50] The *Cassista* decision left unresolved the debate regarding obesity as a behavioral versus a genetic or a physiological issue. Even though other advocates of "fat acceptance" believe that the California Supreme Court Judges did not fully understand the problems that overweight persons face, they still saw this decision as a partial victory in that overweight people now had the opportunity to show that their condition was medically related.

Cook v. Rhode Island

Immediately after the *Cassista* ruling, the tide shifted in favor of "fat pride" advocates when the first Federal Appeals decision of its kind ruled that job discrimination against severely obese people violated a federal disabilities law. On November 22, 1993, in the landmark case of *Cook v. Rhode Island*, the First Circuit Court of Appeals decided that morbid obesity is a handicap under Section 504 of the Rehabilitation Act of 1973[51]. Equally as significant, the court explored what it called "new frontiers" when it decided to apply the "perceived disability" theory to Section 504 of the Act.[52] The *Cook* holding permits all morbidly obese individuals to utilize the "perceived disability" theory without any requirements of a medical nexus.

In 1988, Bonnie Cook, a 5'2" woman weighing 320 pounds, reapplied for a position that she previously held from 1978 to 1980 and from 1981 to 1986 with the Rhode Island Department of Mental Health, Retardation, and Hospitals (MHRH) and which she voluntarily left with a "spotless work record." She was accepted for reemployment subject to completion of a physical examination. The agency's physician, Dr. O'Brien, denied her medical clearance because he believed that her morbid obesity could (1) place her own health at risk for serious diseases; (2) put the retarded residents at risk in emergency situations; (3) enhance absenteeism; and (4) increase the costs of Worker's Compensation injuries.[53]

The court set forth the following test to determine if morbid obesity was a handicap under the Rehabilitation Act: The four qualifications to invoke Section 504 of the Act for a failure to hire are (1) "that she applied for a post in a federally funded program or activity; (2) that, at the time, she suffered from a cognizable disability; (3) but was, nevertheless, qualified for the position; and (4) that she was not hired due solely to her disability."[54]

In applying the above criteria, the court found that the position for which Cook applied as an institutional attendant was federally funded. Additionally, the court testimony established her qualifications for the position because of her previous employment in the same position. The two remaining criteria that had to be discussed were whether she in fact had a disability that was covered by the Act and if so whether she was not hired solely because of her disability.

MHRH asserted that morbid obesity was not a handicap protected by Section 504 of the Rehabilitation Act, but a mutable condition that could be corrected by dieting.[55] The court rejected MHRH's arguments that all Cook had to do was diet and she would be able to simultaneously rid herself of the excess weight and her disability. The court found that "the jury had before it credible evidence that metabolic dysfunction ... lingers even after weight loss" in the morbidly obese and is a permanent physical impairment.[56]

In addition, the MHRH claimed that morbid obesity is caused by voluntary conduct, thereby not constituting an impairment as defined by Section 504 of the Rehabilitation Act. The court held that the Act does not contain language that links its protection with "how an individual became impaired or whether an individual contributed to his/her impairment...." It was further indicated "that the Act applies to many conditions that may have been caused or exacerbated by the individual such as AIDS, alcoholism, and diabetes.... Voluntariness is relevant only in deciding whether the condition has a substantially limiting effect."[57]

Next, the court considered whether a jury could properly have concluded that Cook regarded her condition as substantially limiting one of her "major life activities." The regulations define "major life activities" as walking, breathing, working, and other manual tasks. The evidence showed that MHRH refused to hire the plaintiff because it was believed that her morbid obesity interfered with her ability to perform a "major life activity," the right to work.[58]

The court stated that its job was greatly simplified because the Equal Employment Opportunity Commission (EEOC) has promulgated regulations setting forth three ways an individual can qualify for protection on the basis of a "perceived disability" under section 504 of the Act. Cook had to establish that: (1) her morbid obesity did not "substantially limit her ability to perform major life activities;" or (2) "she did not suffer at all from a statutorily prescribed physical or mental impairment;" and (3) MHRH viewed her impairment "whether actual or perceived as substantially limiting one or more of her major life activities."[59]

Additionally, the court explained that the regulations define physical or mental impairment broadly and are open ended to encompass disorders not presently known. The regulations also cover a person who is "regarded as having an impairment" if that person: "has a physical or mental impairment that does not substantially limit major life activities but that is treated by a recipient as constituting such a limitation; has a physical or mental impairment that substantially limits major life activities only as a result of the attitudes of others toward such impairment; or bas none of the impairments defined in...this section but is treated by a recipient as having such an impairment."[60]

The court held that "MHRH treated the plaintiff's obesity as if it actually affected her musculoskeletal and cardiovascular system."[61] She was treated as if she had a physical impairment, and MHRH refused to hire her because her limited mobility could interfere with her ability to evacuate patients in case of an emergency. Therefore, the jury could find that she was refused employment solely because of her perceived handicap.[62]

The court held that the employer had to apply objective standards reasonably set to determine if the candidate could handle the job, rather than acting solely on the basis of a subjective belief that doing the job could potentially cause harm to other people. The court indicated that MHRH failed to inquire into the plaintiff's physical abilities and relied solely on generalizations about obese people. The court noted that the plaintiff had done the job before and at times weighed almost as much.[63] In addition, the "...Act requires employers to bear the cost of absenteeism and other burdens involving reasonable accommodations..." for disabled individuals to be able to work.[64]

The court concluded that MHRH rejected the plaintiff on the basis of weight-related reasons. Consequently, on the evidence presented, a jury could find that MHRH's refusal to hire the plaintiff was based solely on her perceived handicap.[65] Therefore, for the first time a Federal Appellate court extended coverage to include morbidly obese individuals under the federal Rehabilitation Act of 1973.

Legislative Responses

In addition to the coverage provided under the Rehabilitation Act, obese individuals have been provided some protection, although limited, at the state and local levels. The only state statute under which obese people have been able to seek redress is Michigan's Elliott-Larsen Civil Rights Act,[66] which prohibits employment discrimination on the basis of height and weight. The Act also prohibits employers

from discriminating against an individual with respect to employment because of religion, race, color, national origin, age, and sex, in addition to *height* and *weight*.[67] The Act specifies that an employer shall not discharge or refuse to hire an employee or "limit, segregate or classify an employee for employment in a way that deprives...the employee of an employment opportunity" because of *height* and *weight*.[68] In addition, under the Act, employment agencies and labor organizations are also prohibited from discriminating against an individual in any way because of height and weight.[69] Recently, Connie Soviak brought suit against First Federal Savings and Loan under Elliott-Larsen Act for weight harassment due to mistreatment she received while employed at the bank. Ms. Soviak alleges that management ignored her complaints about being humiliated, harassed, and punched by a coworker for being fat. Ms. Soviak argued that according to the Michigan Civil Rights Act an employer is required to investigate a charge of harassment by a member of a "protected class."[70]

The statute states further that any employer, labor organization, or employment agency found to be in violation of the terms of the Act must cease and desist the unlawful discriminatory practices.[71] The violating party is also subject to other penalties such as compensatory damages including reasonable attorney's fees[72] and payment for all or a portion of the cost of the action plus expert witness fees.[73]

Two local communities, the District of Columbia and the City of Santa Cruz, have addressed the issue of size-related employment discrimination. It is interesting to note that the District of Columbia's Human Rights Act[74] protects against employment discrimination based on personal appearance rather than specifically weight or height.[75] The Act also includes a special section to cover franchisees. Under the Code a franchisee is prohibited from discharging or refusing to hire or otherwise discriminate against a person for any reason provided in the Human Rights Act of 1977, the provisions of which would also apply to the franchisee.[76]

Santa Cruz became the first city in the State of California to prohibit employers and labor organizations from discriminating in all forms of employment-related activities on the basis of "age, race, color, creed, religion, national origin, ancestry, disability, marital status, sex, gender, sexual orientation, *height*, *weight* or *physical characteristics*."[77] Patterning their ordinance after the Michigan and District of Columbia statutes, the Santa Cruz ordinance added an innovative mediation clause, the intent of which was to provide an inexpensive and expedient method of resolving complaints of discrimination in the workplace.[78] The clause states that after exhausting the mediation remedy, the aggrieved party can commence a civil action "within one year of the alleged discriminatory act or within six months of the termination of mediation."[79]

Proposed Legislation

Bills in New York and Texas could bring obese individuals under the protective umbrella of civil rights laws. New York is currently considering enacting Assembly Bill 3484, which would extend the New York State Civil Rights Statute to include height and weight as protected categories.[80] The proposed Act would make it an unlawful discriminatory practice for an employer or licensing agency "to refuse to hire, employ or discharge from employment ... or to discriminate against any individual because of age, race, creed, color, national origin, sex, *height* and *weight* considerations."[81] Similar to the Michigan statute, the proposed Act prohibits employment agencies and labor organizations from discriminating against individuals due to height and weight.[82] The sponsors of the proposed bill have indicated that there is a strong possibility of passage in 1994 because this legislation is consistent with the state's long-term commitment to condemn unreasonable exclusionary practices in employment.[83]

Two bills that were introduced in the Texas State Legislature in the 1990's also addressed the issue of weight discrimination. In 1991, Representative Debra Danburg introduced a bill that would have amended the Texas Human Rights Act by prohibiting weight discrimination based on gender.[84] The bill would allow an employee's weight to be classified as a bona fide occupational qualification if an employer could show that the employee's weight was reasonably likely to hinder the employee from carrying out the employee's duties in a safe and efficient manner.[85] This bill passed through committee but never made it to the floor for a vote for passage.

In 1993, Representative Sherri Greenberg introduced a similar bill, without the gender qualification, in the Texas State Legislature. This bill amends The Texas Human Rights Act to end weight discrimination in the workplace.[86] Furthermore, the proposed amended bill would make it an unlawful practice for an employer, an employment agency, or a labor organization to engage in any form of weight-based employment-discrimination because of "race, color, disability, religion, sex, national origin, *weight* or age."[87] The bill states that an employer cannot use an employee's weight as a "bona fide occupational qualification" without providing medical evidence "on the basis of a medical examination conducted by a physician approved by both the employer and the employee, that the employee's weight (was) reasonably likely to prevent the employee from performing the employee's duties safely and efficiently."[88] In addition to these legislative proposals, other segments of society have proposed solutions to weight-based employment discrimination.

Obesity: Handicap Or Civil Rights Issue?

Legal and medical experts, as well as scholars and lobbyists, have examined the problem of employment discrimination of the obese and have offered recommendations in an effort toward solving it. The EEOC has been instrumental in calling attention to the problem by representing obese individuals in weight-discrimination lawsuits. The EEOC filed an *amicus brief* with the United States First Circuit Court of Appeals in the *Cook* case protecting the morbidly obese from employment discrimination by supporting the premise that "morbid obesity per se" is a handicap under the Rehabilitation Act of 1973.[89] The EEOC has also favored extending the Americans with Disabilities Act (ADA) to cover discrimination against morbidly obese individuals.[90] This is a departure from the traditional interpretation that to be considered a disability the obesity must be proved to have been caused by a physiological condition.

One legal scholar would extend the EEOC's recommendation by eliminating any form of weight discrimination in employment.[91] Extension of the Rehabilitation Act to protect obese and overweight individuals in the workplace was suggested to help change the negative image of overweight individuals and protect their employment rights.[92] Additionally, this classification would be consistent with the legal definition of physical or mental impairment and "with the treatment afforded alcoholics and drug addicts under the Act."[93]

The authors of the *New England Journal of Medicine* study would extend the above legal scholar's recommendation to apply to the recent Americans with Disabilities Act (ADA)[94]. They suggest that the ADA be broadened to include all overweight individuals, not just the morbidly obese, to protect them against weight discrimination in employment.

NAAFA has a somewhat different view of weight-based employment-discrimination issues. Sally Smith, Executive Director of NAAFA, said that while ADA protection would open up opportunities for public accommodations for "fat people," it could serve as a roadblock in seeking broader protection from employment discrimination.[95] Smith stated that defining morbid obesity as a disability does not fully address the issue of weight discrimination in employment and that the EEOC action still doesn't address those who are 50% overweight or 50 pounds overweight.[96] She said that denying employment to a 200-pound woman or firing a 140-pound flight attendant would not be illegal under the EEOC's interpretations.[97] Smith expressed concern that legislative efforts to make height and weight a protected category under state civil rights laws would be sidetracked and pointed out that the EEOC's argument

that some obese people are covered under disability rights laws would be used to oppose potential federal and state anti-size discrimination bills.[98]

For example, the New York Human Rights Commission has claimed that Assembly Bill 3484, which would add height and weight as a protected class under New York law, is unnecessary since weight discrimination is covered under disability rights laws.[99] And while it is true that morbidly obese individuals may be protected by these laws, protection is not so clear for slightly overweight or moderately obese individuals. Indeed, flight attendants are routinely suspended or fired for being over airlines' height/weight charts, yet they cannot use disability rights laws.[100]

A recent law review article concurs with the NAAFA's position[101] in suggesting that holding "obesity per se" as a handicap under the Rehabilitation Act of 1973 creates numerous implications. Employers who are subject to this Act would be required to use weight as a factor in their hiring decisions and in their affirmative-action programs.[102] Workplace adjustments and accommodations may also be required to assist in the hiring, promoting, or transferring of obese persons.[103] The ADA currently excludes obesity as a protected classification.[104] By extending "obesity per se" to the ADA, the private sector would face these problems as well.

Although the finding that obesity is a handicap has resulted in some positive implications, this is not a fail-safe solution. If "obesity per se" is protected by the Act, employers would not be able to use weight as a factor in the decision to hire as long as the obese person could adequately perform the job after reasonable accommodations had been made by the employer.[105]

Even though employers would be prohibited from discriminating on the basis of obesity, prospective employees would have to litigate to determine if obesity was the reason for their not being hired. Each case would also require proof of whether or not reasonable accommodations had been made for the job applicant.[106] These requirements place a heavy burden on prospective employees to prove that they were not hired because the employer perceived that their obesity would impair their job performance. Employees would also have to show that the employer could have made reasonable accommodations for them.[107]

The law review commentator recommends that all victims of weight-based employment discrimination be afforded protection under federal and state civil rights laws, that the statutes exclude non-work-related factors as criteria for employment-related decisions, and that employees and employment applicants be considered on merit rather than on any irrelevant criterion such as weight.[108] The commentator

further urged that obese persons be protected in the same manner as other protected classes.[109]

Conclusion

An estimated 25% of Americans are obese. Many in our society regard them as "lazy," "stupid," "ugly," and lacking in discipline despite the consistent findings by medical experts that most individuals have little control over their body weight. Obese individuals have a condition that is not tolerated in our society. As a result, they are discriminated against socially and in the job market. Frequently, these individuals are denied employment, promotions, and raises unrelated to factors of competence.

