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ARTICLES

THE ROLE OF MEDIATION IN OVERCOMING BARRIERS TO THE SETTLEMENT OF LEGAL DISPUTES: A CASE BASED APPROACH

By William D. LeMoult*

This paper was inspired by observations resulting from the mediation of more than 100 civil legal disputes in five states (Connecticut, New Jersey, New York, Massachusetts and Rhode Island) involving personal injury, wrongful death, property, landlord/tenant, workers' compensation, medical malpractice, attorney malpractice, contract, attorney's fee, employment, civil assault and battery, collective bargaining, and real estate. All negotiating parties involved in the mediations were attorneys and/or claims personnel employed by insurance carriers, and the parties they represented.[1]

Original inquiry involved the attempt to discern factors which kept litigants from settling their disputes, and distinguishing them in terms of case type. But the barriers to settlement were indistinguishable from case to case. In addition, there were often several barriers present in a given case, each presenting its own set of problems and requiring the employment of varying mediation skills.

A syllogism of sorts developed in the process of relating mediation to the problems experienced by litigants attempting to resolve their conflicts. Namely, that if settlement of a litigable matter was to be achieved at all, the notion that mediation could contribute presupposed that there were obstacles to timely settlement through direct negotiation which could be overcome by the intervention of a third party. Put another way, mediation appeared unnecessary unless there were barriers which inhibited direct negotiation and settlement in a timely fashion.[2] One exception to this notion involved those cases where representatives of the parties were willing to settle, but for a variety of reasons wanted a forum to achieve this objective. Reasons included client distrust, a lack of client control, and efforts at keeping clients fully involved and informed.

This paper discusses the barriers to direct settlement (which are sometimes also barriers to effective mediation) and recommends the role of mediation in helping to overcome those barriers. Hopefully it will contribute in some small way to the timely settlement of conflict and an improved image of attorneys in pursuit of their clients' best interests.

This Article received the Hoehlein Award for Distinguished paper at the 1995 Annual Conference of the North East Academy of Legal Studies in Business in Kiamesha Lake, New York.

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Finally, this paper does not distinguish matters that are not suitable for mediation. The point of view that seems most valid on this issue is that all matters may be properly mediated save those in which either party can achieve satisfaction only through a binding declaration.[3]

I. Barriers

The barriers to settlement of legal disputes discussed herein are:

1. Delays in litigation;
2. Differences regarding valuation/remedy;
3. Posturing;
4. Individuals with ultimate authority who do not participate directly in negotiations, referred to as "Phantom Negotiators";
5. Limits on authority to settle;
6. Egos;
7. Attorney's personal economic interest;
8. Failure of parties to properly prepare cases;
9. Phenomena regarding multi-party cases.

The presence or absence of these barriers is not a signal that an attorney or party has done something "wrong" or "right"; they are simply part of the fabric of litigation. Representatives of parties who pursue their clients' best interests, and who thoughtfully analyze the environments which affect those interests, should examine barriers to settlement as well, and consider the question of whether mediation would constitute an effective vehicle for overcoming the obstacles which inhibit a satisfactory and mutually agreeable solution. It is the failure to identify and acknowledge these barriers that is largely responsible for protracted negotiations and resistance to facilitated settlement.[4]

A. Delay in Litigation

A threshold issue revolves around the notion of delay. It is well known that approximately 95% of all litigated matters are never pursued to judgment.[5] If the number of claims and conflicts settled by parties before the commencement of litigation was documented, the percentage of untried litigable matters would be greater. Since all litigable matters not tried or discharged under the law are settled, it is reasonable to ask what motivation exists to seek mediation if the parties can reasonably expect that the controversy will ultimately be resolved without mediation. The answer depends on what is meant by "ultimately," what the nature of the other barriers to settlement are, and how they affect the client's interest in the case.

The extent of societal damage being created by delay in the litigatory process is unclear.[6] Factors contributing to delay include court congestion caused by the enormous volume of cases in the court system[7] and the panoply of mechanisms available to litigants in the adversarial process.[8]

It is not necessary to analyze the myriad justifications for delay or the use of legal mechanisms which contribute to delay since attorneys can always evaluate their conduct against a single ethical standard: Is the conduct in the best interest of the client?[9] Permitting or contributing to excessive delay with regard to matters that will, in all likelihood, settle privately seems not to comply with the standard.

A possible measure, then, of whether delay is excessive might be the extent to which it serves the interest of the client. An individual injured in an auto accident may have sustained latent damages not readily identifiable. Here, resolution cannot be achieved until the nature and extent of damages is known or reasonably foreseeable. Consider, however, a multi-party property damage case in which one of five defendants has taken a no-pay position. The parties wrangle bilaterally for years over damages alleged to be $20,000. Each party is, or should be, acutely aware of the likelihood of settlement, the improbability of a trial, and the disservice to clients resulting from the failure to seriously attempt multilateral settlement efforts. Yet the case drags on with no party undertaking a serious settlement initiative. The case assumes a life of its own independent of the interests of the parties. There are adverse economic consequences to defendants and plaintiffs for whom the concept of the present value of money is forever lost. Between these extremes there is, of course, a plethora of possible scenarios; but all are measurable against the client interest standard.

Mediation provides an escape from the spiral of excessive delay and serves to crystallize issues, focus on client interest, and achieve closure. Mediation brings parties together, relieves tension, focuses on issues which separate the parties, and seeks win-win phenomena. It has as its primary focus the interests of all clients and the most satisfactory solution possible in light of competing interests. Most importantly, results can be achieved in a timely fashion.

Excessive delay, however, is not a **cause** of failure to settle, it is a **result**. While there are forces inherent in the litigation process which contribute to delay, parties are still free at anytime to discuss and settle differences. Why, then, does it take so long? Why is the route to settlement often such a tortuous one?

There are other barriers which can be effectively overcome by the use of mediation, and which contribute to excessive delay.

B. Valuation and Remedy

It seems reasonable to assume that differences regarding the settlement value or outcome of a particular claim or lawsuit contribute more than any other single factor to the failure to settle. Absent this element there is no reason for litigants to continue, and the pursuit of litigation without legitimate differences regarding the outcome seems again to violate the client interest test.

Yet it is true that mediation efforts take place regarding litigation that has been in process for years without settlement demands or offers ever having been exchanged.[10] The reasons for a failure to negotiate are sometimes legitimate and in the client's best interest. But very often they are not, and ethical advocates should universally examine the issue of client interest as it applies to settlement initiatives, particularly in light of the statistical data regarding the likelihood of trial.

Since the process of settlement necessarily involves negotiations, and attorneys are nurtured on notions of strategy, there is an ever present danger that the objective of achieving a realistic outcome in the best interest of the client may become subordinate to achieving what is believed to be a strategic advantage. Making the first settlement overture, for example, may be perceived as indicating a weak position. The results of this attitude on both sides is, of course, inertia.

If reasonable settlement is an option in the best interest of the client, it cannot be achieved without an initiative from one side and response from the other. However, once expressed or pursued it may be that a negotiating strategy or posture is forever damaged. (Lawyers and claims personnel are haunted by the prospect of offering more than is minimally acceptable to the other side, even though such a condition should be idyllic from the perspective of the parties). Or it may be that a demand or offer will later operate to haunt the negotiating parties to their detriment at a pre-trial conference.[11] Mediation obviates most problems inherent in valuation issues. Skillful mediators will not lead parties into positions which will be detrimental to future negotiations or processes, and a skillful use of the confidential nature of the proceedings will leave all sides in a condition of parity. One complex personal injury mediation involving six defendants was conducted over a period of eight hours without a single demand or offer being exchanged among the parties. Barriers to settlement involved perceptions of value as well as comparative contribution of the defendants. Although settlement was not achieved, issues were crystallized, and information obtained in the mediation was the foundation upon which the eventual settlement was built.

It is most often true that valuation of a case is a highly subjective matter, and that no party to the action can forecast the likely outcome with clarity. Speculation regarding probabilities and possibilities of recovery is fueled by the interplay between issues of liability and damages, and the vagaries of jury behavior and venue.

Holmes circumscribes the dilemma of case evaluation when he defines the law: "The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law."[12]

Addressing his concept of the relationship between law and logic, Holmes is plain:

> You can give any conclusion a logical form. You always can imply a condition in a contract. Buy why do you imply it? Is it because of some belief as to the practice of the community or a class, or because of some opinion as to policy, or, in short, because of some attitude of yours upon a matter not capable of exact quantitative measurement, and therefore not capable of founding exact logical conclusions. Such matters really are battle grounds where the means do not exist for determinations that shall be good for all time, and where the decision can do no more than embody the preference of a given body in a given time and place. We do not realize how large a part of our law is open to reconsideration upon slight change in the habit of the public mind. No concrete proposition is self evident, no matter how ready we may be to accept it.[13]

Mediation acknowledges the wisdom of Holmes. It provides a forum for the honest repose of uncertainty and the quiet impartial evaluation of prophecy. Competent mediators will maximize the benefits to be derived from the judicious use of confidentiality,[14] drawing the parties closer and closer based on the exercise of their own reason as well as the mediators.[15] Mediation is also an excellent forum for discussing matters that are relevant yet outside the actual merits of the case, such as the likelihood of an adverse judgment in a jurisdiction known for bias in favor of plaintiffs or defendants.

C. <u>The Perils of Posturing</u>

If we can accept a dictionary definition of "posturing" as acting "in an affected or artificial manner, as to create a certain impression,"[16] then it is probably safe to say that every negotiator of a legal dispute is posturing to some degree up to that point beyond which further concessions will not be made and positions will not change; it is at that point that final impasse is reached. Since each party to a negotiation legitimately seeks to get as much as possible while conceding as little as possible,[17] it is necessary during the negotiation to communicate in a manner which represents something short of the negotiator's final impasse position.[18] The ethics and proficiency of the negotiation process have been explored by scholars and it is plain that not all negotiators perceive the ethics of negotiation in the same light, or are equally competent in that process.[19] The danger for negotiators lies not so much in the perception of their own attributes in these matters, as in the perception of their adversaries'.

The very notion of disequilibrium between and among negotiators constitutes a barrier that Mnookin might refer to as "cognitive."[20] Thus, as negotiators wend their way through the mine fields of adversarial discourse, creating images as they go which represent something other than their ultimate concerns, opportunities for error and miscalculation are created. When these are combined with the difficulties inherent in principal/agent relationships[21] there arises a permutation of barriers to timely and effective negotiation and settlement that sometimes become so insurmountable a trial is unavoidable.[22]

In one case involving recovery of an attorney's fee and a counterclaim of attorney malpractice, the parties had become so hostile during their bilateral settlement efforts that civil discussion was impossible. This continued through the joint session of the mediation, and into the caucus phase, degenerating eventually into a notion of killing the messenger. Mediation in the early stages of this relationship, before the parties had become encrusted in a reverence of their own posturings, would have stood an excellent chance of success, and would have preserved a friendship between former business associates.

Barriers to effective negotiations and settlement, whether among those specifically discussed herein or those formulating part of the accouterment of the communication process, have a universal quality about them in that they operate to damage relationships between adversaries to some degree, if not irreparably.

Professor Fuller describes the "central quality of mediation" as:

> ... its capacity to reorient the parties toward each other, not by imposing rules on them, but by helping them to achieve a new and shared perception of their relationship, a perception that will redirect their attitudes and disposition toward one another.[23]

This "new and shared perception" is largely a product of structuring the posturings of the parties, and of providing a parity in negotiating techniques and competencies, thereby intercepting potential barriers in such a way as to appeal to the negotiators' most productive and rational inclinations.[24]

This view is reinforced by generally accepted notions of the mediator's functions. Stulberg relates them as being that of educator, translator, expander of resources, bearer of bad news, agent of reality and scapegoat.[25]

D. <u>Phantom Negotiators</u>

Another obstacle to negotiated settlement, that sometimes also inhibits mediation, is the specter of phantom negotiators, i.e., individuals who are in control of the outcome of a negotiation but do not participate directly in it. In these scenarios, negotiations are conducted by individuals with or without any given authority, and it is left to the negotiating party either to achieve preordained objectives or persuade the phantom of the rationale for movement to other or broader objectives. These structures are often logistically necessary, but a barrier nonetheless.

The notion of compromise implies that the compromiser is equipped with all available influences which permit a reasoned judgment and the ability to achieve closure. In the settlement of legal disputes every discussion or communication contains its own environment as well as reasoning, and the evaluation of positions is best done by those who are in a position to assess both.

One mediation where a good faith effort by both sides over several hours proved successful was summarily undone by a 10-second telephone call from the plaintiff to a relative with an obviously preconceived notion of value.

Mediators provide a sounding board to those with authority who are not actively involved. In addition, the representations of mediators are more thoughtfully and thoroughly considered by phantom negotiators than are the representations of the adversary, or sometimes even their own representatives.[26]

Also, mediators can often talk directly with phantom negotiators, which generally is not an option available in direct negotiations due to considerations involving the undermining of authority. One two-party personal injury mediation occurred at the office of the defendant insurance carrier. The claims representative was unusually intransigent and matters were proceeding badly. This mediator went to the kitchen for a cup of coffee and, by chance, met the claims representative's supervisor who was familiar with the case. The three of us met thereafter and in five minutes ironed out a more reasonable and realistic approach. It seemed the claims person had authority for more than he had revealed, and had apparently been through a tough negotiation with plaintiff's counsel.

E. <u>Limits on Authority</u>

Plaintiffs and defendants generally will not reveal to each other limits on authority. Most often they negotiate as if there were none, although each side is strictly bound and must, at some juncture, or through prior experience, wrestle with the prospect of the other side's natural boundaries.

Mediation is a method of ferreting out those secret logistical barriers in an environment of strict confidentiality, evaluating their validity in light of the corpus of the argument, and using the information in the best interests of settlement rather than strategy. Effective mediators test the validity of negotiators' constraints and may pose to those with ultimate authority the bases for modification or abandonment of disputed positions.

In one two-party medical malpractice mediation, the parties negotiated in good faith, finally becoming positioned at numbers which virtually demanded a compromise to which both seemed to be pointing. At this juncture both parties had to stop negotiating to seek authority from their principals. The principals eventually consented to this obvious compromise, but it was four years after the injury had occurred.

The matter of limits on authority applies to plaintiffs as well as defendants. With regard to plaintiffs, it is often true that lay persons have envisioned some dollar value that seems a reasonable settlement to them, and which bears no relationship to reality. In an action involving liability under a life insurance policy a beneficiary had become entrenched in a demand which corresponded to his needs for an annual income. The number bore no relationship to the prospect of what the case was worth in light of the facts and law. After five years of litigation the matter was settled in one mediation session after the beneficiary's personal representative, a relative, acquired an in depth understanding of the issues.

With regard to defendants, limits on authority are often rational boundaries thoughtfully conceived, but sometimes they are arbitrarily derived and refer more to the negotiator that the case value. For example, a claims person might have a limit on authority based on some arbitrary standard such as tenure with the insurance company.

Limits on authority, even those with a foundation in precedent, should be kept flexible for negotiators because of the uniqueness of every case. In the world of negotiation, parties focus on the multitude of variables extant and consider most acutely those which have any prospect of affecting their internal prophecies. It is the strength or attractiveness of these variables which command the need for flexibility.

F. Egos[27]

In a perfect world, notions of egotism of the negotiator would never enter upon the field of a bona fide negotiation. In the world of law it is often true that concerns of self worth, or reputation, or image, play a part in considerations of success. Negotiations often reverberate with contempt for the other side, or their position, based not upon a realistic prognosis of the outcome, but rather on such matters as the opposing negotiator's stature, apparent skill, level of education, erudition, experience, personality, or communications technique. The focus in negotiations is often on "winning" or "losing" all or any part of the contest, confusing sometimes the lawyers' and clients' interests. If winning and not losing is the overriding consideration, the most legitimate forum for resolution is a trial or other binding process; but this is antithetical to the reality that 95% of all litigation never goes to trial. The negotiation, therefore, sometimes becomes the field of combat upon which adversaries test each others' mettle for no truly productive purpose, knowing all the while that the likelihood of a trial is remote.

Attorneys sometimes want to project an image to their clients of infallibility or invincibility. The use of mediation interferes with such pretensions. In one mediation involving a very serious injury, the plaintiff's credibility was the focus of the defendant's resistance to settlement. Although there was evidence on both sides regarding the facts, it was clear that if a jury believed the plaintiff's version of events (which was distinctly possible) the defendant was exposed to serious liability. In the course of the mediation the defendant insurance claims person and his attorney made a nuisance-value offer which the plaintiff responded to with a modified demand. The defendant thereafter refused to move based on the credibility issue. This left the plaintiff in almost exactly the same position she had been in prior to the mediation. When the plaintiff refused to "bid against herself" the defendant's counsel terminated the mediation, saying to her claims person "I told you mediation wouldn't work." The insurance carrier later admitted that the case was not suitable for mediation in light of counsel's feelings.

Sometimes the barrier to settlement is found in one party's interest in a remedy which not only compensates for client damages, but which also seeks to embarrass the other party, or as often, the other party's representative. Arbitrator Joseph Pastore tells of a recent conflict which, although within reach of settlement, raged for over two years because the plaintiff sought, in the

mind of the defendant, a reasonable solution but with an added twist designed to "rub the settlement in the face" of defendant's counsel. When the case reached arbitration and my colleague as arbitrator suggested that an *ad hominem* remedy was not only unlikely but unprofessional, the parties settled the case in minutes.

Mediation defuses most, and sometimes all, of these barriers because mediation eliminates the battlefield. There is nothing from which the ego can seek reflection. Focus is away from psychic obstructions and toward substantive issues upon which agreement is sought. "Winning" and "losing" surrender to "agreeing." In mediation there is usually a "joint session," where parties present their overall arguments, followed by "caucuses" with the parties individually. There's no benefit to be derived from extraneous behaviors by advocates in caucuses. While acting-out occasionally occurs in mediation, it almost invariably subsides with regard to those who are involved in good faith efforts at settlement.

G. Attorney's Economic Interest

It is part of the process of the law that lawyers are necessarily compensated for their skill in conditions of both success and failure. Indeed, the rewards for failure often exceed those for success, and failure and unnecessary delay are often the allies of enhanced attorney compensation. Since dilatory lawyering is older by centuries than any code of ethics, it seems fair that this article will not cause in any measure the reform of those who abuse their trust by failing to resolve resolvable matters or advise clients of ways to end litigation when such tactics appear warranted.[28]

Notwithstanding attorney duties and obligations, lawyers need to cast their vision to other horizons. ADR offers an opportunity to improve service to clients, and in an industry which offers that product alone there is a broad opportunity for change in focus to achieve improved market share through offering clients better ways to meet their needs. Ultimately, the satisfaction of client needs (to the extent possible) is the mission and purpose of every representation, and in rapidly changing client and social environments, those who can adapt will be the survivors in this increasingly competitive profession.[29] It seems axiomatic that the notion of improved service implies reduced costs and the requirement that firms will seek vehicles for maintaining profitability without diminished service.

H. Failure to Prepare Properly

The failure of attorneys and claims representatives to prepare a case properly is often based on the very knowledge of the plodding nature of legal processes. As time passes, and files thicken, substance and strategy sometimes become disconnected. Words and communications circumvent the gravamen of cases, and parties tend to lose track of just what, exactly, the case is all about, often to the detriment of those represented. This is particularly true for parties handling large numbers of cases and cases with small economic values.