With the knowledge that physiological factors may account for obesity and dispelling typical stereotypes that all obese individuals lack discipline, obese workers are fighting back on the federal and state levels. Until recently, federal prohibition of employment discrimination has been concentrated in areas unrelated to the obese. Although an important segment of the workforce, the obese have been virtually ignored. The recent burgeoning of interest in weight-based employment discrimination, albeit in a limited way, is significant in light of the intense concern over employment discrimination that has occurred within the past 15 years.

It is possible that we are on the threshold of significant changes as a result of the *Cook* decision and its application to the Rehabilitation Act of 1973. With the *Cook* decision, no longer is the employer able to hide behind the stereotypes and generalizations directed at the morbidly obese. Instead, the *Cook* case imposes an obligation on certain employers not to discriminate against the morbidly obese in an actual or a "perceived" manner. As new lawsuits challenging weight-based employment discrimination emerge, the legislatures and the courts will be pressured to correct this injustice just as they did the prejudices against racial minorities, women, and the underprivileged.

Two legal concepts are emerging to support this discrimination challenge. One argument is that obesity is a handicap protected by state and federal laws that prohibit discrimination against the handicapped. The other argument relies on a civil rights theory that makes weight a protected class under state and federal civil rights laws. While it is true that the morbidly obese individual may be protected by handicap laws, protection is not so clear for overweight or mildly or moderately obese individuals. Indeed, flight attendants are routinely suspended or fined for being over height/weight charts, yet they cannot use handicap statutes for protection. Most recently, USAir, in a civil rights action based on sex discrimination, became the latest airline to drop its

weight standards for flight attendants, requiring a performance test to establish flight attendants' agility and maneuverability.[110] Workplace discrimination against the obese has been well documented; yet in the current wave in political correctness, the 1990's could be the decade that exhibits extreme sensitivity to discrimination faced by the obese.

This article argues that weight, like race and gender, is almost always an illegitimate employment criterion and that it is frequently used to make decisions based on personal dislike or prejudicial assumptions rather than merit. Two proposed actions could possibly protect victims of weight-based employment discrimination: First, victims might try framing a civil rights action based on the premise that victims of weight discrimination are also members of other protected classes and may find protection under race-, sex-, or age-discrimination statutes. Civil rights laws reject any point of view that encourages innate inferiority and reflect a commitment to the principle that competition for jobs or opportunities should be based on individual merit. Second, in initiating weight-based employment-discrimination suits, the morbidly obese could try to gain general protection under handicap discrimination laws.

The closing paragraph of the *Cook* decision signals a warning to all employers that weight-based employment discrimination will not be tolerated. The court concluded:

> In a society that all too often confuses "slim" with "beautiful" or "good," morbid obesity can present formidable barriers to employment. Where, as here, the barriers transgress federal law, those who erect and seek to preserve them must suffer the consequences.[111]

ENDNOTES

[1] "U-Haul Penalizing Fat Employees," NAAFA NEWSLETTER, Vol.XIX, July 1990, p.1.

[2] *Bonnie Cook v. State of Rhode Island Department of Mental Health, Retardation and Hospitals,* 10 F.3d 17 (1st Cir.1993).

[3] THE MERCK MANUAL OF DIAGNOSIS AND THERAPY, 15th edition, 1987, p.950.

[4] Tierney, McPhee, Papadakis, CURRENT MEDICAL DIAGNOSIS & TREATMENT, (1994),p.1036.

[5] *See* MERCK MANUAL, *supra* at note 3,951.

[6] *Id.* at 951-952.

[7] *Id.* at 951.

[8] "Experts say dieting may cause obesity," CHICAGO TRIBUNE, September 21, 1993, p.11.

[9] *See* Current MEDICAL DIAGNOSIS AND TREATMENT *supra* at note 4, p.1036.

[10] Charles B. Claman, ed., THE AMERICAN MEDICAL ASSOCIATION ENCYCLOPEDIA OF MEDICINE (1989).

[11] G. Kolata, "The Burdens of Being Overweight: Mistreatment and Misconceptions," THE NEW YORK TIMES, November 22, 1992, p.38.

[12] Donna Ciliska, BEYOND DIETING,1990, p.16.

[13] The National Association to Advance Fat Acceptance, Inc. (NAAFA) is an advocacy group formed in Sacramento, California with over 4,000 members nationwide.

[14] "Fat is a Big Issue," THE GUARDIAN, December 10, 1993, p.15.

[15] Albert J. Stunkard and Thorkild Sorensen, "Obesity and Socioeconomic Status - A Complex Relation," 329 THE NEW ENGLAND JOURNAL OF MEDICINE, 1036, 1037, September 30, 1993.

[16] *Id.* at 1036.

[17] Steven Gortmaker et al., "Social and Economic Consequences of Overweight in Adolescence and Young Adulthood," 329 THE NEW ENGLAND JOURNAL OF MEDICINE,1008,1012, September 30, 1993.

[18] *Id.* at 1010.

[19] *Id.* at 1011.

[20] Rothblum, Brand, Miller, Oeijen,"Summary of the Results of the NAAFA Survey on Employment Discrimination", NAAFA (Unpublished summary) Fall 1987, p.6-11.

[21] *Id.* at 6-13.

[22] *Id.* at 6-11.

[23] Kolata, Gina, "The Burdens of Being Overweight: Mistreatment and Misconceptions," THE NEW YORK TIMES, November 22, 1992, p.38.

[24] *Id.*

[25] Comments, "Employment Discrimination Overweight Individuals: Should Obesity be a Protected Classification?" 30 SANTA CLARA L. REV. 951,959 (1990).

[26] Comments, "Employment Discrimination Against the Overweight," 15 U. MICH.J.L.R.337,340-341, Winter 1982.

[27] "Fair Employment Practices," BUREAU OF NATIONAL AFFAIRS, 1992, p.421:852.

[28] The New York State Court of Appeals in *State Division of Human Rights v. Xerox Corporation,*
65 N.Y.2d213, 480 N.E.2d 695, 491 N.Y.S.2d 106 (1985), virtually stands alone in holding that obesity is a handicap. The plaintiff, Catherine McDermott, applied for a position as a systems consultant with the Xerox Corporation. She was accepted for employment subject to a physical examination. Because Ms. McDermott was 5'6" and weighed 249 pounds, the examining physician found that she had the "disease" of "active gross obesity." On this finding alone, the examining physician concluded that Ms. McDermott was medically unacceptable for employment. The company's physician concurred. When Ms. McDermott inquired about the reason for not being hired, she was informed that she was rejected solely because of her obesity.

At the Human Rights Appeal Board Hearing, Xerox officials said that they did not refuse Ms. McDermott's employment because of a present disability, but because of a "statistical likelihood" that her obese condition would produce future impairments. The company argued that people "with such conditions are not disabled within the meaning of the statute". Ms. McDermott testified that she had always been overweight and that it had never prevented her from performing her job. She stated further that she fully performed other jobs similar to the one originally offered by Xerox. The Commissioner upheld Ms. McDermott's position and concluded that Xerox had discriminated against Ms. McDermott on the basis of a disability unrelated to her employment, in violation of the

Human Rights Law. However, the Human Rights Appeals Board reversed and dismissed the complaint. The Board held that "being overweight without proof of any impairment (was) not a disability covered by the statute." The Board noted further that Ms. McDermott's condition was a mutable and voluntarily induced condition unrelated to a medical or physiological disorder.

On appeal, the Appellate Division reversed the holding of the Board, whereupon Xerox appealed to the New York Court of Appeals. The Court of Appeals affirmed the Appellate Division's ruling, holding that obesity is a disability as statutorily defined; therefore, Xerox could not refuse Ms. McDermott's employment application on that basis regardless of her mutable and voluntary condition. The New York Court of Appeals held that an employer cannot deny employment to persons with disabilities because of any actual or perceived "undesirable effect the person's employment may have on disability or life insurance programs." It should be noted that the Court took a very liberal interpretation of the statute, claiming that legislative history indicated a legislative intent to restrict employers from refusing to hire individuals who are capable of performing a job mainly because they have a voluntary condition.

[29] *Philadelphia Electric Company, Petitioner v. Commonwealth of Pennsylvania, Pennsylvania Human Relations Commission and Joyce English Respondents*, 68 Commonwealth Ct. 212, 1982.

[30] *Id.* at 215.

[31] *Id.*

[32] *Id.* at 225.

[33] *Id.* at 228.

[34] *Greene v. Union Pacific Railroad Co.*, 548 F. Supp.3 (1981).

[35] *Id.* at 4.

[36] *Id.* at 5.

[37] *Cassista v. Community Foods,Inc.*, 5 Cal.4th 1050, 856 P.2d 1143, 22 Cal. Rptr.2d 287 (1993).

[38] *Id.* at 1053, 856 P.2d 1144, 22 Cal. Rptr.2d 288.

[39] *Id.*, 856 P.2d 1145, 22 Cal. Rptr.2d 289.

[40] *Cassista v. Community Foods, Inc.*, 10 Cal.Rptr.2d 98,106,(Cal. App.6 Dist., 1992).

[41] *Id.* at 104.

[42] *See Cassista supra* note 46 at 1056, 856 P.2d 1146, 22 Cal. Rptr.2d 290.

[43] *Id.* at 1059, 856 P.2d 1153, 22 Cal. Rptr.2d 297.

[44] *Id.* at 1056, 856 P.2d 1146, 22 Cal. Rptr.2d 290.

[45] *Id.* at 1057, 856 P.2d 1147- 1149, 22 Cal. Rptr.2d 292-293.

[46] *Id.* at 1058, 856 P.2d 1150, 22 Cal. Rptr.2d 294.

[47] *Id.* at 1057, 856 P.2d 1148, 22 Cal. Rptr.2d 292.

[48] *Id.* at 1059, 856 P.2d 1153, 22 Cal. Rptr.2d 297.

[49] *Id.*

[50] "Standard Set in Fat Bias Suits: Scales of Justice Tipped to Business," WASHINGTON TIMES, September 4, 1993, p.A1.

[51] Rehabilitation Act of 1973, Sect.504, Pub. L. No.93-112, 87 Stat.355, 29 U.S.C. Sec.701-796 (Supp. 1993).

[52] *See Cook supra* at note 2, 22.

[53] *Id.* at 20,21.

[54] *Id.* at 22.

[55] *Id.* at 23.

[56] *Id.* at 24.

[57] *Id.*

[58] *Id.* at 25.

[59] *Id.* at 23.

[60] *Id.* at 22 fn.4.

[61] *Id.*

[62] *Id.*

[63] *Id.* at 27.

[64] *Id.*

[65] *Id.* at 28.

[66] Michigan Compiled Laws, Chapter 37, Civil Rights, Elliott-Larsen Civil Rights Act (1992).

[67] *Id.* at M.C.L. 37.2202. Section 202.(1)(a).

[68] *Id.* at M.C.L. 37.2202. Section 202.(1)(b).

[69] *Id.* at M.C.L. 37.2203, Section 203 and MCL 37.2204, Section 204.

[70] "Michigan's Civil Rights Act to Be Tested," NAAFA NEWSLETTER, October/November 1993, vol. XXIV, p.6.

[71] *Id.* at M.C.L. 37.2206, Section 605.(1).

[72] *Id.* at M.C.L. 37.2206, Section 605.(2)(i)

[73] *Id.* at M.C.L. 37.2206. Section 605.(2)(j)

[74] District of Columbia, Human Rights Act, Section 1-2501 et seq. (1993).

[75] District of Columbia Human Rights Act, Section 1-2512 (1993).

[76] District of Columbia Code, Section 43-1840 (1993).

[77] Santa Cruz Municipal Code, Prohibition Against Discrimination, Sections 9.83.01, 9.83.03(1), (1992).

[78] *Id.*

[79] Santa Cruz Municipal Code, Section 9.83.12(2)(b)(1992).

[80] 1993-1994 Regular Sessions New York State Assembly A.3484 and S.6382.

[81] *Id.* A.3484, Section 296(a).

[82] *Id.* A.3484, Section 296(b)(c)

[83] 1993-1994 Regular Sessions New York State Senate Memorandum to S.6382.

[84] 72nd Regular Session Texas House of Representatives, H.B.#1445, Section 1.04(d).

[85] *Id.* H.B.#1445, Section 1.04(e).

[86] 73rd Regular Session Texas House of Representatives, H.B. #1560. Telephone interview with Linda Hymans, Administrative Assistant to Representative Greenberg, indicated that this bill died in Committee and Representative Greenberg is not currently planning to reintroduce it.

[87] *Id.* H.B.#1560, Section 5.01(1),5.02,5.03.

[88] *Id.* H.B.#1560, Section 1 (d) lines 8-14.

[89] "ADA May Cover Very Fat People EEOC Files Brief in Cook Case," NAAFA NEWSLETTER, Vol.XXIV, December 1993/January 1994, p.1.

[90] *Id.*

[91] Comment, "The Rehabilitation Act of 1973: Protection for Victims of Weight Discrimination," 29 U.C.L.A. L. REV. 947 (1982).

[92] *Id.* at 970.

[93] *Id.* at 967.

[94] Americans with Disabilities Act of 1990, Pub. L. No.101-336, 104 Stat.327,330 (Codified as 42 U.S.C.12101 (1990).

[95] *See* NAAFA NEWSLETTER *supra* note 97 at 1.

[96] Bill McAllister, "Obesity Can Be a Disability,EEOC Says," WASHINGTON POST, November 13, 1993, p.A5.

[97] *See* NAAFA NEWSLETTER *supra* note 97 at 1.

[98] *Id.*

[99] See New York State Assembly *supra* note 88.

[100] *See* Johnson, "Flight Attendants at Pan Am Settle a Weighty Matter," WALL STREET JOURNAL, 1987 and McEvoy, Sharlene A., "Fat Chance: Employment Discrimination Against the Overweight," 43 LAB.L.J.3,8-9,(1992).

[101] *See* Comments, SANTA CLARA L. REV., *supra* note 25 at 951.

[102] *Id.* at 970.

[103] *Id.*

[104] 42 USC Section 12101(1990).

[105] *See* Comments, SANTA CLARA L.REV., *supra* note 25 at 970.

[106] *Id.* at 971.

[107] *Id.*.

[108] *Id.*

[109] *Id.* at 976.

[110] Tamar Lewin, "USAir Agrees to Lift Rules On the Weight of Attendants," THE NEW YORK TIMES, April 8, 1994, A12. USAir indicated it would place a moratorium on its weight chart for three years and substitute a performance test requiring flight attendants that they could move comfortably down the aisle and fit quickly through the cabin emergency windows on USAir's smallest jets. Under prior standards a 5'3" female flight attendant in her twenties could weigh no more than 130 pounds. In ten year increments, a small addition of weight could be added. If attendants failed to meet these requirements, they were either not hired or suspended. Flight attendants asserted that it was a form of sex discrimination to require them to meet weight requirements as a condition for holding their jobs.

[111] *See* Cook *supra* at note 2, 28.

COPYRIGHT LAW IN THE PEOPLE'S REPUBLIC OF CHINA

by

Roy J. Girasa*

Introduction

The People's Republic of China (P.R.C.) with its 1.2 billion population and its gradual assimilation of a market economy may surpass Japan in the near future in import and export trade. Trade between the United States and China annually exceeds $30 billion ($23 billion surplus in favor of China)[1] and it is anticipated that trade will dramatically escalate in future years. A major issue which has caused some friction between the two states is the protection of intellectual property rights in the P.R.C. After a review of the historical antecedents to its current legal progression, this paper will detail the laws and regulations protecting foreign and domestic copyrights afforded by the P.R.C.

China has had a long tradition of autocratic rule, marked with centuries of the rise and fall of great dynasties from about 2200 B.C. to 1911 A.D., led by emperors who possessed near absolute power. Except for a brief interlude of a republican government under Sun Yat-sen, China's history after the fall of dynastic rule was one of warlords and finally communist rule under Mao-Tse-Tung. The relationship of western powers to China is marked by a century of attempts to open and dominate China's market. There were sporadic aggressions including the Opium War with the British and the Boxer Rebellion of 1900. The ultimate victory of Mao Tse-Tung and his imposition of communist rule in 1949 closed China's door to global trade until 1972 when President Nixon made his historic trip to China.[2] The establishment of diplomatic and trade relations gave impetus to the gradual evolution of China's

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economy from a governmentally planned to a market economy, particularly after the death of Mao in 1976.[3]

In late 1972, China reactivated the Technical Export-Imports Corporation which was followed by turnkey countertrade contracts and a new open door policy for foreign enterprises. The encouragement of trade with the outside world, of necessity, led to the enactment of laws affording protection for foreigners. The first major enactment was the "Law of the People's Republic of China on Chinese-Foreign-Equity Joint Ventures."[4] Diverse tax and other economic incentives were offered to foreign investors in an effort to spur economic growth along the paths taken by Japan, Korea and other states in Southeast Asia.

Laws protecting intellectual property were enacted from 1982 and continuing to the present. The first of the laws was the 1982 "Trademark Law of the People's Republic of China."[5] It was followed in 1984 with passage of the "Patent Law of the People's Republic of China,"[6] the 1990 "Copyright Law of the People's Republic of China"[7] (the statute under discussion herein) and part of the "General Principles of the Civil Law of the People's Republic of China" (1990).[8]

In addition to the above statutory investments, China joined the Berne Convention for the Protection of Literary and Artistic Works (October 15, 1991) and entered into the Universal Copyright Convention (October 30, 1991). In 1992, the China Council passed the International Copyright Treaties Implementing Rules and in 1993 joined the Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of their Phonograms.

Thus, legislatively, China has fully entered the global marketplace in its adherence to intellectual property protection. The difficulty to date, as discussed below, is the enforcement of its decrees and regulations.

Copyright

The P.R.C. enacted the last of the major three intellectual property rights statutes in 1990, namely, the "Copyright Law of the People's Republic of China," which became effective on June 1, 1991. It was supplemented by the "Implementing Regulations of the Copyright Law" as well as by "Regulations for the Protection of Computer Software." It has constitutional protection. Article 47 of the Constitution of the People's Republic of China[9] provides:

> "Citizens of the People's Republic of China have the freedom to engage in scientific research, literary and artistic creation and other cultural pursuits. The state encourages and assists creative endeavors conducive to the interests of the people that are made by citizens engaged in education, science, technology, literature, art and other cultural works."

The purpose of the law is to protect authors in their literary, artistic and scientific works as well as to encourage the creation and distribution of works in order to assist in the development of the state.[10] It coincides with Articles 19-24 of the Constitution which mandates the state's encouragement of such enterprises.[11] Obviously, there is a clear undercurrent operating herein. Inasmucb as private ownership of property in a communist state was de minimus, nevertheless, China enacted all of the intellectual property legislation to encourage investment and become the recipient of advanced technology. Not only are the works of Chinese citizens protected, but the law extends to foreigners initially publishing their works within China.[12] Also protected are foreigners publishing their works outside of China whose home states have a bilateral treaty protecting these works or are otherwise protected by international convention.[13]

Works include those of literature, art, natural and social sciences, engineering, technology and other works taking any of numerous specified forms, such as (a) written works; (b) oral works; (c) musical, dramatic, choreographic, storytelling works; (d) fine art and photographic work; (e) cinematographic, television and video work; (f) drawings of engineering and product designs; (g) maps, sketches and other graphic arts; (h) computer software; and (i) other works specified by law.[14] The implementing regulation expands on each category. For example, protection extends to "cross talk", "local art forms" and "facial movement."[15]

Excluded from protection are prohibited works (presumably pornography) and works which "prejudice the public interest."[16] Governmental laws, regulations and other output are not subject to copyright as well as news concerning current events, calendars, numerical tables, formulas and forms of general use.[17] Apparently, although laws and regulations escape copyright protection, nevertheless, collections of laws and/or rules may be protected by virtue of other provisions of law.[18]

As in the U.S., the emphasis of the subject matter of copyright is originality. The statute uses the word "created."[19] The word "created" is clarified in the Implementing Regulations (Article 3) wherein it is defined as referring "to intellectual activities from which literary, artistic and scientific works are directly resulted." Mere arrangement, consultation and support services for others engaged in the creative

process are not sufficient to warrant protection. Like U.S. law, originality is not necessarily novelty. An author may have derived all of his/her ideas from other authors. The unique mode of expression will suffice to receive protection.[20] Governmental administration of copyrights is not exclusive to the national authority (as in the U.S.) but also extends to local regions and municipalities.[21]

Exclusivity

A copyright gives the owner thereof five basic rights with respect to subject matter. They are:

(1) Right of divulgation (publication), i.e., the right to decide whether or not to make public the protected work;

(2) The right of authority (authorship), i.e., the right to claim one is the owner and to have his/her name stated on the work;

(3) The right of alteration, i.e., the right to modify and authorize other to alter to change the work;

(4) The right of integrity, i.e., the right to prevent others from distorting and mutilating the work; and

(5) The right of exploitation and remuneration, i.e., the right to reproduce the work in any manner; to perform the work publicly in any manner; to broadcast; exhibit publicly; distribute copies such as by sale or rental; publish the work; make cinemagraphic, televised or video works; adaptation, translation, annotation, compilation and sorting-out (rearrangement) or the works.[22]

Ownership

Ordinarily, the copyright of a work belongs to the person who created it (the author). If the work was derived under the sponsorship by an entity (e.g. joint venture or corporation) then the entity shall be the author. If an entity or other name appears on the work without the individual's name, then it is deemed to be the author in the absence of proof to the contrary (e.g. publisher's name only appears).[23]

Article 16 of the Statute differentiates two types of works: (1) works created by an employee under "ordinary' conditions wherein the employee is entitled to the copyright but the employer has the right to exploit the copyright for a two year period in its business; and (2) more specialized works such as engineering designs, drawings, maps, computer software and the like which were created while working for the employer and utilizing the employer's materials and technical facilities. In the latter situation, the employee has the right to be known as the author but the employer is entitled to the copyright and all benefits accruing therein.

If a work is a translation, adaptation, annotation or arrangement of a pre-existing work, and provided it does not conflict with the copyright of the underlying work, then the protection shall go to the person accomplishing the activity.[24] Unlike U.S. law, the Regulations seem to permit the grant of a copyright to such persons even if the authors having the pre-existing copyright of the original work object.[25] It is possible, however, that damages may be awarded against the compiler, translator, etc., however, for unauthorized use of such materials.

When there are two or more authors of a work, then the copyright extends to both of them. Each such person may have a separate copyright for those portions of a work which are divisible as independent units provided no prejudice occurs to the other author(s).[26] If the joint authors disagree on the exercise of the copyright (e.g. selection of a publisher, licensee, etc.), the Regulations state simply: "any party may not unreasonably prohibit the exercise by others of the said copyright."[27]

If a work is a compilation (encyclopedia, dictionaries and the like), the copyright shall go to the entity expending the resources for the compilation.[28] Copyright holders of the underlying works maintain their rights irrespective of the compilation. With respect to cinematographic, television or video work, authorship may be claimed by the director, lyricist, screenwriter, composer, a cameraman and other authors. The producer may also enjoy a copyright with respect to the work.[29] If permission is given by any such person to make a movie, television show or video work of such person's work, then the right to alter it is implied provided it is not a distortion or mutilation.[30]

Duration

China grants authors unlimited time with respect to the right of authorship, alteration and integrity of the work;[31] however, the right to exploit the work, as well as remuneration, is limited to the life of the author plus fifty years. Where there are multiple authors, the fifty year period accrues from date of death of the last surviving

author. If the owner is a foreign entity or anonymous domestic concern, or where the copyright is for a cinematographic, television, videographic or photographic work, the term is limited to 50 years from first publication.[32] The property right accruing to copyrighted works descends to the author's heirs or devisees or to the state in their absence.

The limitation on rights of an author or owner of a copyright is fairly extensive. A work may be used without permission in ten circumstances, provided the identity of the author and title of the owrk is made known. They include: (1) use of work for individual study, research or entertainment; (2) use of an "appropriate quotation" (insubstantial); (3) media use for purposes of reporting current events, speeches and reprints; (4) translation of a small number of copies for use by teachers or scientific researchers solely for classroom use or scientific research; (5) use of the work by a state organization for performance of official duties; (6) reproduction of the work by a library; museum, art gallery and the like for exhibition purposes or to preserve a copy of the work; (7) performance of a published work provided the admission is free and no monies are paid to the performers: (8) copying, photographic, drawing a video taping of an artistic work displayed publicly; (9) translation of a published work by a Han nationality into minority nationality languages for local distribution of works originally created in Chinese; and (10) transliteration of a published work into Braille.[33]

Requirements For Use By Others

A person seeking to exploit a "copyrighted work" must receive permission in a written contract with the copyright owner, which shall specify the manner of use; its exclusivity; the scope and term of the liceuse; the amount and method of remuneration; liability for breach and any other pertinent data.[34] The term of the licensing agreement is limited to ten years but the contract is renewable. The rate of remuneration is determined by the National Copyright Administration. Remuneration may also be stipulated by the parties to the licensing agreement. The statute makes clear that without explicit consent, no right may be inferred vis-a-vis against the copyright owner.

The Copyright Law specifies various requirements for book publishers, performances, sound and video recording and broadcasting. In summary, a book publisher must have concluded a written contract and pay remuneration to the copyright owner. The publisher has the exclusive right to publish the work for a renewable period of ten years. Eacb party is responsible for the performance specified by contract. If the publisher refuses to print additional copies or publish a new edition

of the book when all copies have been exhausted, the copyright owner has the right to terminate the contract. If a work is submitted to a newspaper or periodical for publication, and bas not received notification to publish within 15 days from a newspaper publisher or 30 days from the periodical publisher from date of transmission to it, then the copyright owner may submit it to other publishers. A book publisher cannot modify the contents of the work without owner consent.[35]

A performer who exploits an unpublished copyright work must obtain permission from and pay remuneration to the owner. With respect to published works, a performer does not need to secure permission from the copyright owner but must pay remuneration to the said owner. A performer with respect to the performance is entitled to its exclusive benefits including the right to make live broadcasts, and authorize for money the recording of the performance for commercial purposes.[36] Similar rules apply to sound and video recordings as well as broadcasting by radio and television stations.[37] In essence, producers of the recordings and broadcasts are entitled to use the published works or performances of others by the payment of remuneration to the copyright owner. Note, however, that a radio or television station broadcasting a sound recording for non-commericial purposes is exempt for obtaining permission from or pay remuneration to the copyright owner, performer or producer of the recording.[38]

Liability

Civil liability does accrue for infringement but includes "making a public apology" as one of the remedies. It also provides for the payment of damages for infringement by a person(s) making public the work of the copyright owner without consent; distorting or mutiliating a work of other; claiming wrongfully one is the creator of a work; exploiting the work of others through performance, exhibition, adaptation, broadcasting, translation, television or other means, without consent; and also by the publication of a work by a joint-owner of the copyright without the other's consent.[39]

Governmental authorities may also assess administrative penalties such as confiscation of unlawful income and imposing fines for serious violations of the copyright. Such acts include: plagiarizing a work of another; commercial reproduction of a work without consent; publication of a work licensed by another publisher; and reproducing a sound or video recording or a radio or television program of a performance, without consent. Mediation appears to be emphasized initially, thereby showing a penchant of Asian states for non-judicial remedies. Arbitration is permitted

by contract or consent of the parties. The People's Court is the ultimate arena for dispute resolution.[40]

Judicial Remedies

The General Principles of the Civil Law confer jurisdiction upon the People's Court for matters litgated by the parties. In addition to the remedies specified in the intellectual property statutes, Article 118 expressly gives an injured party the right to demand "that the infringement be stopped, its ill effects be eliminated and the damages by compensated for." The Court, pursuant to Article 1343, may grant one or more of the following remedies:

"(1) cessation of infringements;
(2) removal of obstacles;
(3) elimination of changes;
(4) return of property;
(5) restoration of original condition;
(6) repair, reworking or replacement;
(7) compensation for losses;
(8) payment for breach of contract damages;
(9) elimination of ill effects and rehabilitation of reputation; and
(10) extension of apology."

The Court may also serve admonitions, order the offender to sign a pledge of repentance, confiscate property and/or income arising from the illegality, and/or impose fines or inprisonment as specified by law.

Intellectual property cases are heard by specialized people's courts. For instance, review decisions by the Patent Office of the Patent Re-examination Board are heard in the Beijing intermediate court, seated in Beijing. Judges who sit are selected according to their background in technology and foreign languages. The court may require a posting of security, attach or freeze assets as injunction.[41]

Administration

The administration of the copyright laws and regulations are conducted by the National Copyright Adminstration (NACA) which is the copyright administration

department under the State Council. There are also local adminstrative authorities for copyright affairs in the regional and municipal levels. NACA is responsible for the enforcement of copyright law and regulations; investigating infringement cases; approval of collective adminstrative societies and supervising local copyright authorities.

Local authorities perform somewhat comparable duties within their domain including the adminstration of copyrights, investigation and prosecution of infringements, arbitrating copyright disputes, monitoring copyright transactions and supervising local administrative societies.