In a mediation involving six insurance carriers, one of the claims representatives made opening remarks that had nothing to do with the case at bar. When corrected by others present, the representative deferred to them to set out the case. A thirty-minute break was suggested in order to give the first claims representative time to refamiliarize herself with the issues. During two subsequent caucuses with this claims person, she kept confusing the instant case with others she was handling. She subsequently advised this mediator that she was handling 350 cases and expected tbe load to possibly increase due to a reorganization at her office.

In another case a multi-party mediation was conducted and continued so that a party could seek additional authority. In the interim, the case file changed hands and subsequent discussion with the new representative focused on issues of liability. The representative was adamant about the minimal exposure of his client. Further discussion revealed that although he knew details of the case he was mistaken about which party he represented. Undaunted (and now in the throes of the Ego barrier) he continued the same argument although it was obviously inapplicable.

Mediation helps to refocus on cases in a timely fashion, giving them the importance to which clients are entitled. Because the process is informal, parties re-explore the vital issues in a noncombative environment. Timely mediations also circumvent most problems inherent in the practice of reassigning files among attorneys and insurance claims representatives. Mediations tend to be most fruitful when the parties are represented by advocates with an ongoing, thorough familiarity with the facts and issues, unless settlement negotiations have been chronically unproductive, in which case new faces and voices may be appropriate. In a memorable case, this mediator was seated in the lobby of a large law firm waiting for the parties to arrive, and a woman entered and sat down. We made small talk, and were soon joined by an attorney who identified himself as a party to the mediation. The woman introduced herself as the plaintiff and complained bitterly that the case had heen in litigation for more than four years. She then asked the attorney who his client was. "You" was the reply. The case settled in 55 minutes.

The preparation required of mediation is simply that of knowledge. The burdens of trial preparation are completely absent. Eloquence and strategy give way to reasoning and dialogue, as the parties strive to discover whether the prophecies described by Holmes are within their mutual contemplation.

I. Phenomena Regarding Multi-Party Cases

All of the barriers to effective settlement heretofore discussed compound and become more forbidding as parties are added to a lawsuit. There are, in addition, certain barriers that are unique to these cases and are created simply by virtue of the numbers of parties in interest.

1. Complexity of Communications

Communications among parties in multi-party cases become a logistical challenge, often avoided by litigants in favor of time spent creating further support for entrenchment.

Consider, for example, a personal injury in a leased portion of a building undergoing renovation. Parties to the action may include the General Contractor, all relevant subcontractors, the architect(s), landlord(s), tenant(s), manufacturers of objects connected with the injury, municipalities, and others brought in directly or by impleader. Each adopts an initial position which, ipso facto, has relevance to the position of the others both in law and in fact. Bilateral discussions are virtually impossible because of the multilateral, interdependent nature of the controversy. Within this population there seems invariably to be one or more parties who resist collective efforts to resolve the dispute. Unstructured multilateral negotiations without a neutral are fraught with difficulties.[30]

There is an unheralded skill extant possessed exclusively by the Case Administrators of good ADR providers whose job it is to bring together in one forum the warring interests in multi-party litigation. Their efforts, which are often threshold mediations in and of themselves, combine many of the skills of effective mediators, with an emphasis on patience, tenacity, perception, and knowledge of the subject matter.

Mediation serves, therefore, not only as a forum for settlement, but also as a vehicle for bridging complex relationships, bringing adversaries to the table for discussion where they might otherwise have been unwilling, and moving along those advocates who, by virtue of the complexity of communications, are inclined to delay the inevitable, to the detriment of their clients.

2. Theories of Relativity

A significant barrier to settlement in multi party negotiations is the perception that defendants bear a certain proportionate liability relative to each other. This view, which is dependent on, and as imperfect as, estimates of overall case value, sometimes maintain irrespective of the amount of dollars a defendant has to spend. For example, it is not uncommon, even in mediation, that parties will state their dollar contribution to an overall settlement, only to recant upon learning of the contribution of other defendants who they believe bear a greater share of the burden. The dilemma is complicated when those who seem to contribute a comparatively low amount are constrained by limits on their authority imposed, sometimes, by phantom negotiators. In these cases the dispute is not with the plaintiff and may have no immediate bearing on settlement value.

In one personal injury matter involving five defendants and one plaintiff, the parties were asked to write a confidential note stating their view regarding the value of the case, their individual percent of liability, and the relative liability of the remaining defendants. There was no consensus regarding the case value, and little accord on comparative liability. The parties were then asked privately how their estimates of their own liability stacked up against specific settlement values. Every party was prepared to pay their own estimate of their own liability relative to their estimated case value, which collectively constituted an appropriate settlement value for the case. The parties then all agreed to reveal their confidential evaluations. When some parties realized that their estimated case values were greater than the values of others, thereby giving them a proportionately greater share, those parties balked. A mutually satisfactory compromise was subsequently reached which focused more on the parties attitudes regarding value to **them** rather than the perceptions of others. This is not to say that perceptions of relative liability do not have quantitative dimensions and are not valid considerations in case settlement. The point is that there are other dimensions of liability in multi-party cases that need to be focused on and addressed.

There are effective techniques in mediation to bring defendants to a point of agreement regarding relative contribution within the context of a total settlement. Plainly these are fluid in nature, and change and move within the framework of the entire mediation and shifting attitudes in response to the plaintiff's demands. But there is a group dynamic[31] that occurs involving group pressure, values and attitudes[32] which, if understood and effectively managed by the mediator, will tend to bring tbe parties to agreed upon norms,[33] a central logic, and recognition of the desirability of facing square-on their mutual BATNAs (Best Alternatives To a Negotiated Agreement).[34]

Conclusion

To effectively represent a client, or an employer, attorneys and insurance claims personnel should examine the barriers to settlement and consider the prospect of mediation as a legitimate vehicle for overcoming the barriers, particularly in light of settlement statistics. Strategies of delay, until the pressure of trial serves as an enforcer, often fail to inure to the benefit of principals, and must be questioned against tbe standard of the best interest of the client.

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*Some of the concepts discussed were first presented at a seminar sponsored by the Connecticut Bar Association, Continuing Education Series, regarding "Settling Insurance Claims and Lawsuits," May 20, 1993.

The author expresses appreciation to his Pace University colleague, Joseph M. Pastore, Jr., himself an arbitrator/mediator for over 20 years, for his invaluable comments.

All cases discussed in this paper are actual. However non-essential facts have been disguised to preserve confidentiality and the identity of circumstances and parties.

[1] The burden of research was lightened by John P. McCrory's compilation: "Dispute Resolution: Alternatives To Litigation: Selected Readings", Vermont Law School, 1992-1993,unpublished manuscript in hans of author and Leonard L Riskin and James E. Westbrook, DISPUTE RESOLUTION AND LAWYERS (1987, 1993 Supplement).

[2] Barriers can exist at any stage of litigation from inception to trial. *See* William H. Champlin, III, "When Settlement is Appropriate", Settling Insurance Claims and Lawsuits, Connecticut Bar Association, Continuing Legal Education series, May 20, 1993. *See* also Robert H. Mnookin, "Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict", FORUM, National Institute For Dispute Resolution, Summer/Fall, 1993.

In Getting to Yes, Fisher and Ury explore ways that people can deal with their differences. In doing so the authors indirectly identify a spectrum of barriers to settling legal conflict, and recommend ways to overcome them. ROGER FISHER, WILLIAM URY AND BRUCE PATTON, GETTING TO YES (1981).

[3] *See* Nonna Skumanich and Denise Lach, When Mediation Won't Work, 47 WASH. STATE BAR NEWS (April, 1993). This topic is also dealt with in "The Role of Mediation in Public Interest Disputes." Barbara A. Phillips and Anthony C. Piazza, 34 HASTINGS LAW JOURNAL, 1231, 1236. The authors cite an unpublished paper by Mark Galanter, University of Wisconsin Law School, October 1982, in which Galanter summarizes cases requiring judicial declaration including those (a) where a disputant needs to secure a declaration of "good law," (b) where an employee doesn't want to take responsibility for a settlement (c) fear of weakening future bargaining credibility, (d) vindication of fundamental values. The authors point out, however, Galanter's view that parties to civil litigation frequently change perceptions of what is and is not negotiable.

[4] *See* Leonard L. Riskin, "Mediation and Lawyers", 43 OHIO STATE L.J. 29,43 (1982) (hereinafter Riskin). Riskin discusses thereason for lawyers' reluctance to use mediation.

[5] George L. Priest and Benjamin Klein, The Selection of Disputes for Litigation, RAND INSTITUTE FOR CIVIL JUSTICE, (1984), citing H. Laurence Ross, Settlement Out of Court, The Social Process of Insurance Claims Adjustment (1970). Hon. Beverly J. Hodgson and Robert A. Fuller, "Summary Jury Trials in Connecticut Courts", 67 CONN. B.J. 181 (1993).

[6] For example, it is unclear how much legitimate legal activity is not instituted, or bad decisions not appealed, because of the ponderous, dilatory, and costly nature of the process, and the economic and emotional strain it inflicts on the parties. Nor is it clear how much civil injustice is being committed with the understanding that it will not be remedied within a reasonable time.

The quality of justice seems also adversely affected in, for example, pre-trial proceedings where judges, frustrated by delay, dispatch justice summarily. *See* Jan Hoffman, "A Judge says Now", The N.Y. Times, Metro Section, April 24, 1994, at 35.

[7] In 1988, of the approximately 30 million **new** cases filed in state courts; 16.9 million were civil cases. This figure does not include 68.2 million traffic or other ordinance violation cases. *See* State Court Caseload Statistics: Annual Report 1988, A Joint Effort of the Conference of State Court Administrators and the National Center for State Courts, February, 1990.

[8] *See* Stephen Landsman, "Readings On Adversarial Justice: The American Approach to Adjudication" (1988), at 25. Consider the findings in a Rand Institute study which concluded that from the clients' point of view delay in matters **tried** did not appear to play a "substantial" role in determining whether tort procedures were seen as fair and whether litigants were "satisfied." They did, however, find a modest but statistically significant correlation between these concepts. E. Allan Lind, et al., "The Perception of Justice: Tort Litigants' Views of Trial, Court Annexed Arbitration, and Judicial Settlement Conferences," Rand - The Institute for Civil Justice, R-3708-ICJ (1989). Study is warranted on the perceptions of litigants whose cases are settled after various durations and before trial. *See* an unpublished paper by U.S. District Judge Robert C. Zampano, "Court Annexed ADR: A View From The Bench" at p. 3 (undated), (Copy in possession of author) where it is stated that "in many cases the objective served by discovery is not a search for truth; rather it has become a vehicle of attrition designed to harass, demoralize, and pummel the opponent with time consuming, lengthy and expensive proceedings.

[9] Roger J. Patterson, Dispute Resolution In a World of Alternatives, 37 CATH. UNIV. L. REV. 591, 601, 604 (1987). Patterson provides guidelines in considering alternatives to litigation involving a balancing of clients' interests.

[10] One extreme case began as a personal injury, developed into medical malpractice, continued with attorney malpractice, and 15 years from the date of the injury was settled in a 6 hour mediation where, for the very first time, demands and offers were exchanged. In a property damage case where five defendant companies were scattered all over the country, a three hour mediation settled the six year old dispute in which no party present had ever discussed settlement with the other.

[11] The disregard of the need for confidentiality in pre-settlement negotiations by some judges is deserving of more concern by the judiciary. Requests by judges for revelation of bargaining history very often operate to the serious detriment of good faith settlement negotiations and subsequent effective mediation. Too often parties will reveal to a judge their last demands and offers, or limits on settlement authority, only to be confronted with an off-the-cuff compromise number from an overworked judge. This number then becomes the reference point for all future discussions between the parties, whether or not the number is rooted in reality. The judge's number is often not the result of a thorough mediated negotiation, and the parties are virtually stripped of their ability to pursue further rational discussion based on the ubiety of a judicially sanctioned conclusion. Ethics opinion 93-370 of the ABA Standing Committee on Ethics and Professional Responsibility covers the issue of the responsibilities of attorneys regarding disclosure of limits on settlement authority and recommendations to clients of a judge's recommended figure. But these structures do not always prevail in the pretrial world of settlement (see Champlin, *supra*, note 2, at 75).

At the same time, and in a more positive sense, judicial intervention often prompts a settlement which is both timely and satisfactory to the parties. This is particularly true of well managed court annexed systems.

[12] Oliver W. Holmes, The Common Law and Other Writings The Legal Classics Library (1983), at 173.

[13] *Id.* at 181.

[14] *See* RISKIN, *supra* note 1, at 247.

[15] In capturing some of the ethos of mediation Fuller quotes Edmund Burke: "The world is governed by go-betweens. These go-betweens influence the persons with whom they carry on the intercourse by stating their own sense to each of them as the sense of the other; and thus they reciprocally master both sides." Lon N. Fuller, "Mediation: Its Form and Functions", 44 S. CAL. L. REV. 305, 324 (1971), citing Burke's "An Appeal from the New to the Old Whigs," (1791), in THE WORKS OF EDMUND BURKE (1904), 189-190.

[16] RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE, Unabridged, 1967, def. 9.

[17] The minimal return that must be achieved before breaking off negotiations is discussed in HOWARD RAIFFA, THE ART AND SCIENCE OF NEGOTIATION (1982), 126 et. seq. Also see Fuller, supra note 15 at 315.

[18] Fuller, discusses the "obvious but mistaken expedient" of having "both parties at the once disclose ... their internal evaluations.", *supra*, note 15, at 371. Fisher and Ury distinguish "less than full disclosure" from "deception". *supra* note 2, at 140

[19] With respect to ethics, Geoffrey Hazard suggests that there is a lack of consensus regarding the standard of openness that should govern lawyers' dealings with others; that lawyers' standards of fairness necessarily derive from society as a whole; and that the legal regulation of trustworthiness cannot go much further than proscribing frauds. Geoffrey C. Hazard, "The Lawyers Obligation to be Trustworthy When Dealing With Opposing Parties", 33 S. CAROLINA LAW REVIEW 181, 193 (1981). Hazard cites White, Machavelli and The Bar: Ethical Limitations on Lying in Negotiation, AM.B. FOUNDATION RESEARCH J. 926, 927 (1980).
A rebuttal of Hazard's position appears in Gary Tobias Lowenthal, 2 GEORGETOWN JOURNAL OF LEGAL ETHICS 411,988-89. Lowenthal decries the failure of the ABA's Rules of Professional Conduct to address certain matters of attorney conduct in negotiations, thereby permitting unacceptable behavior, such as lying.

With regard to proficiency in negotiations, in LEGAL NEGOTIATION AND SETTLEMENT (1983), author Gerald R. Williams presents his research on negotiating styles.

Felstiner, Abel and Sarate discuss transformations between stages of disputes, ascribing to lawyers a central role in that process. William Felstiner, Richard Abel and Austin Sarate, "The Emergence and Transformation of Disputes: Naming, Blaming, Claiming", 15 LAW & SOCIETY REVIEW, at 642 (1980-81).

Redmont suggests that different personality characteristics are required for litigation than for negotiation and conciliation. Robert S. Redmount, "Attorney Personalities and Some Psychological Aspects of Legal Consultation", 109 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 972. (1961)

See also DAVID A. LAX AND JAMES K. SEBENIUS, THE MANAGER AS NEGOTIATOR: BARGAINING FOR COOPERATION AND COMPETITIVE GAIN (1986), discussing negotiators who are valuecreators (win/win) and value claimers (win/lose).

See KENNETH W. TERHUNE, The Effects of Personality in Cooperation and Conflict, SOCIAL PSYCHOLOGY: A SERIES OF MONOGRAPHS, TREATIES, AND TEXTS (1970) concluding that personality is considered one of two main influences on cooperation - conflict behavior.

[20] Mnookin, *supra*, note 2, at 26.

[21] *Id.* at 25.

[22] Hazard states that "the event of a trial shows that the less costly alternative (of negotiation) has failed in a particular case". *supra*, note 19 at 187.

[23] Fuller, *supra*, note 15, at 325.

[24] *Id.* at 318.Consider the view that a problem-solving orientation to negotiation has the prospect of leading to improved solutions and a process whicb is more creative and enjoyable than destructive and antagonistic. "Toward Another View of Legal Negotiation: The Structure of Problem Solving," 31 UCLA L. REV. 754 (1984)

[25] Joseph B. Stulberg, The Theory And Practice of Mediation: A Reply To Professor Susskind, 6 VERMONT LAW REVIEW 85 (1981). *See* Leonard Riskin's list of mediators' activities in The Special Place of Mediation In Alternative Dispute Processing, 37 UNIVERSITY OF FLORIDA LAW REVIEW, 19-27. and Jeffrey Rubin, "Negotiation: An Introduction To Some Issues and Themes", 27 AMERICAN BEHAVIORAL SCIENTIST 149 (1983) for a discussion of the role of a third party in "saving face" for negotiators, at pp 138-139, citing R. J. Meeker and G. H. Shure, Pacifist Bargaining Tactics: Some Outside Influences, JOURNAL OF CONFLICT RESOLUTION, 13:487-493 (1969), and J. E. Podell and W. M. Knapp, The Effect of Mediation On The Perceived Fairness of The Opponent. JOURNAL OF CONFLICT RESOLUTION 13:511-520 (1969).

See Frank E. Sander and Jeffrey Rubin, "The Janus Quality of Negotiation: Dealmaking and Dispute Settlement", NEGOTIATION JOURNAL 109-113 (1988) 109-113 (the authors characterize these two different types of negotiation).

[26] Mnookin discusses "Reactive Devaluation" citing the work of his Stanford colleague Professor Lee Ross whose research demonstrated that a given compromise proposal is rated less positively when proposed by an adversary than when proposed by a neutral or ally. (Robert H. Mnookin, *supra*, note 2, at 28).

[27] In his study on negotiating styles, Gerald R. Williams points to only one characteristic shared by all categories of ineffective negotiators: "Egotist." GERALD R. WILLIAMS, LEGAL NEGOTIATIONS AND SETTLEMENT (1983) 39.

[28] There would appear to be both ethical and legal support for the proposition that lawyers need to be knowledgeable about Alternative Dispute Resolution (ADR), and must inform clients of this option, at least when it is offered, and may be required to represent clients in ADR proceedings. Consider the Connecticut Bar Association Informal Ethics Opinion 87-13, January 13, 1988, that counsel for an insured defendant has a professional duty to represent the client at a non-binding ADR proceeding if counsel believes "the proceeding represents a significant opportunity to advance the client's cause" or if the insured's interests are at risk.The "Comment" on Rule 1.2 of the Connecticut Rules of Professional Conduct, 1993, states that "Both lawyer and client have authority and responsibility in the objectives and means of representation." The client has ultimate authority to determine the purposes to be served by legal representation, within the limits imposed by law and the lawyer's professional obligations. Within those limits, a client also has a right to consult with the lawyer about the means to be used in pursuing those objectives." This suggests, at a minimum, that an attorney has a duty to consult with a client regarding an offer to pursue ADR.

Sander and Prigoff argue that there is a duty to discuss ADR with clients., (Sander citing Rule 1.4 (b) of the Model Rules of Prof. Conduct of the ABA) but Prigoff argues that the duty should not be a basis for professional discipline or malpractice liability. See Frank E.A. Sander, "Yes, an to Clients," 76 A.B.A.J. Nov. 1990 at 50 and Michael L. Prigoff, "No, An Unreasonable Burden, " 76 A.B.A.J. Nov. 1990 at 51.