International Copyright Treaties

The accession of China to international copyright treaties (Berne and Universal Copyright Conventions) caused the State Council to issue the "Implementing Regulations of the People's Republic of China and the Regulations on Computer Software Protection in 1992. Article 2 of the Implementing Regulations makes China's copyright laws and regulations applicable to the protection of foreign works. "Foreign works" are those works of authors whose countries are members of the said international conventions or who are not citizens of member-states but have had their works first published or simultaneously published in member-states or are created by consignees and owners of copyrights of Chinese-foreign joint ventures.[42]

Unpublished foreign works are also protected by the Copyright Law.[43] Foreign artistic works (except when applied in industrial goods) are given a 25 year protection from date of their completion. Foreign computer programs are protected on literary works and are given a 50 year protection.[44]

Foreign works compiled from unprotected materials but possess originality in the selection and arrangement of materials are granted protection as is a foreign video which constitutes a film product.[45]

Under the regulations, a copyright owner is given the discretion whether or not to license the performance or dissemination of performance of his (her) works including foreign films, television and videotapes. Except for articles concerning political, economic and social affairs, newspapers and journals require permission before reprinting foreign works. Copyright owners of foreign works may authorize or forbid reproduction of their works or the imposition of pirated reproduction or

unprotected reproductions. The Berne Convention is made applicable to the showing, recording or broadcasting of foreign works.[46]

Present Status

The U.S. has expressed much concern over China's alleged lack of enforcement of its intellectual property laws. Unauthorized software copying by China allegedly causes U.S. companies up to $400 million annually in lost sales.[47] Pressure was placed on the U.S. by the International Intellectual Property Alliance and others to place China under the Special 301 watch list for the purpose of subjecting it to trade sanctions in accordance with the 1988 U.S. Omnibus Trade and Competitiveness Act.[48] As a result, China has been on the list on an annual basis.

China, although denying that large scale pirating does take place and further alleging that attempts to assert pressure will be to no avail, nevertheless, has substantially acceded to U.S. demands. As stated previously, it has joined the major global intellectual property conventions in response to U.S. threats to impose 100 percent tariffs on Chinese imports.[49] Although copyright protection is now the law in China, nevertheless, pirating still continues. The President of the Sbenzhan Software Industry Association acknowledged that piracy exists but said that new pressures were being taken to lessen or eliminate the illegal practices.[50]

China's efforts appear to have convinced reluctant U.S. companies to license their products therein. Microsoft licensed MS-DOS in 1992 to a Chinese consortium after initially refusing to enter the market.[51] Chinese companies, which earlier would not consider suing for copyright violations, have now begun to assert their rights.[52] China has recently been praised by the Director-General of the World Intellectual Property Organization for its highly advanced legislation.[53] China has set up its first copyright school at the Beijing University Intellectual Property Rights School in order to educate students with respect to the requirements and enforcement of its intellectual property laws.[54] Chinese authorities resolved 2500 actions involving intellectual property rights in 1993.[55]

Although it appears that China is making some efforts to protect U.S. and other licensors, nevertheless piracy is still rampant. China has, in fact, moved from the Watch List of the U.S. Trade Representative to the Priority Watcb List on November 30, 1993.[56] China's response is that it has established a modern copyright system in a third world state with little copyright awareness in a period of only 13 years. It is cooperating with world organizations and copyright-related organizations such as the U.S. Copyright Office in an endeavor to achieve its reforms. The General Secretary of

the Central Committee of the Communist Party, Jiang Zemin, stressed the importance of protecting intellectual property rights before the 14th National Congress of the Party in 1992. The general public is being educated to respect such rights. The central and local copyright administration authorities are disseminating and teaching copyright rules and resolving disputes.[57]

In conclusion, there is no doubt that China's statutory and regulatory enactments full comply with global protection schemes. Nevertheless, with constant outside pressure, China will gradually adhere to western standards for the protections desired.

ENDNOTES

1 The Reuter European Business Report, Dec. 13, 1993.

2 For a comprehensive fifteen volume history of China, see Roderick MacFarquhar and John K. Fairbank, ed., The Cambridge History of China (Cambridge: Cambridge University Press, 1987). A shorter, albeit extensive, history may be found in John King Fairbank, China: A New History (Cambridge,, Mass.: Harvard University Press, 1992). A readable history of Pacific Rim countries is Frank Gibney, The Pacific Century: America and Asia in a Changing World (New York, Charles Scribner's Sons, 1992). The developments within China leading to the globalization of its economy may be found in Alexander Eckstein, China's Economic Revolution (Cambridge: Cambridge University Press, 1977). The Chinese perspective may be seen in Ma Hong, ed., Modern China's Economy and Management (Beijing: Foreign Languages Press, 1990.

3 A fascinating account of President Nixon's establishment of relations with China is discussed in Henry Kissinger in White House Years (Boston: Little Brown and Company, 1979), esp. ch. XXIV.

4 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 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).

[5] Adopted at the 24th Meeting of the Standing Committee of the Fifth National People's Congress and promulgated by Order No. 10 of the Standing Committee of the National People's Congress on August 23, 1982 and effective as of March 3, 1983, hereinafter referred to as "Trademark Law."

[6] pted at the Fourth Meeting of the Standing Committee of the Sixth National People's Congress, promulgated by Order No. 11 of the President of the People's Republic of China on March 12, 1984, and effective as of April 1, 1985, hereinafter referred to as "Patent Law."

[7] Copyright Law of the People's Republic of China adopted at the 15th Meeting of the Standing Committee of the Seventh National People's Congress on September 7, 1990, promulgated by Order No. 31 of the President of the People's Republic of China on September 7, 1990 and made effective as of June 1, 1991.

[8] The General Principles of the Civil Law of the People's Republic of China adopted at the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 37 of the President of the People's Republic of China on April 12, 1986, and effective as of January 1, 1987.

[9] Adopted at the Fifth Session of the Fifth National People's Congress and promulgated for implementation by the Proclamation of the National People's Congress on December 4, 1982 as amended at the Seventh National People's Congress at its First Session on April 12, 1988. The English text is published by the Foreign Languages Press, Beijing, 1990.

[10] Copyright Law, Article 1.

[11] The Constitution provides that the state is to undertake the raising of "the scientific and cultural level of the country by establishing universal education" (Article 19), promoting the development and dissemination of science and technology (Article 20), developing medical and health services (Article 21), encourage the growth of art and literature (Article 22) and the expansion of intellectual facilities and faculty (Articles 23 and 24).

[12] Chinese citizens include those persons residing in Taiwan, Hong Kong, Macau and other citizens living beyond China's borders. Foreigners initially publishing their works within China refer to unpublished works published for the first time within China, whether in original, translated or adapted form. It also includes works initially published outside of China but republished in China within 30 days thereof. Shen Rengan, Copyright Law and Copyright Protection in China, unpublished paper delivered at Fordham University School of Law, Second Annual Conference on Intellectual Property Law and Policy, April 7, 1994.

[13] Ibid., Article 2. The Provision for the Implementation of International Copyright Treaties, promulgated in Beijing in September 25, 1992, protects "foreign works" which are defined (Article 4):

> "1. Works whose authors or one of their authors, other copyright owners or one of their copyright owners are citizens of member-states of international copyright treaties, or are residents owning regular residences in member-states of the treaties;
> 2. Works whose authors are not citizens of member-states of member-states of international copyright treaties nor residents owning regular residences in member-states of the treaties, and who have had their works first published or simultaneously published in member-states of their treaties;
> 3. Works created by consignees at the behest of sino-foreign joint ventures, or sino-foreign joint ventures and foreign-invested enterprises, who are copyright owners or one of the copyright owners as specified in relevant contracts".

[14] Ibid., Article 3. Compare U.S. Copyright Law, 17 U.S.C.A. Sec. 102(a) wherein protection is given to expressions "in original works of authorship fixed in a tangible medium or expression, now known or later developed." The Implementing Regulations to the China Copyright Law, Article 2, appears to follows the U.S. It states the works referred as an "original intellectual creations in the literary, artistic and scientific domain, in so far as they are capable of being reproduced in a certain tangible form" (emphasis added).

[15] Chinese law appears to be broader in this respect. Copyright protection was denied to an actor who created a distinct dress and appearance for a cowboy in a television series. Columbia Broadcasting System v. DeCosta, 377 F 2nd 315 (1st Cir., 1967).

[16] Copyright Law, Article 4.

[17] Ibid., Article 5.

[18] The State Council of China on July 29, 1990, published "Rules on the Publication of Collections of Law and Rules" which forbid their unofficial publication to ensure correctness and quality of the translation. See Zheng Chengsi and Michael Pendleton, Copyright Law in China (North Ryde, Australia: CCH International), 1991, p. 82. The text of the Copyright Law is taken from this publication.

[19] Copyright Law, Article 3 states: "For the purposes of this law, the term "works" include works of literature...and others which are created..." (emphasis added).

[20] Co mpare similar comments by Chengsi and Pendleton, op. cit., pp. 107-109 with Arthur R. Miller and Michael H. Davis, Intellectual Property: Patents, Trademarks, and Copyrights (St. Paul, Minn.: West Publishing Co., 1983) pp. 289-290.

[21] Copyright Law, Article 8 and Copyright Regulations, Articles 7 and 8. The National Copyright Administration does supervise local administration, particularly in providing guidance to it.

[22] Copyright Law, Article 10 and Copyright Regulations, Article 5. Compare the five exclusive rights in U.S. law under 17 U.S.C.A. Sec. 101. The right of authority, alteration and integrity are personality rights whereas the right of exploitation and remuneration are property rights. Personality rights are given greater protection than property rights. Shen Rengan, op. cit.

[23] Copyright Law, Article 11.

[24] Ibid., Article 12. Compare Section 17 U.S.C.A. 201.

[25] Copyright Regulations, Article 10.

[26] Copyright Laws, Article 13.

[27] Copyright Regulations, Article 11.

[28] Copyright Law, Article 14 and Copyright Regulations, Articles 12 and 14. Compare 17 U.S.C.A. Sec. 201.

[29] Copyright Law, Article 15.

[30] Copyright Regulations, Article 13.

[31] Copyright Law, Article 20.

[32] Copyright Law, Article 21 and Copyright Regulations, Articles 23-25. Compare 17 U.S.C.A. Sec. 302 which has a similar life plus 50 years after publication.

[33] Copyright Law, Article 22 and Copyright Regulations, Articles 26-31. Compare the fair use doctrine enunciated in 17 U.S.C.A. Sec. 117.

[34] Copyright Law, Articles 23-24. Exception is made for newspapers and perodicals (Copyright Regulations, Article 32), wherein an oral license may be permitted.

[35] Copyright Law, Articles 29-34.

[36] Ibid., Articles 31-36.

[37] Ibid., Articles 37-44.

[38] Ibid., Article 43.

[39] Ibid., Article 45.

[40] Ibid., Articles 45-50. Compare 17 U.S.C.A. Sec. 502a) which provides for reasonable injunctive relief as well as damages, loss of profits and statutory damages. Criminal penalties as well as attorneys fees and costs may also arise. 17 U.S.C.A. Sec. 505 and 506(a).

[41] Ibid., pp. 8-9.

[42] Implementation Regulations, Article 4.

[43] id., Article 5.

[44] Ibid., Articles 6-7.

[45] Ibid., Articles 8-9.

[46] Ibid., Articles 10-16.

[47] Comments by Assistant U.S. Trade Representative, Joseph Massey, Los Angeles Times, March 4, 1991.

[48] East Asian Executive Report, March 15, 1991.

[49] The Washington Times, January 18, 1992.

[50] Deng Aiguo, South China Morning Post, November 4, 1992.

[51] South China Morning Post, November 13, 1992.

[52] United Press International, November 23, 1992.

[53] Xinhua General overseas News Service, September 13, 1993.

[54] Agence France Presse, December 16, 1993.

[55] Agence France Press, December 22, 1993.

[56] Ethan Horwitz, Key Trademark Issues in Asia, unpublished paper delivered at the Fordham University School of Law, Second Annual Conference on International Intellectual Property Law and Policy, April 7, 1994.

[57] Shen Rengan, op. cit.

AN INTERDISCIPLINARY MODEL FOR TEACHING AN UNDERGRADUATE COURSE ON LAW AND ECONOMICS

by

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During the Spring semester of 1993, the business college at New Mexico State University (NMSU) offered a class entitled "Law and Economics". This course was created in response to the perceived need to accommodate the interests of undergraduate business students who were seeking a law-related business elective in their program of studies. The course was taught in team fashion by an economist and the senior business law faculty member at NMSU.

The course proposed to provide undergraduate business students with an appreciation of the coextensive nature of economics and the American legal system.[1] The business college was interested in offering interdisciplinary electives that promoted critical thinking while developing the student's understanding of the interrelationships between various business disciplines. At the same time, the college had faculty within the economics department and legal studies field who were both interested in exploring the expanding role of economic analysis in legal reasoning including applications outside the typical market issues[2], as well as practical applications of economic analysis in the courtroom.[3] With these factors in mind, a course on law and economics provided a perfect fit.

This article describes the framework for a course that is not widely offered in business colleges, but warrants consideration by programs at other business

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schools. Although the course at NMSU was offered as an undergraduate course, the course could be taught as a graduate seminar in a masters program with equal success. A few comments regarding the nature of our university and the characteristics of the business program will be helpful in evaluating the value that a course of this type might have for programs of study at other schools.

The University Forum

The forum for the new course, NMSU, is located in the city of Las Cruces in southern New Mexico. NMSU presently serves about 15,500 students, and approximately 2,100 are enrolled in the College of Business Administration and Economics. As suggested by the name of the college, the economics discipline is housed in the business college, rather than in the liberal arts college as is the case at many universities. The administrative and physical proximity of the legal studies and economics disciplines at NMSU enhances the opportunity for collaborative efforts between faculty in these two fields. Law courses in the NMSU business school curriculum are designed to emphasize the legal environment within which businesses operate. Undergraduate students studying for the Bachelor of Business Administration are required to take either a traditional business law course (emphasizing contract law) or a legal environment course, at their option. The business law faculty is encouraged to develop junior and senior level elective courses that build upon the basic law foundation in a manner that is relevant to business students. An advanced law class that pertains to a specific business discipline was perceived as particularly valuable to the education of students in the business college.[4]

The Law and Economics course was offered as a senior level three-hour general elective in the undergraduate program. As seniors, all the students enrolled in the course had already met the core curriculum requirements for their major course of study within the College of Business, which as a practical matter meant each student had taken a foundation law course and at least several basic economics courses. No additional prerequisite courses were required of students enrolling in the Law and Economics class. The course was well received by the students and was strongly supported by both the Department of Economics and the Department of Finance which houses the legal studies faculty.