In a Connecticut case, *Laura Klingeman Admin. v. Joseph Sakal et al.* 8 CSCR 928, CU 293949 (1993), the court held that plaintiff pleaded a legally sufficient CUTPA (Conn. Unfair Trade Practices Act) claim against her attorneys, alleging they did not fully inform her of anoffer of settlement. Since ADR is now part of the Connecticut's judicial framework (CONN. PRAC. BOOK §546T) the "Cigarette rule" recited in *Daddona v. Liberty Mobile Homes Sales, Inc.*, 209 Conn. 243 (1988) could be expanded to embrace an attorney's duty to discuss the ADR option. See Riskin, *supra* note 4, citing as a reason for lawyer reluctance to use mediation "The economics and structure of contemporary law practice."

[29] New York's LeBoeuf, Lamb, Leiby & Mac Rae is illustrative of changes in the basic economic approach of many law firms. They have entered an agreement to handle all of Alcoa's litigation for a period of more than three years for a fixed fee of between $6 and $7 million.

Corporate Legal Times, October 1993, at 1. Making money under these circumstances will require a policy of expense reduction.

See Steven Brill, "The New Leverage," The American Lawyer, July/August 1993, regarding innovative billing practices based on value to clients and results. There is a strong movement afoot to limit the amount of attorney compensation in contingency fee cases by linking fees to the degree of risk actually borne by personal injury lawyers. The contingency portion of the fee would kick in only after trial and would be based on that portion of the award which exceeds the defendant's original offer. Peter Passell, *Windfall Fees in Injury Cases Under Assault*, New York Times, February 11, 1994, Section A, Page 1. If this or similar approaches achieve success in bar associations, ethics ruling, or in the judiciary, lawyers should lean more and more to neutral forums where clients can be seen and heard in a timely fashion, barriers to settlement can be effectively eliminated by neutrals, and value judgments can he truth-tested at an early stage in the BATNA (Best Alternative To a Negotiated Agreement) evaluation process. (Fisher and Ury, supra note 2, at 101.) Attorneys who doubt the changing attitude of corporate America regarding obtaining value and results for legal expenditures should consult *Corporate Legal Times*, Chicago, Illinois, a national monthly on managing in-house corporate legal departments.

See also Dahlgren, Jennifer, *Consulting the Future*, ABA Journal, April 1994, regarding prepaid legal services.

[30] In this connection *see* HOWARD RAIFFA, *supra*, note 17, especially part IV "Many Parties, Many Issues," at 251.

[31] KEITH DAVIS AND JOHN W. NEWSTROM, HUMAN BEHAVIOR AT WORK: ORGANIZATIONAL BEHAVIOR, (7th ed. 1985), at 217 et. seq.
See ARNOLD BIRENBAUM AND EDWARD SAGARIN, NORMS AND HUMAN BEHAVIOR (1976), especially Chapter 4, "Explaining Behaviors." and Hubert Bonner, GROUP DYNAMICS (1959), at 45. In describing "togetherness" of a group as a dynamic structure he refers to a "circular reaction" in which there is a high degree of self intensification in each member of his own 'excitement' as he finds it reflected in others. In this process shared feelings and tension, which in each member separately had no adequate outlet, are freely expressed. When a person's responses to others is shared by them when these experiences become reciprocal or interactive, there exists the basic condition of group behavior."

[32] J. JAY BRAUN AND DARWYN E. LINDER, PSYCHOLOGY TODAY: AN INTRODUCTION, (4th ed. 1975), at 619 et. seq.

[33] Davis and Newstrom, *supra,* Fuller *supra* note 15, at 308, suggests that the mediation is directed not to conforming to norms, but rather to creating the relevant norms. Note 31, at 312.

[34] FISHER AND URY, *supra*, note 2, at 101.

PROTECTING THE CONSUMER: BUYER AGENCY IN RESIDENTIAL REAL ESTATE TRANSACTIONS

by

Robert D. King*

I. Introduction

The single most important investment for most Americans is the purchase of a home. The decision to buy a home requires substantial financial consideration. Similarly, one who sells a home must consider the financial consequences. It is inappropriate, therefore, that such an important financial transaction is in many instances conducted in a manner which is inconsistent with prevailing notions of agency theory and which does not accurately reflect the understanding of the buyer, the seller, and the real estate professional.

The typical residential real estate transaction promotes this inconsistency through the use of "listing brokers" and "cooperating or selling brokers," the latter of whom are deemed to be "sub-agents" of the listing broker.[1] In this transaction, the seller designates a broker to act as his or her exclusive agent in marketing the property. A listing agreement setting forth the obligations of the parties is executed.[2] This broker is referred to as the "listing broker," and is legally recognized as the agent of the seller in the sale of the property.[3] The listing agreement typically requires the listing broker to place the listing in the local Multiple Listing Service ("MLS"). Through the MLS, selling brokers learn that the property is for sale and are advised of the conditions and terms of the offer to sell. The selling brokers who market the property to prospective buyers are deemed sub-agents of the listing broker and, consequently, sub-agents of the seller, to whom they owe a fiduciary obligation.[4]

The typical real estate sale involves the prospective buyer contacting the sub-agent and requesting that the sub-agent assist the buyer in locating suitable property that is for sale. The sub-agent reviews properties listed for sale in the MLS and presents them to the buyer for consideration. If the buyer decides to bid on a property, the sub-agent then prepares the buyer's offer to purchase, often after having counselled the buyer on the purchase bid as compared with similar properties in the area. As negotiations with the seller over the terms of the proposed sale continue, the sub-agent often negotiates on behalf of the buyer.[5]

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The close relationship between the selling broker and the buyer implies that the selling broker is the buyer's agent. In fact, in a survey conducted by the Federal Trade Commission ("FTC"), 67% of buyers surveyed stated that they relied on the advice of a listing or selling broker, including advice concerning the valuation of the property. As might be expected, the typical buyer assumes that he or she is represented by the selling broker. Approximately 71% of buyers surveyed in the FTC Report believed that the selling broker was the agent of the buyer.[6] Indeed, the entire selling process, when accomplished through the use of a selling broker, supports this assumption. In fact, most selling brokers see themselves as representing the buyer.[7] The entire range of activities which transpire from the moment the buyer steps into the selling broker's office until the buyer is handed the keys to the new residence suggests that the selling broker represents the buyer.

Notwithstanding the sub-agent's apparent representation of the buyer in identifying, valuing, bidding for and negotiating with the seller over the property, the selling broker, as a sub-agent, is considered the agent of the seller.[8] This agency scheme is confusing to the average real estate purchaser and inconsistent with the actions of both the buyer and the selling broker. Moreover, the seller too is victimized by the sub-agency principle. Sellers who use due care in selecting a listing broker as a sales agent may nonetheless become liable in tort to the buyer for any misrepresentation of agents, including the sub-agents about whom the seller knows little or nothing.[9]

The purpose of this article is to identify the weaknesses in the sub-agent rule; examine the principal alternatives to sub-agency; and, recommend a form of buyer's agency which will comport with the realities of the real estate sale process, offer protection to the consumer, particularly the buyer, and do as little damage to the existing methodology of real estate sales as possible.

II. The Weaknesses Of Sub-agency In Residential Real Estate

A typical home sale involves a seller, a buyer, and two real estate brokers: the listing broker and the selling broker.[10] The contractual agency relationship is created by the seller's execution of a listing contract. Contained within the agreement is the seller's consent to the placement of the property in the MLS.[11] The MLS serves as a quasi-public market for residential real estate transactions whereby the listing and other relevant information about the property is made available to all brokers who subscribe to the service.[12] Moreover, participation in the MLS by the seller is interpreted as consent to the creation of subagents.[13] The listing agreement is a unilateral contract by the seller to pay the commission if the property is sold according to the terms of the listing agreement.[14]

Without a doubt, it is clear that an MLS listing benefits the parties to the proposed transaction. The MLS listing benefits the seller by increasing the universe of prospective buyers aware that the property is for sale. Similarly, the MLS provides exposure to the maximum number of brokers in the area, assuring that in the event the listing broker is unable or unwilling to market the property actively, the seller may find another listing broker. The listing broker benefits from the MLS listing because it better enables him or her to bring an

offer to buy to the seller within the terms of the listing agreement, thereby increasing the likelihood that the listing broker will receive at least some portion of the commission.[15] The MLS listing procedure also benefits the selling broker by increasing the inventory of properties available to show the buyer. And finally, the buyer benefits from the broker's affiliation with the MLS since the MLS provides the buyer with a catalog of similar properties in the area having the qualities that the buyer is seeking.

The benefits afforded by the MLS, including the efficiencies related to seller liquidity, valuation for the buyer and the seller, and the aggregation of inventory from which the buyer may choose, all suggest that the MLS system should be maintained. It is, however, the notion of sub-agency connected to the MLS which needs to be abolished. As one commentary noted, "Even though the NAR [National Association of Realtors] urges and promotes this subagency theory, the agency relation between the seller and the cooperating [selling] broker 'has led to much misunderstanding and confusion regarding the broker's proper relationship to the buyers among the general public, the real estate industry, and the legal profession.' It should not be the law."[16]

When brokers become members of the MLS they agree to pool listings and share commissions. Under the NAR framework, placing the listing in the MLS "constitutes an offer of subagency by the listing broker to other [MLS] members to procure a buyer in exchange for a percentage of the sale commission."[17] In the typical transaction utilizing the MLS, the selling broker functions as the agent of the listing broker and, thereby, is deemed the sub-agent of the seller.[18] Consequently, both the listing and the selling broker stand in a fiduciary relationship to the seller.[19]

While it is clear to the parties and indeed makes sense that the listing broker is the agent of the seller and, therefore, stands in a fiduciary relationship to him or her, it is generally contrary to the beliefs and reasonable expectations of the parties that the selling broker is also the agent of the seller. As commentators have suggested,

> Most buyers and sellers are unaware of the true legal relationship between them and the brokers under the MLS structure. The sellers do not understand the listing agreements and the consent to subagency. ...Sellers are not informed to the potential liability for the conduct of agents and subagents. The buyer does not know that secrets revealed may be divulged by the [selling] broker under the legal duty owed to the seller.[20]

And further,

> [E]ven experienced real estate brokers are not fully aware of the agency relationships created in real estate transactions, particularly those involving MLS, nor can they be certain of the extent of their duties and liabilities. If experienced real estate brokers are not sure of their own agency status, the average homebuyer and seller, who may be involved in a real estate transaction only two or three times during their lifetimes, probably will not know who represents whom and what responsibilities each has.[21]

But it is the buyer, who under sub-agency is not legally represented by a real estate agent, who is the most vulnerable. Virtually every aspect of the relationship between the buyer and the selling agent suggests that the selling agent represents the buyer. Typically, the buyer, acting as a principal, initiates the contact with the selling agent and controls the entire venture, and through his/her actions manifests an intent that the selling agent act on his/her behalf.[22] Among the actions indicating the buyer's belief that the selling agent acts on his/her behalf are the buyer's reliance on the expertise and counsel of the selling agent with regard to issues such as the market value of the prospective purchase, financing terms, inspection and repair procedures, and the condition of the property. Furthermore, the buyer is often requested to reveal his/her financial position to the selling agent in order for the agent to "qualify" the buyer for financing purposes and to allow the selling agent to select property listings which the buyer can afford.[23] Indeed, buyers often feel so comfortable with selling agents that they reveal the highest price they are willing to pay for a property. Clearly, the relationship between the buyer and selling agent suggests that the selling agent is acting on the buyer's behalf.[24]

The selling agent's actions also suggest that the selling agent is acting as the agent of the buyer. As one commentator noted:

> ...the selling agent will locate and show property to the buyer which meets the buyer's specifications. This action creates the impression that the selling agent is working for the buyer. Then, once the buyer is interested in a property, the selling agent will assist the buyer in determining an offer price, provide financing information, and accompany the purchaser in a final "walk through." Again, these actions would suggest an intent on the part of the selling agent to act as the buyer's representative.[25]

Notwithstanding the plethora of indications that the selling agent is the agent of the buyer, the rule of sub-agency holds that the selling agent is the agent of the seller. This means that the broker "owes his principals an obligation of utmost fidelity and good faith."[26] The element of "good faith" includes a legal, ethical, and moral responsibility to obtain for the principal, the seller, the best bargain and terms that his/her skill, judgment and diligence can achieve.[27]

In spite of the sub-agent rule's apparent shortcomings for the buyer, some commentators have nonetheless maintained that the rule actually benefits the buyer. The Colorado Supreme Court, for example, concluded that the buyer is actually protected as a result of the sub-agency relationship.[28]

> Since both real estate agents are agents of the seller, the seller may become liable to the buyer in tort for any misrepresentation of his agent through the ratification doctrine. Such liability allows the remedy of rescission against the seller. If there is no agency relationship between the seller and the selling broker, but the agency relationship is between the buyer and the selling broker, this remedy of rescission is no longer available to the buyer because the ratification doctrine would not be applicable, and the buyer's only recourse may be a suit against the broker for damages.[29]

The continuation of sub-agency as the preferred interpretation of the relationship between the buyer and the selling broker also avoids the problems created by dual agency. Dual agency arises when both the seller and buyer are represented by the same agency.[30] Problems of conflict of interest are immediately apparent. Although the disclosure of dual agency and the written consent of both principals, the buyer and seller, can ostensibly avoid the charge of conflict of interest, the question remains regarding the benefits to the consumer. As one commentator noted:

> It's no problem ... if an agency attempts to [represent both the buyer and seller] so long as all parties agree to it. The agent involved simply slips into neutral territory, the firms say, and becomes a dual agent--not favoring either seller or buyer but just attempting to bring them together.
>
> Critics of dual agency say that point of view is hogwash, that agents will knowingly or unknowingly do whatever is necessary to make a deal.[31]

III. Alternatives to Sub-agency

The obvious deficiencies in sub-agency began to attract the attention of commentators during the mid-1980s.[32] The typical response to the objection that the sub-agent rule leaves the seller vulnerable and buyer unrepresented was that through disclosure of the workings of sub-agency to all parties by the sales agents the consumer would be made aware and therefore able to protect himself. The disclosure contemplated can apply to an agent who wishes to represent more than one party in the transaction notifying all the parties, or alternatively, an agent who represents only one party disclosing this fact to the other principals. Pressure from consumer groups, primarily, with some help from the real estate industry itself, caused many states to enact laws to require disclosure by sales agents about whom he or she represents.[33] There is no uniformity among the states, however, with regard to the nature and extent of the disclosure. Although the majority of states today have mandatory disclosure laws, a study by the Consumer Federation of America concluded that few have disclosure requirements essential to meet the needs of buyers.[34] The Consumer Federation of America proposed a four-pronged test that every disclosure should meet:

> A written statement, provided to the purchaser, that explains the relationship between the agent, the seller and the buyer. If the agent is functioning as a "buyer's broker"...that, too, must be explained.
>
> The disclosure must take a standard, prescribed form.... Agents must be required to provide the disclosure to the buyer at the first "substantive contact." Substantial contact means any circumstance in which a buyer begins to relate information about the type, location or price range of the property he or she desires. Unwary buyers who assume that the agent represents them can divulge valuable tactical information early on, and then be handed a disclosure form at the closing table--far too late to be of any value.
>
> The forms must be short, simple and to the point. Lengthy, boilerplate forms rarely get read.

Both the buyer and the agent need to sign the disclosure form, acknowledging that the prescribed form was read and understood by the consumer.[35]

Disclosure, however, does not appear to be the panacea for all the ills suggested by sub-agency. As one commentator noted, "...mere disclosure still fails to provide the buyer with adequate representation."[36] Another commentator noted that, "Limiting the disclosure solely to the agency relationship does not provide the consumer with information about many of the options available that would be helpful, though perhaps not in the best interests of the broker, in choosing how to market his or her property or how to locate a home that best satisfies his or her requirements."[37] Practical reality suggests as well that the buyer may simply not comprehend the significance and consequences that result from disclosure.[38]Does the average consumer understand what is meant by the phrases "fiduciary duty" or "duty to disclose?"[39] Moreover, will disclosures simply be lost on buyers who are preoccupied with all the other issues and paperwork attending the purchase of a home?[40]

In response to the weaknesses inherent in sub-agency, even with mandatory disclosure of the agency relationships, some commentators have suggested other alternatives which ostensibly would better protect the consumer and at the same time give legal effect to the intentions of the parties as manifested by their conduct. Two of the principal alternatives are dual agency and buyer's or seller's agency.

As the agent of both the seller and the buyer, the dual agent owes each the duties of loyalty, good faith and disclosure.[41] However, since the interests of the buyer and seller are invariably at odds, it seems impossible for the fully disclosed dual agent to fully represent both parties at the same time. Consequently, the dual agent will typically assume the role of a neutral facilitator, providing the parties with the means to obtain information which they may need to negotiate the terms of the purchase. The dual agent refrains from giving advice to either party. Moreover, since the dual agent must still reveal any material facts of which he or she is aware, the dual agent is not likely to get too involved with either party in order to avoid the duty to disclose. The buyer and seller obviously are disadvantaged by this arrangement. As one commentator noted:

> In fact, dual agency appears only to benefit the real estate agents. As dual agents, real estate agents are now free from some of the responsibilities of agency, but are still able to collect both the listing and sales commissions. Meanwhile, both the buyer and seller are left to represent themselves.[42]

The dual agency practice is essentially the equivalent of the "facilitator," "mediator," or "middleman" approach. This practice allows the real estate agent to stand in the middle of the transaction and releases the sales agent from the traditional fiduciary responsibilities toward his or her client.[43] This approach does allow for the even-handed treatment of both the seller and buyer,[44] and may even reflect the real nature of the real estate agent's efforts, since the real estate agent is not generally paid unless a sale is consummated. If, for example, the seller rejects a buyer's offer, the agent typically receives no commission. The agent may, therefore, attempt to persuade the seller to accept the offer even when it may not be in the seller's best

interest. A sample facilitator contract form prepared by the Greater Boston Real Estate Board defines the broker's duties as furnishing "'general advice concerning real estate practices and procedures' and assisting in 'communications and negotiation' between the seller and buyer 'so they can reach agreement between themselves.'"[45] Like the criticism of the dual agency, the facilitator approach is criticized as giving "the consumer the worst of all possible worlds."[46] However, it is the seller who is deemed to be the biggest loser under the facilitator approach:

> "You give up the most important legal protections you have" as a seller--a binding "agency relationship." This fiduciary role is a major part of the package of services sellers pay for in their sales commissions. ...Signing a facilitator agreement means "you throw away all that" ... but pay the same.[47]

Buyer's agency or seller's agency, or a combination of both, is the other most frequently suggested alternative to sub-agency. Some real estate brokerage firms have recently decided to add formal representation of buyers, or buyer's agency, to their offered services.[48] Some commentators argue, however, that this process is akin to dual agency and, therefore, as noted earlier, leaves the buyer and seller with little or no real benefits.[49] The issue of dual agency arises most often in these situations when the buyer decides to purchase a listing of the sales agent's firm. Again, the proponents of this process suggest that the potential for conflict of interest on the part of the agent can be dealt with through disclosure.[50]

Obviously, firms that specialize in providing either buyer's brokerage or seller's brokerage, but not both, avoid the potential for dual agency suggested by the above-mentioned. Firms specializing in seller's agency provide essentially the same services as the seller receives under sub-agency. The seller, however, would presumably not be appointing sub-agents and would benefit by not being liable for the sub-agent's misrepresentations and misdeeds.[51] The buyer, on the other hand, is clearly a beneficiary of buyer's agency. Whereas buyers are unrepresented in the typical sub-agency sale process, in the buyer's agency mode the buyer has an agent representing him or her exclusively. Issues which once were thought to doom the utility and practicality of buyer's agency, such as the buyer's agent's splitting the listing agent's commission from the seller and the apparent unavailability of the MLS to buyer's agents, have been resolved. The fact that the buyer's agent may be splitting a commission paid by the seller with the listing agent is no longer viewed as determining the agent's principal.[52] Moreover, the availability of the MLS to buyer's agents as been agreed to by the NAR.[53] As one commentator noted, "In 1976 when the NAR defined the MLS as a 'means of disseminating information,' the California Supreme Court ruled that the NAR couldn't restrict MLS access to Realtors."[54] Buyer's agents benefit the buyer by allowing the buyer access not only to all the homes listed in the MLS (where the buyer's agent will typically split the commission with the listing agent) but also to homes that are for sale by owners (where the buyer's agent may negotiate a fee beforehand with the sellers or arrange for the buyer to pay a fee). Furthermore, buyer's agents claim that they are free to render an honest assessment of a home to the buyer since they are not agents of the seller.