As will be the case in most business schools, no single instructor at NMSU holds both a law degree and a terminal degree in economics. Accordingly, it was essential for the course to be taught in team fashion with an instructor from each discipline willing to invest the time and effort to learn more about the other's area

of expertise.[5] Although the economist teaching this course had virtually no formal legal training and the lawyer had very little background in economics, each was excited by the prospect of learning from each other. Rather than disguise their lack of expertise, the instructors routinely asked each other questions in class. Students responded favorably to the more relaxed atmosphere engendered by learning with the instructors and showed an atypical willingness to actively participate in discussions.

Some background on law and economics may be useful to the business law professor who might consider offering such a course.

Law And Economics Basics

For over a century, both economists and legal academicians have applied economic thought and reasoning to legal issues.[6] Early economic analysis of the law focused predominantly on market-related topics such as antitrust,[7] taxation[8] and labor law.[9] Beginning in about 1960, economic analysis of the law changed significantly both in terms of methodology and subject matter. The use of formal mathematical models for economic analysis of the law became fashionable[10] and economic analysis moved from strictly market-related subjects to non-market issues, such as marriage,[11] crime[12] and discrimination.[13] This new conception of law and economics as a field of inquiry has often been referred to as the "law & economics movement".[14] The movement was dominated by a group of politically conservative microeconomists with a strong pro-market and anti-government bias,[15] commonly referred to as the "Chicago school" economists.[16] Many such economists take the position that economic analysis provides a useful framework for understanding *all* human behavior.[17] Their work is harshly criticized by many other economists and jurists who are skeptical about whether models developed to predict market behavior have any value when applied to non-market activities, who question whether the primary purpose of the law should be the promotion of economic efficiency (as defined by the Chicago school economists) and who are dubious about markets as a method for achieving social justice.[18]

Microeconomic analysis of market transactions can be reduced to relatively simplistic terms, albeit with some risk of diminished accuracy. The analysis is based on three fundamental premises. First, there is an inverse relationship between the price charged and the quantity demanded.[19] Second, people act as "rational maximizers of their satisfactions".[20] In other words, people deploy the resources they control so as to maximize the utility or benefit that can be obtained from those resources based on the individual's unique preferences. Third,

assuming certain ideal conditions including a perfectly competitive market where voluntary exchange is permitted, resources will gravitate toward their most valuable use so that "economic efficiency" is achieved.[21] Efficiency is defined as using economic resources in such a way that their value (defined as human satisfaction as measured by aggregate consumer willingness to pay for goods and services) is maximized.[22] Microeconomic analysis is subject to many criticisms, perhaps the most common of which is that the many assumptions upon which it is based are unrealistic or simply incorrect in many specific instances.[23] Despite the criticism, this type of economic analysis is taught in an introductory economics course at virtually every major university.

When examining the legal system, the microeconomist adopts still another premise: rules of law operate to impose prices or provide subsidies on specific human behaviors or decisions.[24] Based on this premise, the microeconomist attempts to predict the law's effect on value and efficiency (as they define these terms).[25] This effort is less controversial when applied to laws and court decisions regulate market behavior (such as antitrust laws, taxation of specific products, restraints on alienation of property) than when applied to laws regulating non-market activities such as whether to marry or divorce, drive carefully or commit a crime. The microeconomists' attempts to predict the effect of specific laws on "economic efficiency" in these non-market activities are highly controversial.

To illustrate, economic analysis suggests that legalizing a free market in human babies would be economically efficient, i.e. human welfare would be maximized. Based on economic analysis, it can be argued that legal restrictions on trafficking in babies keep supply and demand out of balance. Economic analysis predicts that in a free market where biological parents could be paid for babies, the supply of babies available for adoption would increase and the "price" paid (pecuniary and other) to obtain a child would decrease. Accordingly, there would be an increase in overall human welfare.[26] While the microeconomist purports to make no judgment as to whether "efficiency" is good, just or socially or ethically desirable, the mere exercise of evaluating the "efficiency" of legal rules and decisions suggests that such economists believe there is some value in applying an efficiency criterion to the law.

The controversy among economists and jurists over the use of micro-economic analysis of law provides an excellent framework for promoting critical thinking and analysis. The lawyer, even one who is not well-versed in economics, can play a vital role in this effort by interjecting inquiries about equity and social justice into the analysis. This may be particularly important if the economist

instructor's personal ideology is that of a "true believer" in the Chicago-school approach.

While the so-called law & economics movement has been characterized as an "intellectual fad" of the 1970s,[27] in its aftermath there are now four journals devoted to the economic analysis of law and most major law schools now have at least one PhD economist on their faculties.[28] The explicit use of economic analysis in court opinions is much more frequent and economists are commonly recognized as expert witnesses in a variety of legal proceedings. Thus, while the marriage of law and economics may be a stormy one, it appears certain to remain intact for the foreseeable future and continues to offer fertile ground for study and debate.

Course Design And Methodology

The instructors' philosophy in designing the course was that class participation and active student involvement is paramount to the learning process. The goal of the team teaching effort was to facilitate a pro-active rather than reactive response by students. Students were expected to become involved participants in exploring the interface between economics and the law. To achieve the desired student participation, the instructors sought to substitute a somewhat softened Socratic approach for the traditional lecture. Except for the first three class periods which were used for a an overview of the field of law and economics, a review of basic economic principles and a review of basic legal principles respectively, most class periods were treated as a roundtable discussion on the assigned readings. The instructors channeled the discussion through direct thought provoking questions. Students were expected to articulate and defend a particular position or response. The class was limited to ten students, which allowed the use of the seminar format combined with occasional lecture sessions.

Discussion topics covered a broad range of recent issues in the area of law and economics. Fortunately, there is a wealth of interesting topics that illustrate how economic principles relate to the legal policies that shape our society. Course topics were arranged in building block fashion, presenting an increasingly sophisticated level of scholastic inquiry. Some of the topics discussed included: the legal versus economic concepts of property rights, valuation of human resources at trial, the economist's role in the divorce case, and economic principles applied to natural resource issues such as pollution control. Each topic was developed in both its legal and economic implications. Appendix A contains a "Course Outline" with a detailed list of discussion topics.

Reading assignments for the course were taken from two required textbooks and supplemented with relevant journal articles and court opinions. The two required texts were Robin Paul Malloy's Law and Economics, *A Comparative Approach to Theory and Practice*[29] and A. Mitchell Polinsky's *Introduction to Law and Economics, Second Edition*.[30] Both of these texts complimented the interdisciplinary nature and team-teaching format of the course. Textbook reading assignments were supplemented with relevant journal articles and court opinions. A complete list of reading assignments arranged by topic (in the same sequence as the course outline) is found in Appendix B.

Although the reading list was rather ambitious when compared with other business courses, the instructors nonetheless chose to include numerous court decisions. The use of illustrative cases, for both lectures and discussion, was extremely effective in sparking interest and discussion. The use of actual cases added a real-world dimension to the application of the abstract concepts that students were expected to learn. The reading list included articles and cases that students were unlikely to have encountered in a previous law or economics class. Avoiding a duplication of coverage protected the academic integrity of the class.

The evaluation of student performance was based on two exams that utilized essay and short answer questions together with one research paper. For the research paper, students were required to select a topic from a list provided by the instructors or to obtain approval for topics they selected. Topics for papers were selected primarily from current issues presently before state or federal courts. Students manuscripts were expected to be ten to twelve pages in length and thoroughly researched. The research effort was documented through a bibliography attached to the paper. Students subsequently presented their research papers for the edification of the class as a whole, with ensuing discussion solicited from class members. Student comments indicated that the project, although rigorous due to the complex nature of the literature on many of the topics, provided an exceptionally enlightening learning experience.

Although it is beyond the scope of this paper to discuss each of the course topics in detail, a few examples of substantive areas of law and the related economic analysis will serve to illustrate the nature of the course and the instructors' approach to integrating the study of law and economics.

Race And Sex Discrimination In The Labor Market

The law relating to race and sex discrimination is well known to business law professors and is generally addressed in the foundation law course. However, anti-discrimination laws have become the focus of economic analysis, and a sophisticated discussion of these issues is typically beyond the scope of the foundation law course. Accordingly, the study of legal and economic principles as they relate to discrimination in the labor market was particularly appropriate for the Law and Economics course.

The primary inquiry for which economics may provide insight is: how do we prove discrimination has occurred? Increasingly, evidence of race and sex discrimination in the labor market is provided by economists in the courtroom. The intellectual father of the trend is University of Chicago economist Gary Becker who published *The Economics of Discrimination* in 1957.[31] This seminal publication led the way for the use of economists as expert witnesses in cases involving both wage and employment discrimination on racial and gender grounds. Since its publication, courts have placed increased reliance on the empirical proof of discrimination provided by econometric methods.[32]

Econometric methods involve building mathematical models of human behavior. Any model is merely an abstraction of reality: a small version of the real thing (in this case the labor market) that should (if it is constructed correctly) behave like the real thing. The benefit of the econometric model is its ability to present to the human observer (in this case a jury) that which is obscured by the complexity found in reality. For example, econometric models on wage and employment discrimination can compare the actual, observed values of wages and employment of various groups with those that the model indicates would have been expected to occur in the absence of discrimination. Where the actual data on wages and employment differ from the values predicted by the model, there is evidence of discrimination.[33]

Attorneys now commonly rely upon economists in the courtroom to provide such analysis as a method for defining and establishing the presence of various types of discrimination. Opposing attorneys typically seek to discredit the results of such models (with the help of expert economist witnesses) by pointing out deficiencies in the model which are typically quantified as "error terms". All econometric models contain error terms that indicate how much of the observed phenomena (differences between actual data values and predicted values) is explained by the model, and how much is not. Despite the presence of error terms,

courts generally allow juries to consider statistical evidence of discrimination, holding that the error terms go to the weight rather than the admissibility of the evidence.[34]

While sophisticated econometric analysis was beyond the instructional scope of this course, the study of race and sex discrimination provided an ideal forum in which to provide an introduction to econometrics and its use in the courtroom. By citing existing court cases that have rendered opinions discussing the use of econometrics in the courtroom, and by reconstructing the elementary forms of econometrics on which the experts relied, students obtained a foundation for understanding the relationship between the empirical world of the economist and his place in court testimony.

Recovery Of Hedonic Damages

A second topic that was particularly successful in terms of stimulating discussion and debate was that of the recovery of hedonic damages. All students in the class were acquainted with the notion of monetary recovery for personal injury and wrongful death as a result of studies in their foundation law course. None, however, had considered the problems inherent in valuing human resources. Several class periods were devoted to a discussion of the traditional legal approach to this problem and the role that the economists has served in these valuation problems.[35] With this background, students were well prepared to consider the latest innovation in this field, the valuation and award of hedonic damages, or damages for non-pecuniary value of life.[36]

The phrase "hedonic damages" was coined by economist Stanley Smith.[37] Courts have defined hedonic damages as either a loss of enjoyment of life or loss of life's pleasures.[38] Almost everyone intuitively recognizes that an individual's life does have inherent value beyond the present value of the individual's future earnings. It is this other non-pecuniary value, the value of the joy of living, that is referred to as the hedonic value of life. While the existence of hedonic value is widely recognized, our legal system has traditionally based awards in wrongful death cases primarily on pecuniary losses (loss of income) because courts had no method or criteria for placing a dollar value on the hedonic value of the life.

Recently, economists have developed a variety of techniques to estimate hedonic damages.[39] The application of economic tools for estimating the hedonic damages of life has created a storm of controversy. Although courts recognize that there is little agreement among economists as to the studies or elements which

ought to be considered on the question of valuation of hedonic damages,[40] economists are beginning to make inroads with respect to the acceptance of such applications as legitimate valuation techniques.[41]

Many of the techniques used to calculate hedonic value involve using some surrogate criteria to determine the value that individuals themselves place on life. These techniques attempt to determine how much money a person would require in payment before accepting an increase in the risk of dying, or in the alternative, the amount of money a person would be willing to pay to reduce the risk of dying. For example, the estimate may be based on studies regarding the amount of money individuals actually pay to increase their own safety.[42] Information on consumer purchases of safety items such as smoke detectors and air bags are often used. The economist's objective is to quantify dollars spent by the consumer relative to the risk reduction obtained from the items purchased. The economist can then determine the "price" a consumer is willing to pay to reduce his or her risk of dying.

As a simplistic example, if studies indicate that the average consumer is willing to pay $50, but no more, for a smoke detector that reduces the risk of dying in a house fire from 4 in 10,000 to 3 in 10,000, the economist would suggest that this indicates that the average person places a value of $50 on 1/10,000th of the person's life. Therefore, the hedonic value of life is estimated at $500,000 ($50 x 10,000). This does not suggest that this person would exchange his or her life for this sum of money. It is simply a method for estimating a non-pecuniary value of life.

Other techniques used by economists to measure the hedonic value of life are based on studies of wage increases workers must be paid to accept jobs with greater life risks. The general premise behind these wage and risk studies is that the wage will include compensation for the accepted level of risk. Typically, the economist will use differences between wages and deaths for a particular job and make comparisons to other jobs. By using statistical comparisons, the economist can establish a range for estimating the value of human life. Of course, these methods do not actually value life. Instead, measures such as the amount of money consumers are willing to pay to increase safety and how much remuneration workers are willing to accept for higher risk jobs are after-the-fact measures of the actual cost of an incremental statistical increase or decrease in the risk of death.

Economists have also attempted to estimate the hedonic value of life using a cost approach. This technique analyzes variables such as the cost of keeping an individual institutionalized or under intensive care in a hospital or incarcerated in prison. This analysis suggests that the amount of money that society is willing to spend to maintain life bears some relation to the value that society places on life. Critics point out that in none of these contexts is the decision to maintain the life based upon a determination that a life is worth a definitive amount of money. In the case of incarceration, the decision to maintain a life is a political rather than an economic decision. In the context of intensive care, it is a medical decision. The assumption that the cost of these decisions reflects the value society places on life may not be valid.

The use of economic analysis to estimate hedonic damages has been harshly criticized by the defense bar. Defendants argue that the statistical life measures advanced by economists measure the cost of changing the statistical risk of death or the cost of preserving an anonymous life, but are NOT a measure of the value of the life itself.[43] Defendants note that the term "damage" usually denotes the provable "financial consequences" of injury[44] and advance the opinion that the hedonic loss is not one which the tort remedy of damages was designed to compensate. According to opponents of the award of damages for hedonic loss, for a jury to award hedonic damages in a wrongful death action, the jury must imagine a future life for the decedent which will never occur and place a monetary value upon that life based on nothing more than speculation, guess, or conjecture.[45] Defendants reject this scenario and embrace the traditional approach that limits recovery in wrongful death to the present value of the decedent's future projected earnings based on age, earning capacity, health, habits and life expectancy.[46] For all these reasons, it is argued that expert economic testimony is not relevant or admissible on the damages issue in a wrongful death action.