Although buyer's agency has been touted by commentators as the wave of the future,[55] and most barriers to its implementation have been removed, it has not to date caught on. Some of the reasons why the idea of buyer's agency has not caught fire with the public relate to the fact that the established real estate industry, as represented by NAR, have not been generally supportive. While the NAR has given some superficial support for the idea of buyer's agency, or at least has not formally attempted to preclude its development,[56] in reality, the rank and file in the industry have not been supportive.[57] The so-called "traditionalists" argue that buyer representation is not necessary since under the Realtors'Code of Ethics, they must treat both seller and buyer fairly. Moreover, the traditionalists bristle at the notion of sharing commissions with buyer's agents.[58] Buyers too have been slow to embrace the idea of buyer's agency. Buyers' reluctance is based, at least in part, on the belief that the agents working with them are in fact working for them and looking out for their interests.[59] Also, some buyers may believe that using a buyer's agent will cost them a fee.[60] Finally, many firms fear losing part of the market by specializing in seller's or buyer's agency. And, they fear doing both may be a conflict of interest.

IV. A Proposal To Integrate Buyer's Agency Into the Existing Mechanism for Real Estate Sales

Dominance of the sub-agent rule in the sale of residential real estate today indicates that the use of buyer and seller agency on a large scale basis is not likely to occur. For well over a decade sub-agency has been roundly criticized for its failure to protect the consumer.[61] Notwithstanding the well-deserved criticism, the predominate method for the sale of residential real estate remains the traditional sub-agent methodology. The buyer remains essentially unrepresented, although ostensibly better informed of his or her inferior status. One of the principal reasons the sub-agent rule dominates the industry today is that it is so firmly entrenched, there is essentially no strong motive on the part of the industry to change it. Moreover, the buying public continues to labor under misconceptions as to its representation, or better, lack of representation.[62]

The only viable avenue for wholesale change in the existing scheme is to effect it through a process that does minimal damage to the existing structure. This can be accomplished by recognizing and implementing the intentions of the parties. As noted earlier, sellers do not truly understand that they are appointing every real estate broker as their agent when they agree to allow the listing agent to submit their property for inclusion in the MLS. Similarly, buyers do not understand that the agent with whom they have worked so diligently is legally bound to look out for the interests of the unknown seller. The whole sub-agent process is artificial and does not comport with the beliefs and expectations of the parties. Since buyer's agency is now at least recognized as an alternative which can be maintained through the use of the MLS, and the NAR no longer requires sub-agency as a prerequisite to its use, then the beliefs of the buyer and seller should be recognized. In other words, when a buyer contacts a real estate salesperson concerning a property advertised in any manner, the buyer should be able to assume that the agent will be working as the buyer's agent. Only with regard to those listings which are with the agent's own agency should the buyer be informed, in writing at the first contact, that the sales agent is the agent of the seller. This fact is most likely what the average buyer would believe to be the case anyway. Moreover, throughout the interactions between the buyer and the agent, whenever the agent shows one of the agency's own listings,

the buyer should be again informed that the agent is the representative of the seller and the buyer should be advised to seek independent counsel. Although there may still be some instances where the buyer's interests may be compromised using this process, such as when the buyer reveals a maximum purchase price to the agent and subsequently develops an interest in an "in house" listing, the buyer can be made aware at the outset or the first contact with the agent that such information should be withheld. Moreover, the typical buyer is unlikely to discuss the maximum price he or she is willing to pay for a property until one has been found which is of enough interest to consider making an offer. When the property is not an "in house" listing, the buyer is free to disclose such information to the agent. Clearly, this option, while not as perfect as the use of a straight buyer's agency, is a vast improvement over the existing structure which makes all sales agents the agent of the seller. While some disclosure with regard to "in house" listings would still be required, it is much less complex and far more sensible for the average buyer to comprehend. Moreover, to utilize the concept of buyer's agency in this method recognizes the existence of the current structure, allows agencies to both list and sell real estate, and comports with the beliefs and expectations of the parties.

V. Conclusion

The sub-agent rule, which today remains the primary theory explaining and governing the relationship among the parties in residential real estate sales, does not serve the best interests of consumers and should, therefore, be discontinued. While commentators during the 1980s began to criticize the sub-agent rule, powerful forces, such as the NAR, fostered the continuation of the rule by tying use of the Multiple Listing Services to the establishment of sub-agency. Due to increasing criticism of the sub-agent rule, however, the NAR has agreed in more recent years to consider the utility of alternative methods of viewing the relationship among the agents, buyer, and seller. The NAR has dropped the two biggest stumbling blocks to the consideration of other relationships, such as buyer's agency and dual agency. The NAR does not insist upon sub-agency as a prerequisite to utilizing the MLS, and it no longer argues that the seller's payment of a commission necessitates that all who receive a portion are by virtue of that fact agents of the seller. Notwithstanding the favorable conditions for a wholesale change in the manner in which parties to residential real estate are legally related to each other, very little movement has been made away from the rule of sub-agency. Although there are numerous factors which may account for this slow progression, a significant factor concerns the fact that a movement to buyer's agency exclusively would require a major overhaul of the entire industry. Moreover, most real estate firms are not willing to limit their customer base to sellers or buyers exclusively. Consequently, if the customer is going to benefit from the notion of buyer's agency, then its integration into residential real estate sales must be effected in a manner which will essentially leave intact most of the existing structures while at the same time permitting the parties' beliefs and expectations to be given legal and practical effect. This can be accomplished by recognizing that in the typical residential real estate sale the sales agent is the agent of the buyer in all cases except where the buyer is interested in pursuing the purchase of a listing from the inventory of the sales agent's firm. In the latter case the agent would remain the agent of the seller. While this proposal is not without some drawbacks, it is a substantial improvement over the artificial and anti-consumer sub-agent rule.

ENDNOTES

1. Approximately eighty one percent of persons selling single family dwellings employ real estate brokers to assist in the transaction. *See* 1 FTC Los Angeles Regional Office, The Residential Real Estate Brokerage Industry 7 (1983) [hereinafter the "FTC Report"].

2. *Id.* at 4.

3. 12 C.J.S. Brokers sec. 25 (1985).

4. For a discussion of these fiduciary obligations, *see* Paula Murray, *The Real Estae Broker and the Buyer: Negligence and the Duty to Investigate,* 939 VILLANOVA L. REV. 939 (1987); Michael K. Braswell & Stephen L. Poe, *The Residential Real Estate Brokerage Industry: A Proposal For Reform,* 30 A.B.L.J. 271, 276-279 (1992).

5. Approximately eighty one percent of buyers surveyed by the FTC stated that the broker assisting them in the purchase of the home played a significant role in negotiating with the seller. FTC Report, *supra* note 1, at 183.

6. *Id.* at 83-84.

7. *See* Note, *Sub-Agency in Residential Real Estate Brokerage: A Proposal to End the Struggle with Reality,* 61 S. Cal. L. Rev. 399, 419 (1988).

8. *Id.* at 180-81.

9. *See* Louis A. Trosch, *The Effects of North Carolina's New Disclosure Law on Real Estate Agents-- Whom Will They Represent and in What Capacity,* 27 Business L. Rev. 115, 118 (1994).

10. *See* Guy P. Wolf & Marianne M. Jennings, *Seller/Broker Liability in Multiple Listing Service Real Estate Sales: A Case for Uniform Disclosure,* 20 Real Estate L.J. 22, 23-24 (1991).

11. *See* Braswell & Poe, *supra* note 4, at 274-75.

12. An MLS is "operated by a local group of brokers [as] an information sharing or exchange mechanism" through which affiliated brokers may obtain information regarding listed properties. FTC Report, *supra* note 1, at 7.

13. *See* Braswell & Poe, *supra* note 4, at 275.

14. *Id.*

15. When a sale is completed through the efforts of a selling broker, the listing broker splits the commission with the selling broker. Typically, the listing broker and the selling broker each take fifty percent of the commission.

16. *See* Braswell & Poe, *supra* note 4, at 279.

17. People v. Colorado Springs Bd. of Realtors, 692 P.2d 1055, 1059 (Colo. 1984). *See also* Braswell & Poe, *supra* note 4, at 279.

18. *See* Braswell & Poe, *supra* note 4, at 279.

19. *Id.*

20. *Id.* at 273.

21. *See* Wolf & Jennings, *supra*, note 10, at 23-24.

22. *See* Trosch, *supra* note 9, at 118.

23. *Id.*

24. In a 1983 survey conducted by the FTC 71% of buyers believed that the selling agents represented them. *Id.*

25. *Id.* at 119.

26. Spence v. Spaulding and Perkins, Inc., 347 S.E.2d 864, 865 (N.C. App. 1986).

27. *Id.*

28. *See* Trosch, *supra* note 9, at 118. *See also* Stortroen v. Beneficial Finance Co., 736 P.2d 391, 399 (Colo. 1987).

29. *See* Trosch, *supra* note 9, at 118. *See also Stortroen,* 736 P.2d at 399.

30. *See* Trosch, *supra* note 9, at 119.

31. *See* Gene Austin, *Is Dual Agency Nothing More Than "Dual Duplicity"?,* Phila. Inquirer, Sept. 6, 1992, at 1-L.

32. *See, e.g.,* Joseph M. Grohman, *A Reassessment of the Selling Broker's Agency Relationship with the Purchaser,* 61 St. John's L. Rev. 560 (1987).

33. *See* Braswell & Poe, *supra* note 4, at 289.

34. *See* Kenneth Harney, *Reform Is Brewing for Broker Disclosure,* Newsday, July 4, 1992, at 36.

35. *Id.*

36. *See* Trosch, *supra* note 9, at 121.

37. *See* Braswell & Poe, *supra* note 4, at 292-93.

38. *Id.* at 293.

39. *Id.*

40. As one commentator noted:

> The effectiveness of these disclosures also can be affected by their presentation to the consumer, whether made in a prescribed disclosure form or other writing. A written disclosure form is likely to become buried in the forms that a prospective seller or buyer must sign in the course of retaining a broker to sell or buy a home. Also, if circumstances in the transaction change which make a prior disclosure incorrect, most of these laws do not require an updated or corrected disclosure to be made.

Id.

41. *See* Trosch, *supra* note 9, at 121.

42. *Id.* at 121-22.

43.*See Realtors Want People to Know Who's Representing Whom,* Phila. Inquirer, Dec. 13, 1992, at H7.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *See* Gene Austin, *Is Dual Agency Nothing More Than 'Dual Duplicity'?,* Phila. Inquirer, Sept. 6, 1992, at L1.

49. *Id.*

50. *Id.*

51. *See generally,* Elizabeth Lesly, *How Your Realtor Rips You Off,* Wall St. J., Nov. 30, 1990, at A14. It is not entirely clear, however, that seller's agency would not simply maintain

the current system of sub-agency wherein the seller is appointing all realtors, except those who specifically approach the listing broker as buyer's agents, as sub-agents.

52. *See, e.g.,* Braswell & Poe, *supra* note 4, at 291. "In characterizing the agency relationship, some state laws expressly discount compensation relationships as a determining factor of whether the agent is representing the seller or the buyer...." *Id.* Trosch, *supra* note 9, at 122. "As the source of commission does not itself determine agency, the buyer agent can he compensated by either the buyer or seller." *Id.*

53. *See* Kenneth R. Harney, *Things Nader Would Change In Real Estate,* Phila. Inquirer, Dec. 11, 1992, at C14. "The concept [of buyer agency] has been spreading quickly in many states, encouraged in part by support from the industry's trade group, the National Association of Realtors (NAR)." *Id.* In 1992 the NAR amended its rules to permit local realty boards' Multiple Listing Services to he opened to allow buyers' agents access and fee splits as they would enjoy working as sub-agents. *Id.*

54. *See* Lesly, *supra* note 51.

55. *See, e.g.,* Harney, *supra* note 53; Christi Harlan, *Home Buyers' Agents Threaten Brokers,* Wall St. J. Feb. 5, 1991, at B1; Gene Austin, *Home Buyers May Have An Agent In Their Corner Soon,* Phila. Inquirer, Dec. 1, 1991 at L1.

56. *See* Austin, *supra* note 55.

57. *See* Harlan, *supra* note 55.

58. *Id.*

59. *See* Austin, *supra* note 55.

60. *Id.*

61. *See supra* notes 10-31 and accompanying text.

62. *See supra* notes 20-21 and accompanying text.

COMPARATIVE ASPECTS OF CHINESE AND VIETNAMESE TRADE LAW
by

Rosario J. Girasa*

Beginnings

The grand experiment in marxist ideology, which began in 1917 in the former Soviet Union and spread to China in 1949, did not succeed. As market economies flourished in the West, particularly in Germany, and in the East in Japan, it became clear to the leadership of the communist states that existing economic modus operandi would cause continuing decline within their countries. As a result, significant changes had to take place. Refusing to acknowledge that their ideological underpinnings were failures, China's and other communist leaders employed the ruse that they sought to provide a unique combination of marxist and capitalist thought and practices to better serve their constituencies. We will summarily review the statutory enactments which incorporated the changes to a market economy in China. Vietnam did so a decade later. The thesis of this paper is that Vietnam utilized China's experience by copying those enactments which were successful. In doing so, it also is becoming a market economy which will make it a major player in Asia within the next decade.

The transition to a market economy in the People's Republic of China encompassed considerable preparation and planning in untested waters for a Communist society. By the events which followed, it was clear that a complete overhaul of the legal system had to co-exist with the economic statutory enactments. Accordingly, in a dramatic manner, a series of measures were adopted at the Second Session of the Fifth National People's Congress on July 1, 1979. The result was analogous to some extent to the U.S. Constitutional Convention which created the tri-partite system of government in Articles I, II and III of the Constitution. The remarkable success of these measures were to greatly influence a similar transition in Vietnam a decade later.

The first measure, Order No. 1, was the passage of the Organic Law of the Local People's Congresses and Local People's Governments of the People's Republic of China.[1] It established people's congresses and governments at the local level in provinces, autonomous regions, municipalities, counties, municipal districts and towns.[2] By doing so, power was disbursed to centers away from the central government in Beijing.

The second Order was the passage of the Electoral Law of the National People's Congress and Local People's Congresses of the People's Republic of China.[3] It sets forth the procedures for voting at local and national levels, election of deputies to local and national people's congresses, registration and nomination of candidates and election procedures. Although in practice its procedures would not allow for significant opposition to governmental policies, nevertheless, the basis for democratic reform is statutorily present.

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The third order, the Organic Law of the People's Republic of China,[4] reformed the courts which heretofore made a mockery of procedural and substantive rights of parties before them. Unless a judicial system to which adjudication of disputes could be referred was in place, it was highly likely that foreign business enterprises would have demurred in investing significant resources. Thus, the statute created a western-like tripartite system of courts. There are three types of courts: local courts, special people's courts and the Supreme People's courts. The local people's courts has three levels: the basic people's courts, intermediate people's courts and higher people's courts. Special courts exist for military matters, railway transport, water transport and other focused areas including, most recently, courts considering intellectual property matters.

The remaining statutes passed on the same momentous day were major revisions in the criminal sphere. Order No. 4 is the Organic Law of the People's Procuratorates of the People's Republic of China[5] which, in effect, created a prosecutorial office for investigations, initiation and carrying out of judgments with respect to criminal activities. A formalized penal code was enacted as Order No. 6 entitled: Criminal Law of the People's Republic of China.[6] It sets forth the crimes and nature of punishment, including the death penalty for the "most heinous crimes." Order No. 7 is the Criminal Procedure Law of the People's Republic of China,[7] which lays out the methodology for filing of criminal charges, investigation and initiation of a public prosecution. Procedures are also stated for conduct of trials and appeals.

Having created a legal infrastructure including a revision of the Constitution[8] incorporating the statutory changes, China enacted the most important law relevant to our discussion, namely, the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures.[9] Unlike the other statutes enacted on July 1, 1979, this statute was made almost immediately effective (July 8, 1979 rather than January 1, 1980). The statute, though consisting of only 4 pages (15 articles), became the cornerstone of China's entre into western economic mode of doing business. Considering the previous xenophobic governmental attitude towards foreign investments, the law was an extraordinary opening to the outside world.

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

Vietnam's commencement into the global marketplace began 7½ years after China's foray by the enactment of the Law on Foreign Investment in Vietnam.[10] It is an expanded copy of China's legislation. Both have almost identical preambles. China's law begins: "With a view to expanding international cooperation..." Vietnam similarly commences with: "In order to expand economic co-operation with foreign countries..."[11] Both laws immediately disavow past communist ideological mainstays which held that expropriation and/or nationalization of foreign-owned property in compensable only to the extent voluntarily permitted by the host country.[12] Article 2 of China's law states: "The Chinese Government shall protect, in accordance with the law, the investment of foreign joint ventures, the profits due them and their other lawful rights and interests..." Article 1 of Vietnam's law similarly provides: "The State of Vietnam guarantees the ownership of invested capital and other rights of foreign organizations and individuals..." Vietnam recites in its statute a similar wish list of desired projects for investment as China's list recited above.[13]

The major difference between the two statutes is that Vietnam recites three forms of legal enterprises which a foreign investor may become engaged, namely, contractual business co-operation, joint venture and wholly owned enterprises, whereas China began solely with the joint venture as its primary mode of foreign investment. China gradually became more receptive to foreign investment by permitting a variety of methods of doing business in China.

The six basic forms of business enterprises within China are: (1) representative offices. These offices represent other offices of a multi-national company. They may engage in sales and purchases, bargain with local and state governments and enterprises, engage in market studies and collect information. They may not engage directly in business activities (execute contracts and the like); (2) processing and assembling operations. Companies in foreign countries ship raw materials and parts to China where they are assembled and exported; (3) technology transfer. The foreign party licenses its technology which is protected by intellectual property statutes and regulations (patents, trademarks, copyrights, property technology (know-how) and computer software); (4) equity joint ventures; (5) cooperative joint ventures which is similar to equity joint ventures with exceptions such as a variable profit-distribution. It is most used in hotel management; and (6) wholly foreign-owned enterprises.