The controversy surrounding the calculation and award of hedonic damages provided the class with insight into the general law of damage recovery, and the specialized application of economic theory to that area of law. The debate surrounding this issue also offered students insight into the tort reform movement fueled by the liability crisis in this country. Students responded both intellectually and emotionally to the issue. Heated discussions were channeled by the professors, and provided excellent opportunities for students to articulate opinions based upon economic, legal and philosophical analysis. The students indicated that the exploration of hedonic damages was a particularly effective learning experience.

Conclusion

The Law and Economics course that is the subject of this article was not treated as an exclusive forum for the Chicago school economics ideology. Rather, the approach of the course was to examine the relationship of law and economics in a much broader sense. While some of the micro-economic mathematical models were presented and discussed, much of the economic analysis was of a more rudimentary nature. Students generally found the study of economic principles more interesting and relevant when applied to actual real world legal issues. Conversely, students come to understand the significance of legal rules to business by studying the possible economic consequences of those rules. An examination of the tension between the efficiency objective of economics and the equity objective of law provided a valid forum for the discussion of business ethics and the value judgments inherent in economic and legal policy decisions.

This course demonstrated how the interdisciplinary synergism of team-teaching can elevate the role of a business law course and the business law faculty in the undergraduate curriculum. Since the legal issues explored in the Law and Economics course were ones generally not addressed by the foundation business law course, the course served to advance the student's understanding of law in the context of a business discipline. The business law faculty served an important role in the course by challenging students to defend the application of economic principles as applied to legal issues, thus promoting critical thinking. Students responded to the unique course content and methodology with a true zeal for learning.

Implementation of a Law and Economics course at other universities can promote an understanding of the value and function of the legal studies program. The course provides the opportunity for the business law faculty to provide insight for the legal principles that shape modern business policy and procedures. While the suggested classroom activities and instructional resources discussed in this article can be used as a model for structuring a unit on law and economics, the ultimate success of the study of economics in legal education depends upon the interest and resolve of the faculty to commit their energies to the course.

ENDNOTES

1. *See generally* Ernest Gellhorn and Glen O. Robinson, *The Role of Economic Analysis in Legal Education*, 33 J. OF LEGAL EDUC. 247 (1983); Frank I. Michelman, *Reflections on Professional Education, Legal Scholarship, and the Law and Economics Movement*, 33 J. OF LEGAL EDUC. 197 (1983); and Warren F. Schwartz, *The Future of Economics in Legal Education: The Prospects for a New Model Curriculum*, 33 J. OF LEGAL EDUC. 314 (1983).

2. *See infra* notes 11-13 and accompanying text.

3. *See, e.g.*, Severin Borenstein and Paul N. Courant, *How to Carve a Medical Degree: Human Capital Assets in Divorce Settlements*, 79 AM. ECON. REV. 437-454 (1986).

4. *See* William H. Daughtrey and Peter L. Gibbes, *Survey of Collegiate School of Business Deans Concerning Business Law Faculty*, 8 J. LEGAL STUD. EDUC. 53 (1989/90).

5. Judge Richard A. Posner, formerly Professor Posner of the University of Chicago and one of the leading figures in the law and economics movement, has noted: "The economics of law is the set of economic studies that build on a detailed knowledge of some area of law; whether the study is done by a 'lawyer,' an 'economist,' someone with both degrees, or a lawyer-economist team has little significance." *The Law and Economics Movement*, 77 AMER. ECON. REV. 1, 4 (1987).

6. *See* Herbert Hovenkamp, *The First Great Law & Economics Movement*, 42 STANFORD L. REV. 993, 993 (1990).

7. *See* Herbert Hovenkamp, *The Antitrust Movement and the Rise of Industrial Organization*, 68 TEX. L. REV. 105 (1989).

8. *See* JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY (1848); HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938).

9. *See* JOHN R. COMMONS AND EUGENE A. GILMORE, A DOCUMENTARY HISTORY OF AMERICAN INDUSTRIAL SOCIETY, III (1910). Of course, economic analysis of labor markets (as opposed to labor law) dates back to the 1700s. ADAM SMITH, THE WEALTH OF NATIONS (1776).

10. RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW §2.1, 16 (2d ed. 1972) ("[T]he hallmark of the 'new' law and economics . . . is the application of the theories and empirical methods of economics to the legal system across the board . . . .").

11. *See* GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 205 (1976).

12. *Id.* at 39.

13. *Id.* at 17.

14. *See generally* Richard A. Posner, *The Law and Economics Movement*, 77 AMER. ECON. REV. PAPERS AND PROCEEDINGS 1 (1987).

15. Hovenkamp, *supra* note 6, at 994-5.

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17. *E.g.*, GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 14 (1976).

18. *See* Hovenkamp, *supra* note 6, 995. *See generally* Liebhafsky, *supra* note 16, at 23-43; Buchanan, *supra*, note 16, 483-492 (in particular criticizing Posner's *Economic Analysis of Law*); Arthur Allen Leff, *Economic Analysis of Law: Some Realism about Nominalism*, 60 VA. L. REV. 451 (1974).

19. Posner, *supra* note 10, at 4-6.

20. *Id.* at 1 and 6-9.

21. *Id.* at 9-10.

22. *Id.* at 10. Economists define efficiency in several technically different ways. References to "Pareto Optimal" outcomes are simply references to economically efficient outcomes under one of these definitions. *See, e.g.*, ROSS D. ECKERT AND RICHARD H. LEFTWICH, THE PRICE SYSTEM AND RESOURCE ALLOCATION (10th ed. 1988).

23. *See, e.g.*, E. K. HUNT, HISTORY OF ECONOMIC THOUGHT: A CRITICAL PERSPECTIVE 350-373 (1979); CLARENCE E. AYRES, THE THEORY OF ECONOMIC PROGRESS (1944). For a rebuttal to these criticisms, see Posner, *supra* note 10, at 12-14 and 19-23.

24. Posner, *supra* note 10, at 5.

25. *Id.* at 10.

26. *See id.* at 111-116.

27. Robert D. Cooter and Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and their Resolution*, 27 J. ECON LIT. 1067, 1067 (1989).

28. *Id.* at 1067.

29. West Publishing Co. 1990.

30. Little, Brown and Company 1989.

31. *See* GARY S. BECKER, THE ECONOMICS OF DISCRIMINATION (2d ed. 1971).

32. *See* Orley Ashenfelter and Ronald Oaxaca, *The Economics of Discrimination: Economists Enter the Courtroom*, 77 AMER. ECON. REV. 321 (1987).

33. *See, e.g.*, Casteneda v. Partida, 51 L.Ed 2d 498, 512 (1976).

34. *Id.*

35. *See, e.g.*, W. W. Widicus and Alfred Mukatis, *Creation of Net Discount Factors for Estimating Lost Future Earnings in Personal Injury and Wrongful Death Actions*, 27 AMER. BUS. LAW J. 373 (1989).

36. *See generally* Stephen T. Riley, *The Economics of Hedonic Damages*, 1 NEV. L. REV. 24 (Sept. 1993); Thomas R. Ireland and James D. Rodgers, *Hedonic Damages in Wrongful Death/Survival Actions: Equitable Compensation or Optimal Life Protection?*, 3 J. LEGAL ECON. 43 (Dec. 1993); Note, *Hedonic Damages: A New Trend in Compensation?*, 52 OHIO ST. L.J. 331 (1991); Casenote, *Hedonic Damages: Compensation for the Lost Pleasure of Living: Sherrod v. Berry, 827 F.2d 195 (7th Cir. 1987)*, 5 COOLEY L. REV. 861 (1989).

37. *See* Douglas L. Price, *Hedonic Damages: To Value a Life or Not To Volue a Life?*, 95 W. VA. L. REV. 1055, 1055-1056 (Summer 1993).

38. *Id.*

39. *See* Mercado v. Ahmed, 974 F.2d 863 (7th cir. 1992); *see also* Note, *supra* note 36.

40. *See* Southlake Limousine and Coach, Inc. v. Brock, 578 N.E.2d 677, 680 (In. App. 1991).

41. *See* Sherrod v. Berry, 835 F.2d 1222 (7th Cir. 1988).

42. Southlake Limousine and Coach, Inc. v. Brock, 578 N.E.2d 677 (Ct. App. In. 1991).

43. Mercado v. Ahmed, 974 F.2d 863 (7th Cir. 1992).

44. Lovelace Medical Center v. Mendez, 111 N.M. 336, 356, 805 P.2d 603 (1991).

45. Sanchez v. Martinez, 99 N.M. 66, 68, 653 P.2d 897 (Ct.App. 1982) (award of damages may not be based upon speculation, guess or conjecture).

46. Solon v. WEK Drilling Company, Inc., 113 N.M. 566, 829 P.2d 645 (1992).

APPENDIX A

COURSE OUTLINE

I. NATURE OF THE DISCIPLINE. EXPOSITION AND CRITIQUE

II. REVIEW OF MICROECONOMIC THEORY

- A. Markets
- B. Efficiency and Pareto Optimality
- C. Notions if Equity, Fairness, and Justice
- D. Market Failure

III. REVIEW OF LAW AND LEGAL INSTITUTIONS

IV. PROPERTY AND PROPERTY RIGHTS

- A. The Legal versus the Economic Concepts
- B. The Importance of Transactions Costs in Exchange
- C. The Coase Theorem
- D. The Concept of Nuisance

V. CONTRACTS AND BREACH OF CONTRACTS

VI. ECONOMIC WELFARE, TORTS, AND DAMAGES

- A. Elements of a Tort
- B. Critique of Standard Solutions
- C. Pareto Optimality revisited
- D. Concept of Welfare Loss
- E. Measurement of Welfare Loss and the Notion of Compensated Demand Curves
- F. Use of Ordinary Demand Curves as Proxies for Compeusated Demand Curves

- G. Optimal Precaution; Optimal Risk Reduction
- H. Liability
- I. Negligence

VII. VALUATION OF HUMAN RESOURCES, MEASUREMENT OF LOSSES: SOME PRACTICAL CONSIDERATIONS

- A. Concepts of Present Value and Future Value
- B. Concept of discounting; construction of Discount Rates
- C. Past versus future Losses
- D. Real versus Nominal Values
- E. Expected Worklife; Expected Lifetime
- F. Basic Information Required by Economist
- G. The Use of Medical, Physical, and Vocational Rehabilitative Therapists
- H. Actual versus Potential Earnings Losses
- I. Data Courses, Reliable and Non-reliable, Uses and Abuses
- J. The Concept and Measurement of Lost Household services.
- K. The Economist Report and Rebuttal
- L. Qualifying the Economist

VIII. MEASUREMENT OF LOSSES: SOME APPLICATIONS

- A. Wrongful Injury
  1. Damages when Injured Party is Totally or Partially Disabled
  2. Damages when there are no Measurable Earnings Losses
- B. Wrongful Death
  1. Establishing the Worth of Life and Limb; Critique of Current Practices
  2. Hedonic Damages
  3. Death of a Primary Breadwinner
  4. Death of a Child

C. Wrongful Employment Termination
   1. Are Jobs Considered Property?
   2. Discrimination damages

IX. DIVORCE SETTLEMENTS: ALIMONY, PROFESSIONAL DEGREES, PENSIONS

A. Alimony
   1. Standard Rules and Shortcomings
      a. Marriage as a contract Analogy
      b. Marriage as a Partnership Analogy
      c. Rightful Restitution Analogy
   2. Economic Rules
      a. Economic Disparity Between Parties
      b. Career Opportunity Costs

B. Professional Degrees
   1. Can degrees be Considered Property?
   2. Can the Returns to the Degree be divided?

C. Pension Settlements

X. NATURAL RESOURCES, VALUATION AND ALLOCATION ISSUES

A. Deprivation of Benefits, Loss of Opportunity, and Tort

B. Risk Assessment in Hazardous Activities

C. Interstate Allocation of Groundwater

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FLEXIBLE EXAMS IN THE INTRODUCTORY LEGAL ENVIRONMENT COURSE

by

Susan L. Martin*

Introduction

Although testing is a most important aspect of the teaching and learning process, most business law professors have had little preparation in designing evaluation tools. To address this problem which exists for professors in most fields, many articles have been written about choosing an appropriate exam format and constructing meaningful exams.[1] Unfortunately, mere proficiency at creating a particular kind of test no longer seems adequate. No one exam type seems to assess well the learning of an increasingly heterogeneous mix of students. Equally important are students' perceptions that they cannot do well on certain types of exams.

After reviewing the usual exam formats used in business law classes, this article concludes that because of the wide variations in abilities of students and the time constraints on professors, a multiple-choice exam that allows students to respond in essay form can be a useful tool.

Assessing Students

Generally, instructors of an introductory legal environment course test students to assess several areas of achievement. First, instructors want to know that students

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have mastered the substantive content of the course. Examples of this kind of learning might include knowing what jurisdiction means; knowing what provisions employers must make for the religious observances of their employees; or knowing when liability exists for the clean up of toxic waste sites. In addition, instructors expect students to demonstrate that they can use the knowledge they have acquired to solve new problems. This skill would be required to explain, for example, how a new case should be decided based on past precedent. Instructors might also want to assess the attitudes and values students have acquired in connection with business law concepts.

Although constructing meaningful testing instruments has never been a simple task, the job has gotten much more difficult because of the increasingly wide variations in the abilities of students in many collegiate institutions. Because of these differences, it is hard to find one traditional testing format that allows all students to demonstrate their command of the material taught. Although each format has its advantages and drawbacks, each favors and disadvantages different kinds of students. Thus, the instructor is presented with an enhanced problem of grading students fairly and having them perceive that they have been graded fairly. The learning environment is hampered when students feel that although they knew the material, they were not able to demonstrate that knowledge on an exam.

In addition, the instructor's own interest is undermined when students believe that their exam grades do not reflect their mastery of the course work. Colleges and universities are putting increasing emphasis on teaching performance.[2] Usually, an important element in assessing teaching ability is student evaluation data.[3] Therefore, instructors facing reappointment, tenure and promotion decisions have a personal reason for reducing student anxiety about a test format that makes them feel unable to adequately "show what they know."

Exam Formats

Essay Exams

Essay exams are probably the most obvious choice for business law professors. It is the way they were tested in law school. Moreover, essay exams have significant strengths.[4] They can test complex learning outcomes, such as organizing and writing about learned material, that cannot be tested in other formats. Essays are an effective means of testing students' ability to think critically and apply what they have learned in order to solve problems. Essay questions also eliminate the possibility of answering correctly by merely guessing. As a practical matter for the instructor, essay exams can be created rather quickly. Nevertheless, essay tests also have important limitations.

First, various studies have demonstrated the unreliability of essay exams.[5] Different graders may score the same response differently and even the same grader may score responses differently at different times. The response to one question may also influence the grader's assessment of the student's response to another question on the same exam. Moreover, the grader's assessment may be influenced by factors other than what is purportedly being tested, for example, handwriting, spelling or grammar. Second, because essay questions take relatively long to answer, only limited subject matter can be tested. Thus, the student who studied the "right" material may do better than the student who has more comprehensive knowledge but who, unfortunately concentrated on material not covered on the exam.

Third, although essay exams may be constructed more quickly than other formats, they are very time consuming to grade. Not only does it take long to read students' essays once, but ideally, they should be read and scored twice with the grade being the average of the two.[6] Such a process will increase the exam's reliability. Furthermore, for the exam to be a learning experience, comments should correct erroneous statements, note omitted and irrelevant responses, and point out other errors in logic, grammar, spelling, etc. The practical reality for the professoriate is that professional success (reappointment, tenure, promotion) is measured by excellence in teaching, publication and service (to the department, the school, the university), none of which is determined by time spent grading exams. In fact, time spent grading exams specifically and directly limits time that can be spent on publishable research and service activities. Even actual and perceived teaching skills are not necessarily related to time spent grading exams. Essay exams may actually lower students' perceptions of a professor's teaching ability because grading is necessarily subjective and open to interpretation: the student's interpretation may vary significantly from the instructor's. It may be difficult for the poorer students to understand nuances that have made the exam responses of others rate higher grades than their own.

In addition, the disadvantages of essay exams have increased because of changes in students of collegiate business studies. Demographics, institutional financial considerations, affirmative action programs and a larger number of foreign students all play a role in creating the great variation of abilities among students. An instructor of the introductory legal studies course may have students with very poor writing skills. Because of the large amount of substantive material that is covered in this kind of course, there is little time to devote to teaching the test-taking techniques that are necessary to approach an essay question successfully. Furthermore, significant numbers of foreign students may have such a poor command of written English that it is almost impossible for them to demonstrate in an essay, particularly in a limited time period, their understanding of the substantive material.

Short Form Essay Exams

Some business law professors, in an effort to achieve the advantages of an essay exam, particularly avoiding having the mere guess produce the correct answer, while limiting the disadvantages of unreliable and time consuming grading, use the short form essay exam.[7] In this form, instead of being open ended, questions are very focused and require a one, two or three sentence response. This format generally will yield a more reliable score than long, open-ended questions.[8] Restricted response questions are also more appropriate for testing content because, unlike typical extended response essay questions, they do not leave students free to determine what content they want to include in their answer. This format is also more amenable to students with limited writing skills or a limited command of the English language. Unfortunately, the more suitable the short essay question is for the latter students, that is, the shorter the required response, the more uncomfortable it will make students who read into a question and need room to explain fully.

Multiple-Choice Exams

Multiple-choice exams (and other objective variations such as true-false, matching, and fill-ins) are often the exam of choice because they can be scored quickly and efficiently by machine; however, professors seem to be apologetic about their use. According to experts, this guilt is unwarranted.[9] Multiple-choice questions are not necessarily merely superficial, "multiple-guess" exercises.[10] Skillfully drafted multiple choice items may be used to test the same higher levels of learning, analysis, synthesis and evaluation, that an essay exam appraises. In addition, multiple-choice questions can test more material because more questions can be asked than on an essay exam. Luck in choosing the "right" material to study, is neutralized as a factor contributing to success on the exam.

Nevertheless, multiple-choice and other objective format exams have distinct weaknesses. It is difficult to construct multiple-choice questions that are completely without ambiguity. Students may read more into a question than was intended. This may disadvantage students who actually have broader or deeper knowledge. Furthermore, multiple-choice items may require fine distinctions that students perceive to be too subtle and, therefore, unfair. Distinguishing between options may also require good reading skills. Just as increasing numbers of students have insufficient writing skills, some are deficient in reading skills. Thus, there are students who can explain business law concepts in their own words, but who have great difficulty choosing the correct answer from among several options.

Flexible Exams

The foregoing brief review of essay and multiple-choice exams suggests that every student will not be able to demonstrate his or her ability to understand, apply, analyze, synthesize and evaluate legal concepts on one kind of exam. The short essay format is one way of trying to achieve the advantages of both essay and multiple-choice items without the disadvantages of either. Another possibility is adapting the multiple-choice question to an essay format. This method does not eliminate the time consuming task of creating well designed multiple-choice questions, but it does make scoring a relatively easy task and it greatly improves student satisfaction and perception of fairness.

Students are given an ostensibly multiple-choice exam with the following instructions: "Choose the best answer. Mark your response in the appropriate space on the answer sheet. You may answer any question(s) in essay form in the blue book." The instructor explains to the students that multiple-choice questions may contain unintended ambiguities and the blue book gives them the opportunity to answer such questions correctly even though they find none of the provided options satisfactory. Enough time is scheduled for the exam so reading and writing speed is not a significant factor in completing the exam. Thus, students have the opportunity to address a question in the way that suits them best. Any question answered correctly on the answer sheet is marked correct. For every incorrect answer sheet response, the instructor checks the blue book to see if an explanation has been given. Students may explain why none of the choices are satisfactory, why more than one choice is satisfactory, or even their general understanding of the area of the law addressed in the question. They may get full credit or partial credit for their blue book responses. They get no credit for marking the wrong answer on the answer sheet and then merely iterating a second provided option in the blue book. Foreign students unable to write well in English and others with poor writing skills may choose not to use the blue book at all. Students with poor reading skills who have difficulty selecting one option among several, may explain their responses in their own words.

Results of Using Flexible Format Exams

Students in the introductory legal environment course at the Hofstra University School of Business, given exams in a flexible format during seven semesters, Fall 1990 through Fall 1993, have been overwhelmingly satisfied with the format. In four of those semesters a questionnaire was administered after students had taken two mid-term exams but before they had taken a final exam. Table 1 indicates responses of

students to the question, "Do you like the flexible format exam as opposed to a multiple-choice exam or an essay exam?"

TABLE 1

Semester	# Responding	1 Like Format Very Much %	2 Like Format %	3 Neutral About Format %	4 Dislike Format %	5 Dislike Format Very Much %
Fall 1990	29	68	12	16	-	4
	34	91	3	-	-	6
	25	70	4	13	-	13
	26	84	4	-	-	12
Fall 1991	32	82	11	7	-	-
	28	58	31	4	8	-
	30	42	38	15	-	4
	25	71	25	4	-	-
Fall 1992	30	81	12	-	-	8
	56	90	6	-	2	2
	33	97	-	-	3	-
Spring 1993	35	91	6	3	-	-
	40	82	13	5	-	-

Students were also asked what grade they expected to receive for the semester. In the Fall 1989 semester when traditional multiple choice and essay exams were used, the mean expected course grade was a "B". In the four semesters listed in Table I when flexible format exams were given, the mean response to that question was also a "B". Thus, students' preference for the flexible exam does not seem dependent on their perception that the format would result in their receiving higher semester grades. The format does seem to lower student anxiety levels. Some students are uncomfortable with multiple-choice exams because a machine-scored answer sheet does not allow them to add "but ..." to a response. The flexible format permits that. One clear anecdotal result of using the flexible format is the almost complete absence of student complaints about exams, particularly about ambiguous questions or arbitrary grading. The "blue book option" provides a safety net for both the student and the instructor. Time required for grading is much less than that required for an essay exam. As a practical matter, many students choose not to use the blue book at all. Often when students respond in the blue book, it is to items they have gotten right on the answer sheet. Nevertheless, there are always students who get credit for essay

responses that indicate their understanding of the material although they have chosen the wrong answer on the answer sheet. They may have misread the stem of the item or failed to distinguish among the options. They may have misunderstood a word that the instructor assumed was readily understandable. In addition, blue book responses, and those questions to which there are no blue book responses, provide feedback for the instructor that is helpful in creating new test items and in preparing lessons.

Conclusion

The flexible format exam appears to be a useful testing tool that relieves student anxiety and is perceived as fair by an increasingly heterogeneous student body. It is also efficient for the instructor because grading time is considerably less than that required for essay examinations.

ENDNOTES

[1] George D. Cameron III & Cindy A. Schipani, *An Alternative to the Traditional Objective and Essay Examination Formats in Business Law*, 9 J. LEGAL STUD. EDUC. 105 (1990); David A. Frisbie & Kristie K. Waltman, *Developing a Personal Grading Plan*, EDUC. MEAS.: ISSUES & PRACTICE 35 (Fall 1992); Richard J. Stiggins, *High Quality Classroom Assessment: What Does It Really Mean?*, 11 EDUC. MEAS.: ISSUES & PRACTICE 35 (Summer 1992).

[2] *See e.g.*, TEACHING EVALUATION HANDBOOK, Office of Instructional Support, Cornell University (1993).

[3] *Id.* at 28-29.

[4] *See* William E. Cashin, *Improving Essay Tests*, IDEA PAPER NO. 17, Center for Faculty Evaluation & Development, Kansas State University (Jan. 1987).

[5] *Id*

[6] *Id.*

[7] *See, e.g.*, Cameron & Schipani, *supra* note 1, at 105-106.

[8] *See, e.g.*, Cashin, *supra* note 4.

[9] *See e.g.*, Victoria L. Clegg & William E. Cashin, *Improving Multiple-Choice Tests*, IDEA PAPER NO. 17, Center for Faculty Evaluation & Development, Kansas State University (Sept. 1986).

[10] *Id.*

WHY CAN'T WE HAVE BETTER QUESTIONS: A CRITICAL EVALUATION OF THE UNIFORM CPA BUSINESS LAW EXAMINATION OBJECTIVE QUESTIONS, YEARS 1988-1993

by

Arthur M. Magaldi*

As life in the latter stages of the twentieth century has become more complex and financial transactions more intricate, the role of the accountant has grown in importance. With financial and economic complexity has come the need to independently verify the assertions of those involved in business transactions. Indeed, statutes often require that parties submit audited financial statements, for example, when registering a new issue of securities with the SEC for sale to the public by means of interstate commerce.[1] In other transactions like loans to businesses, audited financial statements are routinely required. In many ways, CPAs are considered the guardians of the financial integrity of our institutions.

As the accounting profession has grown in importance, the Uniform CPA Examination has similarly become more important. "The Uniform CPA Examination is the primary means used by the boards of accountancy to measure the technical competence of CPA candidates. To understand the importance of the examination as a prerequisite for the CPA certificate, one must recognize the significance of the certificate. It is awarded in the public interest to qualified candidates in accordance with the accountancy statutes of a given jurisdiction. The certificate is granted to ensure the professional competence of individuals offering their services to the public as professional accountants."[2]

The Uniform CPA Examination is given each year in May and November and has four distinct parts. A candidate must show competency in all four parts of the

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examination by scoring a mark of at least 75 percent on each part of the test. For the years 1988-1993, the various parts of the examination were Accounting Practice, Accounting Theory, Auditing, and Business Law.

The Business Law section of the examination is the focus of this paper. The topics tested and the respective weights given to those topics for the years 1988-1993 were as follows:

The CPA and the Law	10 Percent
Business Organizations	20 Percent
Contracts	15 Percent
Debtor-Creditor Relationships	10 Percent
Government Regulation of Business	10 Percent
Uniform Commercial Code	25 Percent
Property	10 Percent

Of course, each main topic bas various sub-topics.[3]

Traditionally, the Business Law section of the examination consisted of 60 percent objective questions presented in a multiple choice format and 40 percent essay questions. In 1992, the test was changed to a format of 70 percent objective questions and 30 percent essay questions. The additional 10 percent objective questions are so-called "other objective" questions since they are not multiple choice questions. Nevertheless, they are essentially "blacken the oval" variations of multiple choice questions.

Although the importance of the Uniform CPA Examination is understood, the content of the examination has had relatively little critical evaluation. An examination of such importance should meet the highest standards of reliability and validity. This paper scrutinizes the multiple choice portion of the examination for the twelve-exam period from November 1988 through May 1993. Emphasis will be placed on those questions considered inappropriate and an attempt will be made to evaluate the overall reliability and validity of those tests.

The CPA Examination is not intended to be comparable to a bar exam. The AICPA has indicated, "The Business Law section is chiefly conceptual in nature and is broad in scope. It is not intended to test candidates' competence to practice law or their expertise in legal matters, but to recognize relevant issues, recognize the legal

implications of business situations, apply the underlying principles of law to accounting and auditing, and know when to seek legal counsel or recommend that it be sought. This section deals with federal and widely adopted uniform laws. Where there is no federal or appropriate uniform law on a subject, the questions are intended to test candidates' knowledge of the majority rules."[4]

Analysis of the objective portion of the twelve examinations administered between May 1988 and November 1993 reveal a number of inappropriate questions. These questions do not meet the standards established by the examiners for the examination.

Questions which detract from the fairness and effectiveness of the examination are for the purposes of this discussion characterized as follows: questions in which the material tested is outside the scope of the examination; questions in which there is more than one correct or "right" choice and therefore no best choice; questions in which all answer choices are incorrect; questions in which the wording is unreasonably unclear or confusing; questions which are concerned with impractical or irrelevant fact patterns or scenarios.

Question Outside the Scope of the Examination

For the twelve examinations from 1988-1993 inclusive, the examiners asked several questions which were clearly not included in the Content Specification Outline provided for candidates. Question #60 from May 1990 is set forth below and tests the concept of insurable interest in life insurance.

60. Orr is an employee of Vick Corp. Vick relies heavily on Orr's ability to market Vick's products and, for that reason, has acquired a $50,000 insurance policy on Orr's life. Half of the face value of the policy is payable to Vick and the other half is payable to Orr's spouse. Orr dies shortly after the policy is taken out but after leaving Vick's employ. Which of the following statements is correct?

a. Orr's spouse does not have an insurable interest because the policy is owned by Vick.

b. Orr's spouse will be entitled to all of the proceeds of the policy.

c. Vick will not be entitled to any of the proceeds of the policy because Vick is not a creditor or relative of Orr.

d. Vick will be entitled to its share of the proceeds of the policy regardless of whether Orr is employed by Vick at the time of death.

Although a relatively simple question, the fault in this question is that the only insurance concepts on the content specification outline concern fire and casualty insurance. Question #60 concerns life insurance, a concept which was outside the scope of the examination.

The error of including life insurance concepts on the exam is repeated in Question #23 on the May 1993 examination and is set forth below.

23. Long purchased a life insurance policy with Tempo Life Insurance Co. The policy named Long's daughter as beneficiary. Six months after the policy was issued, Long died of a heart attack. Long had failed to disclose on the insurance application a known pre-existing heart condition that caused the heart attack. Tempo refused to pay the death benefit to Long's daughter. If Long's daughter sues, Tempo will:

a. win, because Long's daughter is an incidental beneficiary.
b. win, because of Long's failure to disclose the pre-existing heart condition.
c. lose, because Long's death was from natural causes.
d. lose, because Long's daughter is a third-party donee beneficiary.