Joint Ventures

In China, the joint venture must satisfy at least one of the following requirements: (1) adopt advanced technology, equipment and scientific techniques, increase variety and quality of output of products and conserve energy and materials; (2) benefit technical renovation of the venture and achieve quick results and large profit with small investment; (3) expand exports and increase foreign exchange earnings; and (4) train technical or managerial personnel.[14] Vietnam does not define the type of projects a joint venture may operate but inasmuch as the government has to approve the projects, the result may be similar. One should not lose sight of governmental flexibility as well as intransigence. If Vietnam or China desires particular industries, approvals are readily available. If projects have questionable value, then such approvals may become mired with the bureaucracy.

Establishment

The joint venture with the Chinese enterprise must take place within the PRC.[15] The agreement must be in writing, which agreement, together with the articles of association and other relevant documents, are to be examined and approved by the Ministry of Foreign

Economic Relations with Trade of the People's Republic of China (MOFERT). Once it approves the joint venture, it then authorizes the local or regional authorities under the State Council to examine and permit the joint venture. Application for permission to establish a joint venture consists of three basic documents: the joint venture agreement (document in which the parties consent to the establishment of a joint venture and states the basic principles for its establishment; the joint venture contract (document setting forth the rights and obligations of the parties); and the articles of association (similar to U.S. certificate of incorporation and by-law-names, registered capital, composition of Board of Directors etc.).[16]

In Vietnam, the key document is the joint venture contract between the Vietnamese and foreign parties. Application is made to the State Committee for Co-operation and Investment. The application includes submission of the joint venture contract, a feasibility study, the charter of the enterprise and petition for preferential treatment, if any.[17]

In both countries, the joint venture contract requirements are almost identical, thus further illustrating the thesis of this writer that Vietnam copied China's laws and regulations, adopting those parts which proved successful in transforming the latter's economy. The wording of the later Vietnamese regulations is virtually the same.[18]

Status and Capitalization

The joint venture in both countries is a "limited liability company."[19] Its precise meaning in China is not found in either its statute or regulations but may be gleaned from other parts of the legislation. The statute and regulations do state that the liabilities of the parties are limited to the amount of investment each party has undertaken in the joint venture. The 1979 statute mandated that the foreign party must invest not less than 25% of the registered capital of the joint venture. Most joint ventures invest at least 51% of the capital. Profits and losses are to he divided in proportion to their contribution to the "registered capital."[20] The registered capital which is similar to "stated capital" in the U.S., is the total amount registered with the government agency when the joint venture was established and is the sum of the investment by all parties.[21] The joint venture may not diminish the registered capital but may increase or assign it provided that the Board of Directors and governmental authorities approve.[22] If a party wishes to assign its interest, governmental approval will be necessary and is subject to the right of first refusal by the other party to the joint venture.[23] The difficulty of the joint venture having a strictly Chinese personam is its lack of ability to branch out beyond the national boundaries. It appears, however, that MOFERT may approve a branch office of the joint venture outside of China.[24]

Vietnam similarly provides that the joint venture enterprise by a limited liability company which is one wherein "the liability of each party to the other parties and to the joint venture enterprise being limited to its capital contribution to the prescribed capital."[25] The enterprise's Board of Management is in charge of the venture. In a footnote to its statute, the Board of Management is stated to be equivalent to a Board of Directors but "management" is the preferred terminology because allegedly "Vietnam regards the Vietnamese members of the board as yet not having the directorship skills required for the board properly to be called a board of directors."[26]

Vietnam's statute provides that the minimum contribution of the foreign party is 30% of the total prescribed capital and further states that there is no ceiling to the proportion of the contribution by the foreign party to the prescribed capital.[27] Unlike China, all assets of the joint venture must be insured. The parties share risks and losses in proportion to their respective contributions to the capital.[28]

Capitalization

China's statute states that the investment in a joint venture may be in cash, buildings, plant equipment, machinery, international property rights, technology or right to use a site. The parties are to fix the value of the investment in a fair and reasonable manner.[29] Vietnam's law is almost identical.[30] Foreign currency in China must be converted to renminbi at the foreign exchange rate set by the State Administration of Exchange Control. The rate tends to be considerably lower than the black market exchange rates, although the currency may be exchanged into foreign currency at the same governmental rate.[31] Vietnam does not have the dual system of currency. It does mandate, however, that the parties agree in advance the proportion of products to be sold both abroad and within the country. All foreign currency received from export sales must, at the least, be sufficient to meet the foreign currency requirements of the joint venture.[32]

The right to use a site in China must be compensated either as a credit to the Chinese party as a part of its investment or to the government.[33] The regulations are obviously tipped greatly in favor of the Chinese party. For example, if machinery, equipment or other materials are contributed by the foreign party, they must (1) be indispensable to the joint venture; (2) made in China unless shown that the price, quality or delivery time would not satisfy the joint venture's requirements; and (3) their fixed value may not exceed their current international market price for the equipment. The Chinese party is not bound by the provisions.[34] Vietnam does not address this issue in its law or regulations.

Management

The Board of Directors of a joint venture in China determines all major questions arising with respect to its operation. The board consists of at least three members. The number of directors is determined by the parties who are to take into account the ratio of the investment by each party. The chairman must be the Chinese party and the vice-chairman (vice-chairmen) is the foreign investor. The term of office is four years (Vietnam-maximum of 5 years) which term is renewable.[35] At least one annual meeting is mandatory, which meeting is presided over by the chairman, or vice-chairman if the former is not available (Vietnam concurs). At least two-thirds of the Board must be present, although a board member may give a proxy to act in his/her behalf (Vietnam is the same). Interim board meetings must be called at the request of one-third of the board members. The meeting is held at the official address of the joint venture.[36]

In Vietnam, the parties to the joint venture appoint members to the board of management in proportion to their contribution to capital, although each party must have at least two representatives on the board. The chairman is to be selected by agreement of the

parties. The general director and deputy general director (officers) are appointed by the board. One of the directors must be a Vietnamese citizen.[37] China takes the more traditional approach by providing that the day-to-day operations are to be conducted by the officers named by the board of directors. The duties of the president include promulgation of the resolutions of the board, representation of the joint venture and responsibility for appointment and dismissal of personnel. The officers may be Chinese or foreign persons.[38] The president and vice-president may not hold similar offices or participate in another economic organization within China. They may be dismissed at any time for dereliction of duty or for corruption.[39]

Although board resolutions in China may be adopted by the percentage vote authorized in the articles of association, certain resolutions require unanimous approval, to wit: amendment of the articles of joint venture; termination or dissolution of the joint venture; increase or assignment of the registered capital of the joint venture; or merger of the joint venture with another economic organization.[40] Vietnam appears to mandate unanimity in a broader scope of business activities. Thus, it requires, in addition to the above, unanimity in the production and business plan of the joint venture, borrowing and budgetary matters, appointment, replacement and dismissal of the chairman of the board of management, the general director, any of the deputy general directors and other key personnel of the enterprise.[41]

Foreign Exchange Control

China and Vietnam have similar foreign exchange requirements. The joint venture must use the Bank of China or other designated bank which supervises all receipts and payments. All receipts and deposits must be made through the account. Foreign accounts may be permitted provided the State Administration of Exchange Control allows them. In such circumstances, they are subject to full disclosure of receipts, payments and bank account statements.[42] Similarly, in Vietnam, all enterprises involving foreign owned capital must be deposited with the Bank of Foreign Trade of Vietnam or with branches of Vietnamese foreign or with foreign banks approved by the State Bank of Vietnam. All receipts and expenditures are to be effected through these accounts.[43] Like China, all foreign exchange must be converted into local currency for expenditures within Vietnam.[44]

Both countries permit repatriation of profits after payment of taxes.[45] Loans for foreign exchange and for local currency may be applied for at the Bank of China in accordance with the Bank's regulations. Foreign exchange funds may be borrowed from abroad but a report must be made to the State Administration of Exchange Control.[46] Vietnam mandates that the enterprise have a balance between foreign currency receipts and expenditures, insuring, with some exceptions, that foreign currency receipts derived from exports and other sources are sufficient to meet foreign currency expenditures, including profits to be remitted abroad.[47]

Taxation

The joint venture in China is taxed at the basic rate of 30%; 24% in coastal economic zones (Tianjin, Shanghai, Guangdong) and 15% in special economic zones (e.g. Hunan). Tax holidays are typically two years, 50% reduction for an additional 2-3 years plus investment incentives if capital is reinvested.The joint venture regulations merely recite the necessity of paying taxes in accordance with applicable laws. Imports by a joint venture are exempt from customs duties and from the industrial and commercial consolidated tax with respect to machinery and equipment needed for construction of the factory site or are part of the investment or are used in production of goods for exports and are manufactured within China. Exports may be exempted from industrial and commercial consolidated tax by MOFERT. Exemption from taxation may be granted in the early phase of a joint venture.[48]

In Vietnam, enterprises with foreign parties are subject to profits taxes consisting of: (1) priority category (Article 3 enterprises, i.e., implementing major economic programs, export oriented, use of high technology, building infrastructures and significant foreign currency producing services and meets certain other criteria)[49]- 15-20% of profits earned; 2) standard category-21-25% of earned profits; tax holidays are permitted up to an initial period of two years from commencement of the first profit making year and a 50% reduction for the next two years.[50] A case by case exemption may be made by the State Committee for Co-operation and Investment upon recommendation of the Minister of Finance. Additional special financial incentives are also provided for in the Regulations.[51] A withholding tax is to be paid by the foreign economic organization for profits transmitted abroad consisting of a 5% tax where the foreign organization contributed 70% of the prescribed capital or in excess of $10 million; a 7% tax where the contribution was between 50-70% of the prescribed capital or in excess of $5 million; and 10% tax in all other cases.[52] If the foreign person reinvests any portion of the profits for a period of three years, then the tax thereon will be refunded. The taxable year is the calendar year but permission may be sought from the Ministry of Finance to alter the fiscal year.[53]

Term, Dissolution and Liquidation

In China, the term of a joint venture is dependent upon the nature of the enterprise. Ordinarily, the period extends from 10 to 30 years. A joint venture involving a large investment, a long construction period and a low profit ratio or one in which advanced technology is given or is internationally competitive may extend to 50 or more years.[54] Vietnam's time limits are quite similar. The duration of the enterprise is the limit placed upon by the parties which, in principle, should not exceed 20 years. Like China, the same examples are used to justify extending the duration to 50 years.[55]

Both countries again have almost identical provisions regarding renewal of the enterprise. In China, the parties must apply to the appropriate governmental agency at least six months before the proposed extension of the term. Vietnam clearly copied this provision, using almost identical wording. The application therein is to the State Committee for Co-operation and Investment.[56]

In China, a joint venture may be dissolved: (1) upon expiration of the term of the joint venture; (2) due to major losses in the enterprise; (3) by failure of one of the parties to fulfill its obligations; (4) due to major losses by war, natural disaster or other force majeure; (5) by failure to achieve business objective without possibility for future development; or (6) the occurrence of a stipulated event.[57] Vietnam's regulations are again almost identical.[58] Both countries require notification to the appropriate governmental authorities. The wording of the Vietnamese regulations mirrors that of China. Both countries except expiration of term from

governmental notification and both explicitly state that the defaulting party must indemnify the other party for the losses sustained.[59]

The dissolution procedure is similar. China requires the Board of Directors to propose liquidation procedures and submit its proposal and nominations to the governmental department which processes liquidations.The liquidation committee of the enterprise (members of the Board and/or attorneys, accountants) reviews the finances, collects assets and indebtedness, compiles an inventory and proposes a liquidation plan to the Board. The assets remaining are applied to the indebtedness and any remaining sums are divided pro-rata to the parties.Procedures are then taken to cancel the joint venture registration and turn in the business license.[60] Vietnam requires the Board of Management, no later than six months prior to termination of the enterprise or decision to end the venture, to accomplish the above. It is more explicit as to order of priorities of payment of the liabilities-salaries and insurance premiums have top priority followed by taxes and import duties, then loans and interest thereon and, finally, the remaining indebtedness. The liquidation commmittee submits the liquidation plan to the State Committee for Co-operation and Investment, which, after termination of the work of the liquidation committee, cancels the investment license and retains custody of the books of accounts of the venture.[61]

Dispute Resolution

China and Vietnam reflect the Asian approach, rooted in Confucianism, which abhors litigation. Again, both countries have very similar provisions for procedures to be followed in the event of a dispute between parties to the enterprise. They are to initially negotiate with each other and/or proceed by conciliation (generally, having a neutral person assist in resolving the dispute). If there is no resolution, an arbitration body shall make the determination. If arbitration is within the country, then it proceeds under the auspices of the Foreign Economic and Trade Arbitration Commission of the China Council for the Promotion of International Trade or the Foreign Trade Arbitration Committee of Commerce and Industry of the Socialist Republic of Vietnam. The parties may agree to arbitrate outside of the country before other tribunal bodies. If no arbitration procedures are provided for, the People's courts of both countries may be utilized.[62]

Wholly Owned Enterprises

China was initially very reluctant to allow wholly foreign-owned enterprises due to its long historical abuses by foreigners. Vietnam, although it had concluded its war with the U.S. and the government of South Vietnam in 1975, adopted China's opening to the West, including permission of 100% ownership of enterprises by foreigners. Vietnam's Foreign Investment statute sets forth three types of enterprises: a contractual business co-operation; joint venture enterprise; and a 100% foreign owned enterprise.[63] In China, a foreign company may establish a wholly-owned limited liability (to capital investment) subsidiary.[64] Generally, it must use advanced technology or export more than 50% of its product.The said percentage is subject to a downward modification depending upon the desirability of the enterprise. Generally, the advanced technology requirement poses few problems in negotiating with the government.[65]

Vietnam permits the 100% foreign-owned enterprise to have a duration of up to 50 years. China allows the term of ownership to be 20-30 years which may extend up to 70 years for large properties or business.[66] The advantage of having a fully owned enterprise is that there is no Chinese or Vietnamese party but the advantage may be more than offset by the fact that the local party is not present to provide the contacts, assets and experience.

The procedure for setting up such an enterprise in China is similar to that of the joint venture. Application is made to the appropriate department under the State Council, which has 90 days to examine and decide whether or not to permit the enterprise. The foreign investor has to apply for a business license from the industry and commerce administration authorities for registration.[67] Upon registration the enterprise becomes a Chinese legal person. Investments within China must be made as previously stated in the application and approval. Major changes must be reported to the appropriate governmental agency.[68] The requirements concerning operation, labor agreements, unions, account and reporting taxes, banking, purchase of materials, remission of profits abroad, termination and liquidation are like those of joint ventures. Insurance coverage is to be applied for with Chinese insurance companies.[69]

In Vietnam, the wholly owned enterprise by foreigners is fully responsible for its management and the results therefrom. It must be a limited liability company which is a Vietnamese legal entity subject to the laws of the host state.[70] The enterprise wishing to invest in this manner must file for an investment license to the State Committee for Co-operation and Investment which application is to include: (a) a feasibility study of the proposed investment which contains the economic and social benefits of the project; (b) the organization's charter; (c) assurances that the investor is qualified to embark on a long-term business in Vietnam; (d) the charter of the intended enterprise to be formed in Vietnam; and (e) the petition for preferential treatment, if any.[71]

The Vietnamese requirement for the charter of the enterprise is similar to that found in U.S. states, namely: the business name and address; description of the production and business plan with proposed timetable for investment; the amount of capital; duration; day-to-day management plan and name of the representative responsible for its implementation; financial details and accounting procedures; and details of dissolution conditions and procedure.[72] The same procedure is used for governmental review and approval of the application for a license as for joint ventures. Upon approval, publication of the details of the license takes place within 30 days of the issuance thereof in a prescribed local and national governmental publication.[73] Amendments of the charter require governmental approval. A non-resident owner must have a local representative in Vietnam. In the event of a serious breach of law or deviation from the objectives of the enterprise may lead to the suspension of the license.[74]

Protection of Intellectual Property Rights

The major Chinese statutes governing intellectual property rights were enacted between 1982 and 1990. The relevant statutes are the 1982 Trademark law of the People's Republic of China,[75] the 1984 Patent Law of the People's Republic of China,[76] the 1990 Copyright Law of the People's Republic of China[77] and part of the 1986 General Principles of

the Civil Law of the People's Republic of China.[78] Vietnam also grants protection to intellectual property rights in principle. The relevant authority are the Ordinance on the Transfer of Foreign Technology into Vietnam,[79] Decree No. 49-HDBT[80] which provides guidance for implementation of the said ordinance, Regulations on the Purchase and Sale of the Right to Use Inventions, Utility Solutions, Industrial Designs, Trademarks on Goods and Technical Secrets,[81] Ordinance on the Protection of Industrial Property Rights[82] and Circular No. 03-NCPL of the Supreme People's Court Providing Guidance on the Resolution of Some Disputes over Industrial Property Rights[83]

Trademarks

China. The P.R.C. has had a trademark protection statute since 1982. Prior to that time, it had "Regulations Governing Trademarks" which took effect on April 10, 1963. The Trademark Office is an administrative Office within the Department of Industry and Commerce under the State Council. In order to obtain a trademark, the applicant must be an enterprise, institution or an individual industrialist or businessman.[84] Foreigners and foreign enterprises may also apply for trademark protection within the P.R.C. They must do so through agents within the country.[85] A "trademark" is a work or design or combination thereof having distinctive characteristics so as to distinguish it to facilitate identification from other goods.The purpose of a trademark is to "encourage producers to guarantee the quality of their goods and safeguard the reputation of their trademarks, in order to protect the interests of consumers and promote the development of the economy."[86]

The pharmaceutical and tobacco industries must use registered trademarks. Other persons may apply by filing in accordance with the particular classes of goods for which a trademark is sought.[87] Trademark holders are responsible for the quality of goods. Appropriate administrative governmental departments of industry and commerce are responsible for supervision over the quality of manufactured of goods and are mandated to prevent deceptive practices to consumers.[88] Deceptive practices are subject to loss of trademark, imposition of fines, public notice of the deception (in Asia, this would constitute "loss of face" which is taken quite seriously), cease and desist orders and/or seizure of goods.[89] Infringement of trademarks makes the transgressor liable to an injunction order, compensatory damages to the holder of the trademark, fines and possible criminal liabilities.[90]

The holder of a trademark is required to use appropriate Chinese characters for "Registered Trademark" and its "R" symbol. Trademarks may not have the following words or designs:

-names, flags, emblems or military flags or decorations of the P.R.C. or of foreign countries or of inter-governmental international organizations;
-"Red Cross" or "Red Crescent" symbols or names;
-generic names or designs of goods;
-those stating quality, major raw materials, function, use, weight, quality or other characteristic of the goods;, exaggerated and deceptive advertising; and
-those detrimental to morality or prevailing customer or other undesirable influences.[91]

Foreigners seeking trademark protection must come from countries having reciprocal agreements with the P.R.C. and must appoint an agent approved by the government to act on its behalf with respect to the trademark registration.[92] As in the case of patents, time is of the essence in registering for the trademark. A "Trademarks Register" in the Trademark Office is set for the entry of all approved trademarks.[93] Once the preliminary trademark is made public, those persons opposing its filing have three months to file objections. All trademark disputes must be submitted to the Trademark Review and Adjudication Board within one year of approval. The Board ultimately decides the validity of the trademark application.[94]

The trademark, as well as all extensions, is valid for ten year intervals. If a trademark is assigned, both parties must apply to the Trademark Office and both of them must guarantee the quality of the goods to which the trademark is used. Trademark licensing contracts are to be filed with the Trademark Office.[95] A trademark may be revoked if not used for three consecutive years. Other causes for possible revocation include an improper assignment, changes of address and work or design without authorization.[96]

If a trademark is infringed upon, criminal and civil penalties become available to the holder of the trademark. Use of identical or similar trademarks in connection with similar goods without a license or having a person's right to exclusivity of a registered trademark will cause a panoply of remedies to become applicable.[97]

Vietnam. North Vietnam enacted its first intellectual property measures as early as 1958 (17 years before unification) by passage of laws regulating the registration of trademarks.[98] After unification, the Council of Ministers, in 1982, issued regulations for the registration of trademarks which were followed by regulations governing industrial designs in 1988. Other decrees and regulations followed in fairly rapid succession in an endeavor to entice foreign investment.[99]

Vietnam is a signatory to the Paris Convention for the Protection of Industrial Property of March 20, 1883 (governing trademarks), the Madrid Agreement of April 14, 1891 and the Stockholm Convention of July 14, 1967 (the U.N. World Intellectual Property Organization).[100]

The most significant enactment in the area of intellectual rights protection is the Decree on the Protection of Industrial Property Rights.[101] The ordinance and decree give recognition and protection to industrial property rights to all state and private organizations and individuals.[102] "Industrial property" is defined as including: (1) invention (new technical solution); (2) utility solution (application of prior patent in a new manner) (3) industrial design (new, world-wide external appearance of a product embodied by lines, three-dimensional forms, colors or combination thereof which is capable of serving as a pattern for an industrial or handicraft product; (4) trademark (a mark used to distinguish goods or services by a person from goods or services of another person; it may be in the form of words, pictures or combination thereof in one or more colors); and (5) appellation of origin (the geographical

name of a country or locality wherein the manufactured product originates entirely or in essence).[103]

A caveat to be noted and which is common to both China and Vietnam: "Industrial property which is contrary to the social interest, public order, the principles of humanity or socialist morality shall not be protected."[104] The effect of such exception is unclear. Although the implications appear to give governmental authorities very broad powers to deny protection, the practical effect appears to be insignificant in light of the interpretation to date in China and Vietnam.

The governmental organizations having responsibility in the area of intellectual property protection are: the Council of Ministers which has overall supervision and which issues policies for promotion and development thereof; the State Committee for Science and Technology which is responsible for organization, supervision and implementation of State policies; the Inventions Department under the State Committee which promotes procedures for recognition of industrial property rights and cooperates with social organizations (e.g., the General Federation of Labor and the Communist Youth League) and inventors associations in this area; and a variety of ministries, state committees and other organizations under the Council of Ministers, and people's committees in the provinces and cities which are responsible for organization and development of industrial property within their jurisdiction.[105]

The owner (as distinguished from the author or creator) has the exclusive right to use and transfer the protected object and may sue for infringement thereof. If it is transferred, it must be by means of a written agreement which is registered with the Inventions Department.[106] The right to use an invention, utility solution or industrial design includes the right to manufacture, import, advertise and place in circulation. With respect to trademarks or appellation of origin, the owner may exclusively use them on the products, advertising, packaging or on documents relative to the protected indicia.[107] The owner thereof is obligated to use the protected object and to pay the fees required by the government. The requirements reflect the European that protection is a privilege which may be lost if not used for the common benefit of the community.[108] There are provisions for compulsory licensing (with payment to the owner) by the Chairman of the State Committee for Science and Technology where the owner of the protected title has failed to utilize the object or when needed for vital reasons.[109]

The protected object may be assigned by the owner. The author, as distinguished from the owner, has the right to be named in the protected title and in scientific and technical documents. Such person may have the right to receive remuneration in a sum fixed by the Council of Ministers.[110]

Infringement is the lack of consent by an owner to a person who uses the invention, utility solution or industrial design for manufacturing, importing, advertising or other usage of the protected object.[111] Vietnam, however, has fairly liberal exceptions to the prohibition. They included: (1) utilization of the object of industrial property for non-commercial purposes; (2) circulating products which were placed in the market by the owner of the protected title or by the prior manufacturers or licensees; and (3) the use of the protected industrial property in transport vehicles of foreigners when the vehicles temporarily enter or are in Vietnam and provided that they are used solely for the operation of the vehicles.[112]

Patents

The Patent Law of the P.R.C. came into effect on April 1, 1985 and is similar in most respects to other national patent laws. It governs inventions, utility models and designs unless the "invention-creation" involves national security, is violative of state laws, is contrary to social morals or is detrimental to the public interest.[113] The right is given to persons responsible for the invention, to the appropriate job until accomplished while primarily using the resources of the unit or to the enterprise or joint venture if made by a staff member or worker for the foreign-owned enterprise or venture.[114]

It is a "race to the register" right, i.e., as between two applicants, the first to file will be granted the patent.[115] The right is assignable although there are restrictions if the patent right is owned by the government-owned work unit or the patent is being transferred by a Chinese person to a foreign person.[116]

Like the U.S. patent statute, it is necessary that the invention and utility models be novel, possess inventiveness and is practical. By "novel", it is meant that no other identical model was previously publicly disclosed in domestic or foreign publications, or was publicly used in China, otherwise made public or is one identical to a model previously filed and recorded in the Patent Office. "Inventiveness" means that the model has conspicuous and substantially distinguishing characteristics. "Practicability" means it must be capable of being manufactured or used and "is capable of producing positive results."[117]

Vietnam. Vietnam does not have a separate patent statute. The enactment cited above under trademarks is applicable herein.

Copyrights

China. The Copyright Law of the P.R.C. became effective on June 1, 1991. There were implementing regulations and regulations for the protection of computer software.[118] The works covered include those of literature, art, natural and social sciences, engineering and technology. They may take place in a variety of formats such as a writing, oral works, musical and dramatic works, fine art, drawings, maps, computer software and other works.[119] Excluded from protection are prohibited works (pornography) and works which "prejudice the public interest."[120] The subject matter must be original ("created") which means that it derives from intellectual activities from which literary, artistic and scientific works result. Like U.S. law, originality is not necessarily novel. An author may have derived all of his/her ideas from other authors. It is the unique mode of expression which is protected.[121]

A copyright gives the owner five basic rights with respect to the subject matter: the rights of publication, authority, alteration, integrity and exploitation (remuneration).[122] Ordinarily, the copyright belongs to the person creating it (the author). If the work was derived

from the sponsorship of an entity (the joint venture etc.), then the entity is the author.[123] China grants authors unlimited time with respect to the rights of authorship, alteration and integrity of the work; however, the right to exploit the work, including remuneration is limited to the life of the author plus 50 years (50 years if the author is an entity).[124] Exceptions include the right to use the work for individual study; use of an insubstantial quotation; media use, translation of a few copies for teaching or scientific use; use by a governmental organization and several other restricted usages.[125]

A person seeking to exploit a copyrighted work must receive permission in the form of a written contract with the owner, which contract specifies the manner of use, its exclusivity, scope and term of the license, liability for breach and other pertinent data. The term is limited to ten years but is renewable.[126] Civil liability includes a public apology, monetary damages and injunction. Governmental remedies include criminal charges, fines, confiscation and imprisonment.[127]

Vietnam. There is substantial similarity to China's statute. The reason is that both countries adhere to international copyright treaties (the Berne and Universal Copyright Conventions). The works of Vietnamese authors and residents in Vietnam are protected. Similar moral rights (authorship, distortion and integrity) duration and transferability are given recognition. In both countries, it remains to be seen whether de facto protection is rendered. This author, when visiting Vietnam in January, 1995, found innumerable violations of copyright laws, especially in the reproduction without permission of artistic works (musical tapes and cds), computer software and other violations. It appears that China and Vietnam will respond to outside pressure when it serves their best interest to do so. Retaliatory measures by outside governments will eventually limit the violations.

CONCLUSION

China and Vietnam are the last remnants of communist states still in existence today. Communism remains as an ideology to the extent that no competing political ideologies or parties are permitted. Nevertheless, both states have de facto recognized that Marxist economics does not work. The demands of the marketplace have replaced planned economies. China was the first state to experiment and implement the changes within its society after a period of considerable turmoil. Vietnam, unable to sustain itself by the inherent demands of its ideology, has also incorporated market principles. In doing so, it clearly followed the Chinese model. It copied those laws and regulations which have proven successful within China. This paper has attempted to illustrate this thesis.

ENDNOTES

1. Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 1 of the Chairman of the Standing Committee of the National People's Congress on July 4, 1979 effective as of January 1, 1980.

2. Article 1 of the statute.

3. Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No.2 of the Chairman of the Standing Committee on July 4, 1979, effective as of January 1, 1980.

4. Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 3 of the Chairman of the Standing Committee of the National People's Congress on July 5, 1979, effective January 1, 1980. The was amended on September 2, 1983, by decision of the Standing Committee of the Sixth National's People's Congress.

5. Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 4 of the Chairman of the Standing Committee of the National People's Congress on July 5, 1979, effective as of January 1, 1980.

6. Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 5 of the Chairman of the Standing Committee of the National People's Congress on July 6, 1979, effective as of January 1, 1980.

7. Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 7 of the Chairman of the Standing Committee on July 7, 1979, effective as of January 1, 1980.

8. Adopted at the Second Session of the Fifth National People's Congress and promulgated by proclamation of the National People's Congress on July 1, 1979, effective as of January 1, 1980.

9. 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 as of July 8, 1979.

10. Enacted by the Eighth Legislature, Second Session of the National Assembly of the Socialist Republic of Vietnam, 29 December 1987 which statute was amended on 30 June 1990 and 23 December 1992. Vietnam is now open to U.S.investors with the announcement of President Clinton on July 11, 1995 that the United States has established full diplomatic relations witb its former enemy. Nevertheless, importation of goods will not become a significant factor until the U.S. grants Vietnam most-favored-nation status as it presently has with China.

11. Article 1 of the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures and the preamble to Law on Foreign Investment in Vietnam, op. cit.
12. See Guha Roy, "Is the Law Responsibility of States for Injuries to Aliens a Part of the Universal Law," 55 A.J.I.L. 863. See, also, Resolutions 523 (VI) of January 12, 1952; 626 (VII) of December 21, 1952 and 1803 (XVII) of December 14, 1962 of the General Assembly of the United Nations which leave to the host state the compensation to foreign investors for expropriation or nationalization.

13. Article 3 of Vietnam's Law on Foreign Investment.

14. China's Joint-Venture statute, Article 4.

15. *Id.* at Article 1.

16. *Id.* at Articles 13-15.

17. Decree no. 28. HDBT of the Council of Ministers of the Socialist Ram, dated 6 February Republic of V17.ietnam, date 6 February, 1991, Decree Providing Regulations on Foreign Investment in Vietnam, Articles 21-23.

18. Compare China regulations, Article 14 with Article 24 of Vietnam's regulations.

19. China's Joint Venture statute, Article 14 and Regulations, Article 19. Vietnam's Regulations, Article 34.

20. Statute, Article 4.

21. Regulations, supra, Article 21.

22. *Id.* at Articles 22 and 24.

23. *Id.* at Article 23.

24. *Id.* at Article 23.

25. Vietnam's Joint Venture Regulations, Article 34.

26. Office of the State Committee for Co-operation and Investment, Legal Writings on Foreign Investment in Vietnam, footnote 18 to the "Law on Foreign Investment in Vietnam," p.15.

27. Article 8 of the Statute.

28. *Id.* at Articles 8-9.

29. China's Joint Venture statute, Article 14 and Regulations, Article 19.

30. See Article 7 which divides the contribution to prescribed capital into two parts: (1) the foreign party may contribute in foreign currency, plant and equipment and intellectual property rights and technical know-how and processes; and (2) the Vietnamese party may make its contribution in local currency, natural resources, right to use a site, plant and equipment and technical services and know-how.

31. China's Regulations, Article 21. Currency in China has been divided into two types: renminbi, which is the currency used by natives and foreign currency certificates which is the currency given to foreigners. Only the latter may be used to re-convert the currency to foreign currency.

32. Statute, Article 11.

33. Statute, Article 5.

34. Regulations, Article 27.

35. Statute, Article 6 and Regulations, Article 34. Vietnam-Regulations, Article 36.

36. Regulations, Article 35. Vietnam-Regulations, Articles 37-38.

37. Statute, Article 12.

38. Statute, Articles 38-40.

39. *Id.* at Articles 40-41.

40. Regulations, Article 36.

41. Regulations, Article 39.

42. Regulations, Articles 73-76.

43. Regulations, Article 82.

44. Compare China's Regulations, Article 26 with Vietnam's Regulations, Article 83.

45. Compare China's statute, Article 10 and Regulations, Article with Vietnam's Regulations, Article 85.

46. China' Regulations Article 78 and Interim Procedures for the Handling of Loans by the Bank of China to Chinese-Foreign Joint Ventures, promulgated by the State Council, effective July 26, 1980.

47. Vietnam, Regulations, Article 84.

48. Regulations, Articles 69-72.

49. Regulations 69. The additional criteria is the satisfaction of any two of the following: (1) the prescribed capital of the enterprise is under U.S. 10 million; (2) the technology enhances technological standards and production efficiency, is not detrimental to safety and makes rational use of resources and manpower); (3) the enterprises exports at least

80% of the products or derives such percentage in foreign currency; (4) the level of profits is less than average profits from other equivalent projects; (5) the project is located in a less than favorable area of the country; and (6) the investment is made no later than 28 December 1997.

50. *Id.*

51. See Articles 71-72.

52. Regulations, Article 73.

53. Regulations, Articles 74-75.

54. Regulations, Article 100 as revised by the State Council on January 15, 1989.

55. Regulations, Article 44.

56. Regulations, Article 46.

57. Statute, Article 102 and Regulations, Articles 12-13.

58. See Article 47.

59. China's Regulations, Article 102 and Vietnam's Regulations, Article 47.

60. Regulations, Articles 100-108.

61. Regulations, Articles 51-53.

62. In China, see Regulations, Articles 109-112 and Statute, Article 14. In Vietnam, see Regulations, Article 53.

63. Article 4 of the Foreign Investment Law.

64. Law of the People's Republic of China on Foreign-Capital Enterprises, adopted at the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 39 of the President of the People's Republic of China, effective April 12, 1986. "Foreign" enterprises are established within China by foreign investors using their capital exclusively.

65. Regulations, Article 3.

66. Article 15 of Vietnam's Foreign Investment Law.

67. *Id.* at Articles 6-7.

68. *Id.* at Articles 8-19.

69. *Id.* at Articles 11-23.

70. Article 55 of the implementing regulations.

71. *Id.* at 57 of the Regulations.

72. Article 58 of the Regulations.

73. Article 59 of the Regulations.

74. Articles 60-62 of the Regulations.

75. 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, effective as of March 3, 1983.

76. Adopted at the Fourth Meeting of the Standing Committee of the Sixth National People's Congress and promulgated by Order No. 11 of the President of the People's Republic of China on March 12, 1984, effective April 1, 1985.

77. Adopted at the 15th Meeting of the Standing Committee of the Seventh National People's Congress on September 7, 1990 and promulgated by Order No. 31 of the President of the People's Republic of China on September 7, 1990, effective June 1, 1991.

78. Adopted at the Fourth Session of the Sixth National People's Congress and promulgated by Order No. 37 of the President of the People's Republic of China on April 12, 1986, effective January 1, 1987.

79. 5 December 1988

80. 4 March 1991

81. Issued in conjunction with Decree No. 201-HDBT dated 28 December 1988 of the Council of Ministers.

82. 28 January 1989.

83. 22 July 1989.

84. Trademark Law, Articles 2-4 and Trademark Regulations, Article 2.

85. Regulations, Articles 30-31.

86. Trademark statute, "Article 1."

87. Trademark Regulations, Articles 3-4.

88. Trademark statute, Article 6.

89. Trademark law, Articles 31-34 and Regulations, Articles 20-23.

90. Trademark statute, Articles 37-40 and Regulations, Articles 24-26.

91. Trademark statute, Articles 7-8 and Regulations, Article 8.

92. Trademark statute, Articles 9-10.

93. Trademark statue, Article 18, and Regulations, Articles 5-6.

94. Trademark statute, Articles 19, 22, 27-29 and Regulations, Article 11.

95. Trademark statute, Articles 24-26.

96. Trademark statute, Article 30. Compare U.S.C.A. section 1052.

97. Trademark statute, Articles 30-39. Article 127 of the Criminal Law which applies both to patent and trademark law violations, provides for up to a fixed-term imprisonment of not more than three years, criminal detention or a fine.

98. Arrete No. 175/TTG, 3 April 1958. For a brief historical introduction and discussion of the current status of intellectual property laws , see Sesto E. Vecchi and Michael J. Scown, "Vietnam: Intellectual Property Rights Protection," IP Asia, 27 July 1992, pgs. 2-9.

99. See Regulations for the Protection of Industrial Designs, No. 85/HDBT 13 May 1988; Ordinance on the Transfer of Foreign Technology into Vietnam, 5 December, 1988; Regulations governing Utility Solutions, No. 200/HDBT, 28 December 1988; Decree No. 201/HDBT 28 December 1988 on issuance of the Regulations on the Trading of Licensing of Patents Utility Solutions, Industrial Design, Trademark and Know-How; Ordinance on Industrial Protection, 28 January 1989; Decree No. 49/HDBT 4 March 1991 providing detailed stipulations on the Implementation of the Ordinance on the Transfer of Foreign Technology into Vietnam; Ordinance Protecting Industrial Property Rights, Order No. 13/LCT/HDNN, 11 February 1991, Arrete No. 84/HDBT, 20 March 1990 and Circular No. 3/NCPL, 22 July 1989; and Ordinance on the Quality of Goods, 1 July 1991.

100. See Vecchi, op. cit., p. 3.

101. No. 13 LCT/HDNN8, 11 February 1989. The discussion in the article arises out of the Ordinance on the Protection of Industrial Property Rights,issued by the State Council, 28 January 1989.

102. Article 1 of the Ordinance. All citations concerning protection of industrial property rights are to the Ordinance of 28 January 1989.

103. Article 4.

104. Article 4(5). Compare China's similar prohibition in its Patent Law, Articles 4-5.

105. Article 5.

106. Articles 9-10.

107. Article 11.

108. *Id.* at Article 13.

109. *Id.* at Article 14.

110. *Id.* at Articles 16-17.

111. Articles 9-12 of the Ordinance on the Protection of Industrial Property Rights.

112. *Id.* at Article 12.

113. Patent statute, Articles 4-5. An "invention" is any new technical solution relating to a product or a process or the improvement thereof. A "utility model" refers to any new technical solution relating to the shape or structure or combination thereof of a product fit for practical use. An "industrial design" is "any new design of the shape, pattern or color or their combination, of a product that creates an aesthetic feeling and is fit for industrial application." Rules for the Implementation of the Patent Law of the People's Republic of China, approved by the State Council and promulgated by the Patent Office of the P.R.C. on January 19, 1985. Compare U.S. Patent Act, Section 101: "Whoever invents or discovers any new or useful process, machine, manufacture..."

114. Patent statute, Articles 6-8.

115. Patent law, Article 9., Article 5 of the Regulations provides that the postmark date will be the filing date if sent within China or if not legible, the date of receipt by the Patent Office will apply unless the applicant can prove an earlier date. Compare, U.S.C.A., Section 101. The patentee must be the original inventor of the object which was not previously known or discovered. Bockman Instruments v. Chemtronics Inc., C.A. Tel. 1979, 439 F. 2d 1369, on remand 328 F. Supp. 1132.

116. Patent statute, Article 10. Compare U.S.C.A., section 261.

117. Patent statute, Article 22.

118. 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, effective June 1, 1991.