Perhaps the most extreme example of questions clearly outside the scope of the content specifications guidelines is Question #8 from the November 1992 examination. This esoteric question tests candidates on a topic that can be found in virtually none of the leading business law textbooks and concerns a point of law which lawyers traditionally have difficulty understanding - The Rule Against Perpetuities. It should be noted that this question might also be included in the section on questions which are not relevant to the practice of a CPA.

8. To which of the following trusts would the rule against perpetuities not apply?

a. Charitable.
b. Spendthrift.
c. Totten.
d. Constructive.

The correct answer choice is "a" but the more important point is that the concept does not belong on the exam.

More Than One Best Choice

Question #21 from the November 1989 examination tests the suretyship concept of the rights of a surety who has satisfied the obligation of a debtor and is set forth below.

21. If a debtor defaults and the debtor's surety satisfies the obligation, the surety acquires the right of:

a. subrogation.
b. primary lien.
c. indemnification.
d. satisfaction.

In the instance where a surety satisfies an obligation the surety is entitled to the right of subrogation (choice "a"), i.e., the right to succeed to the creditor's rights against the debtor. A surety who satisfies the obligation of the debtor is also entitled to indemnification (choice "c") from the debtor.

The above illustration is the only instance on the twelve examinations in question in which the examiners erred in providing two choices which were equally correct. The question therefore provides no best answer.

Questions in Which All Answer Choices Are Incorrect

Question #60 from the May 1991 examination deals with secured transactions under Article 9 of the UCC. Specifically, the question concerns the rights of a secured creditor who has perfected by the filing of a financing statement a security interest in a transaction involving a purchase money security interest of consumer goods.

UCC Sec. 9-302(1)(d) provides that a creditor who obtains a purchase money security interest in a consumer goods transaction is automatically deemed to have its interest perfected at the time attachment takes place. No filing of a financing statement is required in such a case. If the consumer-debtor should, however, resell the collateral to another consumer who in good faith is ignorant of the security interest, the security interest is defeated (if unfiled). To obtain protection against sub-purchasing consumers of this type, the secured creditor must file a financing statement. Where no filing of a financing statement takes place in a situation concerning a purchase money security interest of consumer goods, the security interest is deemed perfected upon attachment, but it is subject to defeat by a good faith consumer-purchaser from the original debtor.

60. Wine purchased a computer using the proceeds of a loan from MJC Finance Company. Wine gave MJC a security interest in the computer. Wine executed a security agreement and financing statement, which was filed by MJC. Wine used the computer to monitor Wine's personal investments. Later, Wine sold the computer to Jacobs, for Jacobs' family use. Jacobs was unaware of MJC's security interest. Wine now is in default under the MJC loan. May MJC repossess the computer from Jacobs?

a. No, because Jacobs was unaware of the MJC security interest.
b. No, because Jacobs intended to use the computer for family or household purposes.
c. Yes, because MJC's security interest was perfected before Jacobs' purchase.
d. Yes, because Jacobs' purchase of the computer made Jacobs personally liable to MJC.

The examiners offer choice "c" as the correct answer. However, the answer along with the other choices is not a correct statement of law. The secured creditor may repossess not simply because the interest was perfected before Jacobs purchased, since that perfection was automatic. The collateral may be repossessed by the secured

creditor because the security interest was perfected by filing. Question #60 does not mention filing in any of the answer choices.

Questions Which Are Unclear or Confusing

In general, the examiners are clear and straightforward in the wording of questions. Question #60 from May 1989 was somewhat unclear, however, and again deals with a secured transaction.

60. Burn Manufacturing borrowed $500,000 from Howard Finance Co., secured by Burn's present and future inventory, accounts receivable, and the proceeds thereof. The parties signed a financing statement that described the collateral and it was filed in the appropriate state office. Burn subsequently defaulted in the repayment of the loan and Howard attempted to enforce its security interest. Burn contended that Howard's security interest was unenforceable. In addition, Green, who subsequently gave credit to Burn without knowledge of Howard's security interest, is also attempting to defeat Howard's alleged security interest. The security interest in question is valid with respect to:

a. both Burn and Green.
b. neither Burn nor Green.
c. burn but not Green.
d. green but not Burn.

Here the question tells the candidates that a loan was "secured" and a financing statement was signed and filed. The question does not indicate that a security agreement was signed by the debtor. Since an oral security agreement is enforceable only if the creditor has, or takes, possession of the collateral, the argument can be made that no properly en- forceable security interest exists. The examiners find that there is a properly enforceable security interest making choice "a" their correct answer.

Inasmuch as many candidates focus on the signed security agreement as pivotal to creation of a security interest, the question may justifiably be criticized as unclear.

Also unclear or confusing is Question #13 from November of 1993.

13. Generally, a disclosed principal will be liable to third parties for its agent's unauthorized misrepresen- tations if the agent is an:

	Employee	Independent Contractor
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

The confusion concerning this question stems from the fact that the narrative portion of the question describes agents working for a disclosed principal and is concerned with the liability of a disclosed principal for the unauthorized misrepresentations of agents. By definition, an agent is a party authorized to make contracts and a principal is generally bound by the unauthorized misrepresentations of agents. The student is then forced to choose as a correct answer choice "b" because of the inclusion of the term independent contractor. Since an independent contractor is not an agent, it is confusing to apply the term "agent" to that relationship.

Questions Lacking in Relevancy

The area where the examiners apparently have the most difficulty is in consistently providing questions which are relevant to the practice of a CPA. As previously noted, relevancy of material is one of the criteria for the questions.

Despite the need for relevant questions, on four different occasions on the analyzed examinations the examiners posed questions on the legal result of a creditor releasing one surety in a situation where there are two or more sureties for an obligation. Question #26 from the November 1991 examination set forth below is illustrative of this type question.

26. Mane Bank lent Eller $120,000 and received securities valued at $30,000 as collateral. At Mane's request, Salem and Rey agreed to act as uncompensated co-sureties on the loan. The agreement provided that Salem's and Rey's maximum liability would be $120,000 each.

Mane released Rey without Salem's consent. Eller later defaulted when the collateral held by Mane was worthless and the loan balance was $90,000. Salem's maximum liability is:

a. $30,000.
b. $45,000.
c. $60,000.
d. $90,000.

The best answer choice for Question #26 is "b" because a creditor who releases a surety from an obligation where there are two or more sureties may not collect the full amount from the unreleased surety or sureties. The amount that may be recovered from the unreleased surety or sureties is reduced by the amount of contribution that otherwise would have been recoverable from the released surety had that surety not been released.

The difficulty, however, with this question is that it has virtually no relevance in the business world since those engaged in business transactions do not release obligors from their obligations. Question #26 from May 1991, Question #26 from November 1991, and Question #21 from November 1988 develop essentially the same irrelevant point.

Question #23 from November 1990 and Question #5 from May 1991 are based on the unrealistic point that a party who has entered a contract because of duress may avoid the obligation and the contract may be voidable. The aforementioned Question #23 is set forth for reference.

23. For a purchaser of land to avoid a contract with the seller based on duress, it must be shown that the seller's improper threats:

a. constituted a crime or tort.
b. would have induced a reasonably prudent person to assent to the contract.
c. actually induced the purchaser to assent to the contract.
d. were made with the intent to influence the purchaser.

The point of criticism once again focuses on the lack of relevancy of the subject matter of the questions. As a practical matter, a negligible amount of contracts are based on force, fear, or threats. Therefore, there is little reason to test candidates on this subject.

Question #16 from the May 1990 and Question #23 from the May 1992 examinations develop the rather esoteric point that a pledge to a charitable organization which is relied upon by the organization in incurring large expenditures may be enforceable against the promisor despite the fact that the promise is not supported by consideration. Question #23 follows.

23. Which of the following will be legally binding despite lack of consideration?

a. An employer's promise to make a cash payment to a deceased employee's family in recognition of the employee's many years of service.
b. A promise to donate money to a charity on which the charity relied in incurring large expenditures.
c. A modification of a signed contract to purchase a parcel of land.
d. A merchant's oral promise to keep an offer open for 60 days.

While the point of law may be accurate, as a practical matter charitable organizations do not as a general rule sue those who fail to honor promises to contribute. The loss of goodwill would generally outweigh the monetary gain received from the enforced promise. Additionally, there is small likelihood that businesspersons will make pledges of such size as to jeopardize seriously their positions. On the issue of relevancy, therefore, there is little.

Another unrealistic background for a question presented by the examiners is one in which a corporation, not an individual, files a voluntary petition in bankruptcy. An individual may receive a discharge of debts in bankruptcy, but a corporation's debts are not dischargeable in a Chapter 7 proceeding. Therefore, corporations as a general rule do not voluntarily seek to liquidate. Nevertheless, Questions #33 and #42 from May 1991 and November 1991, respectively, use corporations filing voluntary petitions as the framework for the questions.

Question #18 from November 1988, set forth below, involves the ramifications of failing to give notice of assignment to an obligor when a claim has been assigned. Question #23 of May 1988 is similar.

18. Pix borrowed $80,000 from Null Bank. Pix gave Null a promissory note and mortgage. Subsequently, Null assigned the note and mortgage to Reed. Reed failed to record the assignment or notify Pix of the assignment. If Pix pays Null pursuant to the note, Pix will:

a. be primarily liable to Reed for the payments made to Null.
b. be secondarily liable to Reed for the payments made to Null.
c. not be liable to Reed for the payments made to Null because Reed failed to record the assignment.
d. not be liable to Reed for the payments made to Null because Reed failed to give Pix notice of the assignment.

While choice "d" is clearly the best choice for Question #23, another question might be whether this is an important point on which to test candidates. It is routine business practice for those contemplating the purchase of an assignment to notify the obligor. Indeed, the prospective assignee is frequently in contact with the obligor before the claim is purchased in order to ascertain the status of the account or claim. It is extremely uncommon for those involved in business transactions to purchase a claim without contacting the obligor.

Question #55 from May 1990 deals with the various types of recording statutes for interests in real property. In order to answer properly this question set forth below, the candidate must be familiar with not only the types of recording statutes generally in use, but must also be knowledgeable concerning the "race" recording type statute which is virtually non-existent in the United States. This question calls for knowledge of more than the general rule of recording. Under this type statute, the first party to record is deemed to have the greatest rights regardless of the good faith or lack of good faith of the recording party.

55. On February 2, Mazo deeded a warehouse to Parko for $450,000. Parko did not record the deed. On February 12, Mazo deeded the same warehouse to Nexis for $430,000. Nexis was aware of the prior conveyance to Parko. Nexis recorded its deed before Parko recorded. Who would prevail under the following recording statutes?

	Notice statute	Race statute	Race-Notice statute
a.	Nexis	Parko	Parko
b.	Parko	Nexis	Parko
c.	Parko	Nexis	Nexis
d.	Parko	Parko	Nexis

The November 1993 examination contained two questions on securities regulations which focus on issues which are remote or irrelevant to the practice of CPAs. The regulation of the sale of securities is a test area where the examiners formerly seemed to have little difficulty in framing appropriate questions.

Question #4 set forth below is based on this narrative provided to the students:

While conducting an audit, Larson Associates, CPAs, failed to detect material misstatements included in its client's financial statements. Larson's unqualified opinion was included with the financial statements in a registration statement and prospectus for a public offering of securities made by the client. Larson knew that its opinion and the financial statements would be used for this purpose.

4. In a suit by a purchaser against Larson for common law negligence, Larson's best defense would be that the:

a. audit was conducted in accordance with generally accepted auditing standards.
b. client was aware of the misstatements.
c. purchaser was not in privity of contract with Larson.
d. identity of the purchaser was not known to Larson at the time of the audit.

The best answer to Question #4 is clearly "a." However, a purchaser of an original issue of securities in which there was a material misstatement would not sue for common law negligence. The purchaser would enforce the rights provided by the Securities Act of 1933 which provides that there is liability for any materially false, misleading or omitted information in the registration statement or prospectus. Under the statute, there is no need for the plaintiff to establish that the defendant was

negligent. Accordingly, the issue raised by the question, liability for negligence, is irrelevant.

Question #6 from November 1993 deals with an issue of an accountant providing an unqualified opinion on financial statements although material misstatements were discovered. The question then explains that the financial statements were included in a registration statement and prospectus and then raises an issue of fraud under Section 10(b) of the Securities Exchange Act of 1934. While it may be important for accountants to understand Section 10(b), it seems that the question should have a more appropriate focus. As indicated above, a purchaser of an original issue of securities, the situation presented in this question, would in all probability simply enforce its rights under the 1933 Act. Why would the plaintiff undertake the difficult role of proving fraud when this is unnecessary for recovery?

Conclusion

Within the parameters established by the AICPA, the examiners have done a reasonably good job in creating the multiple choice portion of the Uniform CPA Business Law examinations for the years 1988-1992. Recalling former examinations and discussing with candidates who have taken those examinations, the tendency is to focus on the less appropriate questions. But closer observation reveals that with few exceptions the questions fall within the content specification guidelines provided to candidates. The questions in general are clear with only one correct answer.

The area in most need of improvement concerns the relevancy of the questions to the realities of the business world.

Questions which have little or no relevancy to the actual accounting practice of CPAs help to certify candidates who should be tested on more relevant topics. There is also an indirect negative effect of these poor questions. Many faculty prepare students to pass the CPA examination. This is done in classes specifically designed to accomplish this and also in classes where it is simply assumed that the business law/ legal environment course will provide useful information for passing the exam. Faculty are aware of the content of the examination and many will necessarily address topics presented on that examination. Topics which have little application to real life situations end up receiving valuable class time and attention thereby compounding the problem.

The examination assesses the right of a candidate to a license. "Authentic assessment should engage students in meaningful material and in problem solving."[5] We have noted several problem areas where the material is not especially meaningful. Eliminating questions on these topics and replacing them with more topical questions would improve the examination. Perhaps a survey of businesspersons and CPAs to ascertain matters of concern in their experiences might be the source of worthwhile questions.

In addition, analysis of the twelve examinations from 1988-1993 shows a great deal of repetition in the content and the framework of the questions. Inasmuch as the examiners appear to have difficulty creating fresh and challenging questions, it would seem that this problem would be compounded by the examiners' move to an all-objective examination. The wisdom of that approach should be reviewed.

ENDNOTES

1 15 USC Sec. 11.

2 AICPA, INFORMATION FOR CPA CANDIDATES 47-50 (10th ed. 1991).

3 Id. at 47-50.

4 Id. at 6.

5 Scholastic, Instructor (Nov., Dec. 1992), p. 16.