119. *Id.* Article 3. Compare U.S. Copyright Law, 17 U.S.C.A. Sec. 102(a).

120. Statute, Article 4.

121. See Zheng Chengsi and Michael Pendleton, Copyright Law in China (North Ryde, Australia: CCH International, 1991) p.2.

122. Statute, Article 10.

123. *Id.* at Article 11.

124. *Id.* at Articles 21-22.

125. *Id.* at Article 22.

126. *Id.* at Articles 23-24.

127. *Id.* at Articles 45-50. Compare 17 U.S.C.A. Sec. 502(a).

DON'T SLIP UNDER THE APPLE TREE...
BECAUSE "PICK-YOUR-OWN" FARMERS WILL HAVE NO LIABILITY!

by

Dr. Sharlene A. McEvoy*

ABSTRACT

In recent years, there have been efforts by various interest groups to lobby legislatures in an effort to limit liability. Among the groups that have successfully petitioned legislators for such relief are the skiing, horseback riding and white water rafting industries. This article examines a unique law passed by the Massachusetts state legislature to protect "pick your own" farming operations. It is the premise of this article that the passage of such laws is part of an increasing trend to limit the ability of injured parties to recover for their injuries.

Introduction

In August, 1994, Governor William F. Weld signed into law a bill that had been passed by the Massachusetts State legislature to exonerate owners, operators and employees of "pick your own" farmers from liability to those injured on their premises.[1] This first-in-the-nation law provides blanket protection for these agricultural operations but limits the ability of visitors to such farms to recover in the event of injury. It is the premise of this paper that such a law is unnecessary in that it provides overbroad protection for farms in the Commonwealth.

The Legislation

The law added a section to an existing statute, MGLA, Chapter 128, (Agriculture) limiting the extent to which owners and operators of "pick your own" farms could be held liable for injuries to persons who enter the property. The upshot of the law is that a farmer who allows a person to "conduct agricultural harvesting" which includes cutting Christmas trees, would not be held liable for the injury, death, or damage to property which results from the harvesting activity. The only circumstances under which the former could be held liable is if he or she engages in willful, wanton or reckless conduct.[2]

The law requires the farmer to put a sign on the premises in black letters at least one-inch high which states:

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WARNING

Under section 2E of Chapter 128 of General Laws:

"The owner, operator, or any employee of this farm shall not be liable for injury or death of persons or damages to property, resulting out of the conduct of this "pick your own" harvesting activity in the absence of willful, wanton or reckless conduct."[3]

The law was introduced into the state legislature in 1993 but died. In 1994, the bill passed easily, aided by the Massachusetts Farm Bureau Federation, Inc. which made the bill one of its "top legislative priorities."

The Arguments in Favor of the Legislation

The Massachusetts Farm Bureau Federation, Inc. offered a position paper in support of S.929. Noting that the "pick your own" operations are a "unique blend of education, recreation and marketing,"[4] the group stated that orchards, vegetable and small fruit farms, and Christmas tree growers allow consumers and tourists to come to their farms to harvest the crop themselves and then buy what they pick.

Among the activities in which the amateur harvesters engage are climbing ladders, carrying large bags filled with produce such as apples, or cutting and dragging Christmas trees.[5] Under the law, any injury sustained in connection with such activities would be the responsibility of the harvester.

The Farm Bureau, the lobbying group for the seventy-five "pick your own" operations in the Commonwealth, conceded that such enterprises are a "growing form of farm marketing in the Northeast because of labor costs,"[6] as well as a public relations and educational device.

The Farm Bureau cautioned that the "liability exposure" makes such operations "increasingly prohibitive," warning lawmakers that the farmers who opened their acreage to visitors might lose their farms because of litigation. The Farm Bureau advised legislators that passage of the law would give farmers a valuable tool to protect their assets and to minimize their "exposure to claims."[7]

While the Farm Bureau could cite no similar law in effect in other states, it analogized S.929 to another law in the Commonwealth and other states which involves equine liability[8] as well as a law in Massachusetts which limits the liability of property owners who allow recreational users to enter their property without charge. The Farm Bureau noted that in the "pick your own" situation the harvester does not pay to participate but buys only the product harvested.[9]

In its statement on behalf of the legislation, the Farm Bureau labeled it a "pro-consumer" bill because it requires a posted warning. It also argued that the bill did not interfere with legitimate claims in negligence. For example, farmers still owe a duty of care to keep the premises free from hazards that might foreseeably cause injury to visitors such as an open pit into which they might fall or for providing pickers with ladders with loose or missing rungs. Finally, the Farm Bureau argued that passage of the bill "would enhance agricultural, marketing, educational, recreational tourism and open space protection in Massachusetts."[10]

This "mom and apple pie" attitude is a typical approach to legislation of this kind, promising great benefits if the bill is passed and dire consequences if it fails. This argument is similar to those used by the skiing, equine (stable owners) and white water rafting industries when they proposed legislation in other states to limit their liability due to the inherent risks of those recreational activities.

However, not one of the seventy-five "pick your own" operations has closed due to a lawsuit as Douglas Gillespie, Director of Government Relations for the Massachusetts Farm Bureau Federation, conceded.[11]

While there were a few lawsuits brought against growers which prompted the push for the law, the cases were relatively insignificant. One farmer was sued twice in 1982 by a woman who broke a hip when she fell off a ladder and by a man who fell and injured his back. The total damages recovered were $50,000. Another farmer paid more than $20,000 in 1991 to a man who tripped over an apple. In another minor incident, a farmer received a letter from a woman claiming that her son suffered from a case of poison ivy as a result of a visit to his orchard. To stave off a possible lawsuit, the farmer paid $50.00 to cover the boy's medical expenses.[12] According to Farm Family Mutual Insurance Company, there is a claim pending for $100,000 brought by a man who claimed to have sprained his back picking up a pumpkin.[13] This brief list hardly indicates a flood of lawsuits especially when one considers the large numbers of people who have come to these farms over the years and harvested produce for which farmers were paid.

The farmers also claimed that their liability insurance premiums have risen as much as 20% in the past five years but such an experience is little different from that of other providers of recreational activities. The Farm Bureau Federation says that a farmer who paid $200.00 a year in liability premium is now paying $350.00 or more.[14] Yet some farmers admit that they could not survive without the profits from a "pick your own" operation. One conceded that as a result of his "pick your own" farm, he has the money to pay laborers to pick apples on his other properties.[15]

Arguments Against the Legislation

The passage of this law by the Massachusetts State Legislature is a blunderbuss approach to a relatively minor problem. As the facts indicate, there have been few major lawsuits, just some relatively minor claims. No farmer has been forced into bankruptcy or has lost a farm as a result of a lawsuit. That insurance premiums have risen is more a

function of the insurance industry's anticipation of claims which have not materialized, rather than reflection of a large number of suits.

In the claims that did occur, breaking a hip in a fall off a ladder is a serious injury to suffer as a result of undertaking an activity that should be relatively safe. Would it be unreasonable to expect an employee of the farm to hold the ladder for an inexperienced climber or to provide directions for proper placement of the ladder? Certainly the "civilians" who participate in these activities are not experienced in climbing or cutting, and the farmers should be aware that the individuals do not have the agility of experienced pickers. As one farmer admitted, "People come out of the city, they just don't know what they're doing."[16]

Since the farmers know that the "amateur harvesters" do not know what they are doing, farmers or their designated employees should offer an "orientation" lecture to tourists before they harvest about the possible dangers inherent in climbing and picking. Farmers could also require harvesters to sign a waiver which informs them of the potential hazards and notifies them that they assume the risks inherent in produce-gathering activities. These activities should be listed in the document. Harvesters could be also required to pay a nominal "picking fee" in addition to paying for what they gather. The picking fee could be used by farmers to pay any increased insurance costs.

Under this law,[17] a business invitee (the harvester) is relegated to the position of trespasser, owed the lowest duty of care. As a result, any harvester injured by machinery or equipment owned by the farmer, would not be compensated unless the injured party could show willful, wanton or reckless conduct which would be extremely difficult to prove.[18] In fact, this law is so broadly written that gross negligence on the part of the farmer is covered. In his letter to Governor Weld urging a veto, a representative of the Massachusetts Academy of Trial Attorneys, Edward J. Smith, compared S.929 to the duty of ordinary care owed to child trespassers under another Massachusetts law.[19] Smith argued that under the "pick your own" statute, it is unclear what the farmer's duty would be to a minor child, if the farm has an attractive nuisance on the premises. Thus the "pick your own" law is in no way comparable to the equine liability law in place in Massachusetts and elsewhere which does not exonerate the stable owner from liability for negligence.[20]

This law requires a person injured on the premises of a "pick your own" operation to show willful, wanton or reckless conduct. This places an extremely difficult burden on a potential claimant and will shield the farmers from most claims. This is the reason why the Farm Bureau Federation lobbied so vigorously in favor of the law.

Conclusion

One "pick-your-own" operator acknowledged that people want the experience of seeing where their food comes from. These operators also know that in the appropriate season, their orchards and tree farms are meccas for senior citizen groups and families with children who reside in cities and suburbs who are not familiar with the potential hazards of a farm. These "pick your own" operators advertise their farms to attract people to their premises and charge for the produce they pick but will not now be held responsible for injuries sustained during the process of the harvest. Very few businesses are afforded this kind of protection by state statutes where they can invite customers to their premises in search of a profitable transaction and then not be held liable if the patron sustains an injury. The businesses that have heretofore received such protection are those in which the patron might reasonably expect some injury because of risks inherent in the activity like skiing, horseback riding and white water rafting. Yet even these operations almost uniformly require participants to sign an exculpatory agreement which details the risks of participation.

In its successful lobbying effort to secure passage of this law, the Massachusetts Farm Bureau Federation stated that the "pick your own" operations serve as a wonderful public relations and educational tool.[21] Farmers' public relations may not be enhanced when tourists are greeted by a sign disclaiming liability on the premises. Pickers must now understand that they cannot sue for injuries sustained as a result of agricultural harvesting if such injuries are inherent dangers in the activity. Visitors to a "pick your own" operation are not on a par with white water rafters, skiers or horseback riders and do not expect air bags to be placed under trees from which they will pick fruit. But in their lust for risk taking, they do have a right to expect clear information about potential risks, safe equipment and a degree of responsible supervision while on the premises.

ENDNOTES

1. Bill Summary, S. 929, An Act Relative to the Preservation of Farms in the Commonwealth, Courtesy, Elizabeth J. Moroney, Committee on Natural Resources and Agriculture, House of Representatives, Commonwealth of Massachusetts, January 9, 1995.

2. *Id.*

3. MGLA, Ch. 128, Sec. 2E (1994).

4. Douglas P. Gillespie, Position Statement, on S. 929, An Act Relative to the Preservation of Farms in the Commonwealth, Massachusetts Farm Bureau Federation, Inc. (hereinafter Farm Bureau Position Statement).

5. *Id.*

6. *Id.*

7. *Id.*

8. Like many other states Massachusetts has passed a law limiting the liability of stable owners for riding accidents. Connecticut's law P.A. 93-286 says:

    > Each person engaged in recreational equestrian activities shall assume the risk and legal responsibility for any injury to his person or property arising out of the hazards inherent in equestrian sports, unless the injury was proximately caused by the negligence of the person providing the horse or horses to the individual engaged in recreational equestrian activities or the failure to guard or warn against a dangerous condition, use structure or activity by the person providing the horse or horses to his agents or employees.

9. Farm Bureau Position Statement.

10. *Id.*

11. Tom Moroney, "Wary Apple Growers Get Picky," *Boston Sunday Globe*, October 2, 1994 at 36.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. In key part, An Act Limiting the Liability of Certain Farming Operations says:

    > No owner, operator or employee of a farm who allows any person to enter said farm for the purpose of agriculture harvesting, including the cutting of Christmas trees under a so-called "pick-your-own" agreement shall be liable for injuries or death to persons or damage to property resulting from the conduct of such operation in the absence of willful, wanton or reckless conduct on the part of said owner, operator or employee.

18. Letter of Edward J. Smith, Massachusetts Academy of Trial Attorneys to Governor William F. Weld, Aug. 9, 1994, at 1.

19. C. 231, Sec. 85Q.

20. G.L., C. 128, Sec. 2D.

21. Farm Bureau Position Statement.

SMOKE GETS IN YOUR EYES:
IS SECONDHAND SMOKE IN THE WORKPLACE A TORT?

by

Robert S. Wiener*

INTRODUCTION

Employees across the nation work many hours a week indoors where they are exposed to environmental hazards -- among these is secondhand smoke. Recent EPA research reports that long-term exposure to the smoke of others can cause serious disease.[1] Even in the short term, some susceptible people exhibit a wide range of physical reactions.[2]

What are the rights of nonsmokers who want to work in a smoke-free environment? What are the rights of smokers who want to smoke while they work? What are the responsibilities of employers who employ both smokers and nonsmokers?

Many local governments have passed legislation to restrict smoking in workplaces. These laws may sanction employers who do not enforce the rules. But this paper concentrates on civil tort suits filed by individuals[3] against businesses or other individuals for smoking in a workplace.

What tort theories are available to these plaintiffs? What difficulties will they encounter in pursuing their cases? What defenses are available to defendants? What remedies may result from a judgment in favor of the plaintiff? Does the law make sense? What are the public policy considerations involved? Should a smoker have to stop smoking? Should a nonsmoker have to leave? Does the actual or potential injury to the nonsmoker matter? Is it enough if tobacco smoke is noxious to a nonsmoker? Is the test objective or subjective? What ramifications do these answers have for control of other atmospheric chemicals?

Agency issues arise when a company is sued for the actions of its employees. Under the principle of respondeat superior, a principal is legally responsible for the intentional actions of its agents authorized within the scope of employment. Is smoking on the job sucb an action? Is the employer liable for the recreational smoking of its employees?

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I. THE CASES

This paper focuses on four reported cases brought by nonsmokers based on secondhand smoke in the workplace.

1. The first case concerns events that transpired at a WLW radio show in Cincinnati, Ohio. It was the day of the Great American Smokeout, a national promotion to encourage smokers to quit smoking. Ahron Leichtman, who claimed to be "a nationally known"[4] opponent of smoking, was invited to discuss the ill effects of primary and secondary smoke on Bill Cunningham's radio talk show. During the show, Cunningham incited Furman, host of another WLW radio talk show, to repeatedly blow cigar smoke in Leichtman's face. Furman complied. Leichtman sued WLW Jacor Communications, Inc., William Cunningham, and Andy Furman.[5] On 23 January 1994, the Ohio Court of Appeals denied Leichtman's claims based on a tortious invasion of his privacy[6] and negligence,[7] but remanded the case for determination on the issue of battery.[8]

2. Pamela S. Pechan worked as an office manager for Dynapro, Inc. in Oak Brook, Illinois. As a result of her passive inhalation of cigarette smoke, Pechan required "injections, medication and an inhaler because of coughing, wheezing, difficulty breathing and sleeping, swelling sinuses, dripping sinuses, swelled face and eyes, hives, throat irritation and dryness, light-headedness, dizziness, watery eyes, burning nose, headaches and stress manifested by a spastic colon."[9] According to the complaint, although Dynapro had a stated nonsmoking policy and was given documented notification of Pechan's problems, it did not enforce its policy through either prohibition or restriction of smoking. Pecan claims that she was forced to resign. The Illinois Court of Appeals affirmed in its 19 October 1993 opinion the trial court's summary dismissal of Pecan's claims of battery and negligence.[10]

3. Bonnie Richardson worked for several years as a receptionist for First Federal Savings & Loan Association of Valdosta, Inc.[11] J.R. Hennly, Jr., an administrative officer, smoked a pipe. Although Richardson worked in the lobby, about 30 feet from Hennly's office, she medically documented allergic reactions to his pipe smoke that caused "nausea, stomach pain, loss of appetite, loss of weight, headaches, and anxiety."[12] Despite the company's purchase and use of air cleaners, Richardson continued to have adverse reactions resulting in two hospitalizations. In the end, Richardson was discharged, allegedly primarily for excessive absenteeism. The Georgia Court of Appeals decided on 15 July 1993 in favor of Richardson's right to a trial as her claims of battery and intentional infliction of emotional distress.

4. A fourth case well worth considering, if only to see how the law on secondhand smoke may have changed since 1979, is William T. McCracken v. O.B. Sloan.[13] McCracken, a Charlotte, North Carolina postal employee, complained of smoke in the post office building. He asked for sick leave due to his allergic reaction to cigarette smoke. At two meetings with postmaster O.B. Sloan to discuss his request, Sloan smoked a cigar.

McCracken sued Sloan.[14] McCracken lost because the court rejected what it saw as his assertion of a right to a "glass cage."

II. TORTS

In these cases, the plaintiff sued on the basis of a variety of common law tort theories.

A. INTENTIONAL

All plaintiffs argued that the defendants had committed intentional torts.

1. Battery

In each case, the nonsmoker claimed that the smoker had committed a battery with secondhand smoke. A battery is an intentional tort.[15] As with all torts, a plaintiff who proves that the defendant has acted in a tortious manner proximately causing actionable injury to the plaintiff is entitled to a remedy. This is because, as Roscoe Pound wrote, "In civilized society men must be able to assume that others will do them no intentional injury --- that others will commit no intentioned aggressions upon them."[16]

a. Act: The act required to prove a battery is sometimes described as an "intentional, offensive touching."[17] Offensive contact may be described as that which is "offensive to a reasonable sense of personal dignity."[18] The Ohio Supreme Court has defined "offensive" to mean "disagreeable or nauseating or painful because of outrage to taste and sensibilities or affronting insultingness."[19] The act requirement is not satisfied if the touching is consented to or authorized. The concept of implied consent to secondhand smoke is discussed below under the "Glass Cage" Defense. Contact satisfying the battery test includes far more than the contact of a fist. A bat or bullet will also do. But can one commit a battery with tobacco smoke? A battery includes "the precipitation[20] upon the body of a person of any material substance."[21] And courts have decided that tobacco smoke is "particulate matter."[22] "Pipe smoke is visible; it is detectable through the senses and may be ingested or inhaled. It is capable of "touching" or making contact with one's person in a number of ways."[23] So the answer is generally yes.[24] However, the Illinois court in Pechan did seem to question the intentional act aspect of smoking. "[T]he act of smoking generally is not done with the intent of touching others with emitted smoke."[25]

In the Leichtman case, Andy Furman committed a battery by intentionally blowing cigar smoke in Leichtman's face.[26] The Richardson court decided that if Hennly, "knowing it would cause her [Richardson] to suffer an injurious reaction, intentionally and deliberately directed his pipe smoke at her in order to injure her or with conscious disregard of the knowledge that it would do so," that would constitute a battery.[27]

Can one be liable for a battery if the actnal smoke blowing was committed by another person? As with other batteries, encouraging another to commit a battery is a tortious act.[28] Therefore, in the Leichtman case, William Cunningham's urging that Andy Furman blow cigar smoke in Ahron Leichtman's face was, in itself, a battery when Furman

repeatedly did so.[29] And Richardson's suit against First Federal was sent to trial even though Federal's employee, Hennly, smoked only in an enclosed office and First Federal had installed air cleaners.[30]

Pechan also sued her employer for battery because "smoke did contact and enter into and upon"[31] her body without her consent. Furthermore, Dynapro permitted its employees to "intentionally emit cigarette smoke into the office atmosphere" even though it knew of Pechan's sensitivities. Dynapro argued that smoking is a lawful act and does not rise to the level of a battery.[32] Although the Illinois court agreed that the plaintiff's battery theory might prevail,[33] it decided against her based on the facts of the case.

h. Proximate Cause: In battery cases, as with all other torts, the plaintiff must prove that the defendant's act was a proximate cause of its injury, that is, the act was an actual cause of the injury and the injury was reasonahly foreseeahle. It has been argued that with a "smoker battery," if exhaled smoke is substantially certain to contact a nonsmoker, the smoker is liable.[34] However, this argument was rejected by the Leichtman court.[35] And it was not alleged by Pechan "that reasonable persons should have known that their smoke would have contacted Pechan in sufficient quantity to reasonably cause the damages claimed."[36] An interesting question is whether the reasonable foreseeability of harm from secondhand smoke increases as information on the danger of tobacco smoke grows and is widely disseminated.

c. Injury: As long as a tortious battery by the defendant proximately causes injury to the plaintiff, the plaintiff is entitled to a remedy. Even if the injury is trivial, the plaintiff will prevail; however, recovery may be limited to nominal damages of a single dollar.[37]

In the Leichtman case, the court decided that having smoke blown in one's face was injurious, even if trivial.[38] In the Richardson and Pechan cases, the plaintiffs had heightened sensitivities to tobacco smoke and, therefore, significant medical injuries. There was also a sensitive plaintiff in the McCracken case, but the court could "find no evidence that the plaintiff suffered any physical illness from inhaling the cigar smoke."[39]

Injury to ordinary people from mere passive smoke inhalation is not addressed in these cases. Is an increased risk of lung cancer or even the fear of cancer from exposure to secondhand smoke an actionable injury?

2. Infliction of Emotional Distress

Even in the absence of physical illness, nonsmokers may bring tbe intentional tort cause of action of infliction of emotional distress. According to modern common law, if extreme or outrageous intentional conduct by the defendant causes emotional harm, the plaintiff need not show physical injury.[40]

This issue of law was presented to the trial court in the Richardson case. Was Hennly's conduct sufficiently extreme or outrageous as to result in liability for physical injury? Elements to be considered include the defendant's control over the plaintiff, the defendant's awareness of the plaintiff's susceptibility, and the severity of harm suffered by the plaintiff. The Richardson appellate court decided that all of these elements existed. The sole question that remained, the intentionality of Hennly's actions, was for the jury to decide.[41]

Although McCracken filed no complaint based on infliction of emotional distress, the court in his case observed "That person did experience some mental distress as a result of inhaling the cigar smoke."[42] Based on my reading of the opinion, this court would not have seen the postmaster's smoking as either extreme or outrageous conduct, although it was, beyond a doubt, intentional.

3. Invasion of Privacy

Does intentionally blowing tobacco smoke into someone's face constitute the tort of invasion of privacy? The intentional tort of invasion of privacy comprises four separate torts.[43] The only possibly appropriate one here is intrusion on a party's solitude, seclusion, habitation, or affairs that would be highly offensive to a reasonable person.[44]

This claim was raised by Leichtman, but rejected by the court because he "willingly entered the WLW radio studio to make a public radio appearance with Cunningham who is known for his blowtorch rhetoric."[45] Although the result was probably correct in this case, consider whether privacy rights extend outside one's own home and their relevance to secondhand smoke cases.[46]

4. Assault

Assault would be another possible tort claim for violation of one's "interest in freedom from apprehension of a harmful or offensive contact with the person."[47] However, none of the three most recent cases contains a cause of action based on assault.

In William T. McCracken v. O.B. Sloan,[48] Sloan said at least once, "Bill, I know you claim to have an allergy to tobacco smoke and you have presented statements from your doctor stating this, but there is no law against smoking, so I'm going to smoke."[49] This seems to meet the criteria for an assault, but, because there was no evidence of physical harm, the North Carolina Court of Appeals decided that there was no actionable assault.

B. NEGLIGENCE

Injured nonsmokers may also argue the tort of negligence, that is, a breach of a duty of due care.

1. Common Law Negligence

Under common law negligence, the plaintiff would have to prove that a common law duty of due care existed for the defendant to keep the plaintiffs air smoke free and that the duty was breached.

Pechan argued that Dynapro had created a duty of care through its own smoking policy and that it breached that duty through its failure to enforce the policy.[50]

2. Negligence Per Se

Under a theory of negligence per se, the plaintiff's claim is that a statute established the defendant's duty to the plaintiff. For example, a nonsmoker might argue that a health regulation created a duty to provide a smoke-free environment. In the Leichtman case, a Cincinnati Board of Health Regulation[51] made it illegal to smoke in certain public places, but the court determined that the sanctions provided by the statute did not create a common law cause of action for negligence per se.[52]

Pechan argued that Dynapro was statutorily negligent due to its violation of the Illinois Clean Indoor Air Act, but the court decided her case on other grounds.[53]

C. STRICT LIABILITY

Employers may be strictly liable for the tortious acts of their employees under the theory of respondeat superior. However, even if the tort is intentional, the employer will not be liable unless the act is committed within the employee's scope of employment. This is a question of fact usually answered at trial. A number of earlier cases decided that employers were liable for harm done as a result of the smoking of their employees.[54]

The appellate court in Leichtman left it to the trial court to decide if WLW Radio's owner was liable for the tortious acts of its employees. Is blowing cigar smoke into a guest's face within the scope of a radio host's employment? Here the court answered yes.[55]

III. DEFENSES

Aside from the argument that the plaintiff has not proved its case by a preponderance of the evidence, defendants in secondhand smoke cases have offered the following defenses.

A. WORKERS' COMPENSATION

Workers' Compensation Acts typically provide that recovery under the Act is an employee's sole remedy for compensable injuries.[56] Therefore, if an employee is entitled to recover under a Workers' Compensation Act, the employer is protected from a private tort action.

This is may well be a significant reason why employees such as McCracken do not file suits against their employers.[57] The Pechan court decided that her claims based on negligence were compensable under the Workers' Compensation Act and, therefore, she was barred from recovery from her employer.[58]

However, Workers' Compensation does not protect employees who smoke from suits by fellow employees. In the Richardson case, the court rejected the argument by J.R. Hennly, Jr., a fellow employee, that Workers' Compensation defended him against a nonsmoker suit.[59]

B. ASSUMPTION OF RISK

The defendant may argue assumption of risk, that is, that the plaintiff knowingly and voluntary assumed the risk of secondhand smoke. For example, a nonsmoker who is aware of the risk of contact with tobacco smoke, but never complains about exposure has assumed that risk. However, in the cases studied, the plaintiffs did complain. Even though Leichtman may have "willingly entered the WLW radio studio," he did not willingly submit himself to tobacco smoke.[60] Moreover, defendants who become aware only now of the risks associated with secondhand smoke, may not be said to have assumed that risk in the past.

C. THE "GLASS CAGE" DEFENSE

Public policy ramifications of secondhand smoke cases were raised in the 1979 McCracken v. Sloan case.[61] There, the North Carolina Court of Appeals advanced a concept of implied consent to secondhand smoke. [I]n a crowded world, a certain amount of personal contact is inevitable and must be accepted. Consent is assumed to all those ordinary contacts which are customary and reasonably necessary to the common intercourse of life. Smelling smoke from a cigar being smoked by a person in his own office would ordinarily be considered such an innocuous and generally permitted contact.... [I]t may be questioned whether any individual can be permitted, by his own fiat, to erect a glass cage around himself, and to announce that all physical contact with his person is at the expense of liability.[62]

The date of the McCracken case should be noted. Fifteen years ago, the data supporting the harmfulness of secondhand smoke were not well-developed. In fact, that court observed, "We express no opinion as to what the result would be if there were evidence of some physical injury..."[63] But even if there is an allergic reaction, do we want our society to protect us from all injury caused by others, even by their perfume of choice?

The Leichtman court did not apply the "glass cage" defense to Andy Furman because the deliberate blowing of smoke into someone's face is not passive smoke.[64] The McCracken case was cited with approval by the Pechan court.[65]

IV. REMEDIES

In addition to legal remedies such as compensatory and punitive damages, equitable remedies may be appropriate in secondhand smoke cases. If smoke is harming a plaintiff, preliminary and permanent injunctive relief against smoking may be sought; however, if the plaintiff is no longer employed by the defendant, that particular issue is moot.[66] The same may be true of reinstatement because the plaintiff may not wish to return to an unwelcome environment.[67]

V. NON-TORT CLAIMS

Note that certain nonsmokers may have legal recourse based on statutory protection.

A. WORKER'S COMPENSATION

Nonsmoking employees who are harmed by secondhand smoke may file workers' compensation claims. However, these may be rejected if the employer has a defense valid under the applicable Workers' Compensation Act.[68]

B. HANDICAPPED CODES

Legislation to protect the handicapped may protect those with special sensitivity to tobacco smoke. The Georgia Equal Employment for the Handicapped Code (GEEHC)[69] protects the handicapped from discrimination in the workplace. "Handicapped individual" means "any person who has a physical or mental impairment which substantially limits one or more of such person's major life activities, and who has a record of such impairment."[70] Because Richardson's sensitivity to tobacco smoke resulted in problems on the job and, ultimately, in the loss of her job with First Federal, the appellate court could not decide, as a matter of law, that she was not a "handicapped individual."[71]

VI. PUBLIC POLICY

The judges in several cases expressed significant reservations about the appropriateness of dealing with secondhand smoke cases in the courts.

The three appellate judges in the Leichtman case wrote in a per curiam decision, Arguably, trivial cases are responsible for an avalanche of lawsuits in the courts. They delay cases that are important to individuals and corporations and that involve important social issues. The result is justice denied to litigants and their counsel who must wait for their day in court.... This case emphasizes the need for some form of alternative dispute resolution operating totally outside the court system as a means to provide an attentive ear to the parties and a resolution of disputes in a nominal case. Some need a forum in which they can express corrosive contempt for another without dragging their antagonist through the expense inherent in a lawsuit.[72]

It is hard to disagree with the plea for alternative means of dispute resolution, but the more interesting questions is that of the role of law in society discussed in the McCracken case. Surely, unpleasant contacts are an unavoidable part of life to all but hermits in our crowded world. Is secondhand smoke, at least for most, simply a trivial additional cost of living to be added to many others? Or should we deal with this matter differently because this risk is avoidable, if only people would stop smoking, at least around nonsmokers?

CONCLUSION

One might think, with the emergence of anti-smoking legislation, that courts will no longer see suits by nonsmokers based on smoking in the workplace. A reduction of smoke would reduce smoke-caused injuries. However, unless smoking bans are enforced, people will continue to smoke at work. The habit is a hard one to break, even if the smoker wants to.

Nonsmokers often do not complain of smoke and are even less likely to bring a lawsuit. Some may not mind the smoke, but even if they do, they consider the career risks from complaining about it, especially if the smoker is their superior. And the extremely limited protection given to whistle blowers in most states gives little legal incentive to act. On the other hand, if evidence grows about the harm of secondhand smoke, nonsmokers may become more assertive in their quest for cleaner air. And with increasing legislation and suits sucb as the ones discussed in this article, they may take their cases to court.

ENDNOTES

[1] United States Environmental Protection Agency, *Respiratory Health Effects of Passive Smoking: Lung Cancer and Other Disorders* (1992). The Environmental Protection Administration, in a pamphlet released on 21 July 1993, estimated that passive smoke inhalation is responsible for 150,000 to 300,000 cases of
pneumonia and bronchitis annually in children under 18 months of age. The EPA also estimated that secondhand smoke is reponsible for the death of 3,000 nonsmokers from lung cancer each year. Melissa Healy, *Don't Smoke at Home, EPA Urges Parents*, LOS ANGELES TIMES, July 22, 1993, at 1.

[2] See Pechan and Richardson cases below.

[3] Class action suits would probably also be possible, but none have been reported thus far.

[4] Leichtman v. WLW Jacor Communications, Inc., 1994 Ohio App. LEXIS 198 (1994).

[5] *Id.*

[6] *Id.* at *9.

[7] *Id.*

[8] *Id.* at *11.

[9] *Pechan v. Dynapro*, 622 N.E.2d 108, 1993 Ill. App. LEXIS 1598, *2, 1980 Ill. Dec. 698, 8 BNA IER CAS 1793 (1993).

[10] *Id.* at *42.

[11] *Richardson v. Hennly*, 209 Ga. App. 868, 434 S.E.2d 772, 1993 Ga. App. LEXIS 1028, 63 Empl. Prac. Dec. (CCH) P42,628 (1993).

[12] *Id.*

[13] *McCracken v. O.B. Sloan*, 40 N.C. App. 214, 252 S.E.2d 250 (1979).

[14] Another case worth following is that of Andrea Pormier as reported on National Public Radio's news magazine program, All Things Considered, 24 January 1994.

[15] The definition of the intentional tort of battery is:
An actor is subject to liability to another for battery if (a) he acts intending to cause a harm or offensive contact with the person of the other ..., and (b) a harmful contact with the person of the other directly or indirectly results[; or] (c) an offensive contact with the person of the other directly or indirectly results. RESTATEMENT (SECOND) OF TORTS 25 (1965).

[16] ROSCOE POUND, AN INTRODUCTION TO THE PHILOSOPHY OF LAW 169 (1922 1st ed.).

[17] *Love v. Port Clinton*, 37 Ohio St.3d 98, 99, 524 N.E.2d 166, 167 (1988).

[18] *Id.*

[19] *State v. Phipps*, 58 Ohio St.2d 271, 274, 389 N.E.2d 1128, 1131 (1979).

[20] "[W]e construe the word "precipitation" ... as applying to any situation in which contact is made with another person by issuing or directing some substance at the other, rather than making direct bodily contact." Richardson v. Hennly, 209 Ga. App. 868, 870, 434 S.E.2d 772, 1993 Ga. App. LEXIS 1028, 63 Empl. Prac. Dec. (CCH) P42,628 (1993)

[21] *Hendricks v. Southern Bell Tel &c.* [sic] *Col.*, 193 Ga.App. 264, 265, 387 S.E.2d 593 (1989).

[22] R.C. 3704.01(B) and 5709.20(A); Ohio Adm. Code 3745-17.

[23] *Richardson v. Hennly*, 209 Ga. App. 868, 871, 434 S.E.2d 772, 1993 Ga. App. LEXIS 1028, 63 Empl. Prac. Dec. (CCH) P42,628 (1993).

[24] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *5 (1994).

[25] *Pechan v. Dynapro*, 622 N.E.2d 108, 1993 Ill. App. LEXIS 1598, 1980 Ill. Dec. 698, 8 BNA IER CAS 1793 (1993).

[26] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *5 (1994).

[27] *Richardson v. Hennly*, 209 Ga.App. 868, 870-71, 434 S.E.2d 772, 774-75 (1993).

[28] *Bell v. Miller*, 5 Ohio 250 (1831)

[29] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *7 (1994).

[30] *Richardson v. Hennly,* 209 Ga. App. 868, 872, 434 S.E.2d 772, 1993 Ga. App. LEXIS 1028, 63 Empl. Prac. Dec. (CCH) P42,628 (1993).

[31] *Pechan v. Dynapro*, 622 N.E.2d 108, 1993 Ill. App. LEXIS 1598, *5, 1980 Ill. Dec. 698, 8 BNA IER CAS 1793 (1993).

[32] *Id.* at *21.

[33] "[W]e are not holding that one can never be battered by second-hand smoke." Id. at *28.

[34] Ezra, *Smoker Battery: An Antidote to Second-Hand Smoke*, 63 S.Cal.L.Rev. 1061, 1090 (1990).

[35] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *6 (1994).

[36] *Pechan v. Dynapro,* 622 N.E.2d 108, 1993 Ill. App. LEXIS 1598, *28, 1980 Ill. Dec. 698, 8 BNA IER CAS 1793 (1993).

[37] *Lacey v. Laird,* 166 Ohio St. 12, 139 N.E.2d 25, paragraph two of the syllabus (1956).

[38] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198 (1994).

[39] *McCracken v. O.B. Sloan,* 40 N.C. App. 214, 217, 252 S.E.2d 250 (1979).

[40] *Richardson v. Hennly*, 209 Ga. App. 868, 871, 434 S.E.2d 772, 1993 Ga. App. LEXIS 1028, 63 Empl. Prac. Dec. (CCH) P42,628 (1993).

[41] *Id.* at 871-72.

[42] *McCracken v. O.B. Sloan,* 40 N.C. App. 214, 217, 252 S.E.2d 250 (1979).

[43] Prosser, *Privacy*, 48 Cal.L.Rev. 383 (1960).

[44] See RESTATEMENT (SECOND) OF TORTS 46.

[45] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *8-9 (1994).

[46] For example, smoking in a public lavatory.

[47] W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 10, at 43 (5th ed. 1984).

[48] 40 N.C. App. 214, 252 S.E.2d 250 (1979).

[49] *Id.* at 214.

[50] *Pechan v. Dynapro,* 622 N.E.2d 108, 1993 Ill. App. LEXIS 1598, *4, 1980 Ill. Dec. 698, 8 BNA IER CAS 1793 (1993).

[51] Cincinnati Bd. of Health Reg. No. 00083.

[52] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *9 (1994).

[53] 410 ILCS 80/1 et seq (West 1992).

[54] *Iandiorio v. Kriss & Senko Enterprises, Inc.*, 512 Pa. 392, 517 A.2d 530 (1986) (employee burned by match); *Puffin v. General Electric,* 132 Conn. 279, 43 A.2d 746 (1945) (employee's sweater caught fire from match).

[55] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *7-8 (1994).

[56] See OCGA (Official Code of Georgia Annotated) § 34-9-11 (1994), Title 34. Labor and Industrial Relations, Chapter 9. Workers' Compensation, Article 1.

[57] *McCracken v. O.B. Sloan,* 40 N.C. App. 214, 252 S.E.2d 250 (1979).

[58] *Id.*

[59] *Richardson v. Hennly*, 209 Ga. App. 868, 869-70, 434 S.E.2d 772, 1993 Ga. App. LEXIS 1028, 63 Empl. Prac. Dec. (CCH) P42,628 (1993).

[60] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *9 (1994).

[61] 40 N.C.App. 214, 217, 252 S.E.2d 250, 252 (1979).

[62] *McCracken v. O.B. Sloan,* 40 N.C. App. 214, 217, 252 S.E.2d 250 (1979).

[63] *McCracken v. O.B. Sloan,* 40 N.C. App. 214, 217, 252 S.E.2d 250 (1979).

[64] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *7 (1994).

[65] *Pechan v. Dynapro,* 622 N.E. 2d 108, 1993 Ill. App. LEXIS 1598, 1980 Ill. Dec. 698, 8 BNA IER CAS 1793 (1993).

[66] *Pechan v. Dynapro,* 622 N.E.2d 108, 1993 Ill. App. LEXIS 1598, *3, 1980 Ill. Dec. 698, 8 BNA IER CAS 1793 (1993).

[67] Pechan did not seek reinstatement. Id. at *10.

[68] Further research may reveal arbitrators who granted workers' compensation to employees who suffered allegic reactions from cigarette smoke, but compensation was denied in *Witte v. Department of Rehabilitative Services* (Mar. 19, 1991), 88 W.C. 44629.

[69] *Id.* § 34-6A-1 et seq.

[70] OCGA § 34-6A-2 (3).

[71] *Richardson v. Hennly*, 209 Ga. App. 868, 872, 434 S.E.2d 772, 1993 Ga. App. LEXIS 1028, 63 Empl. Prac. Dec. (CCH) P42,628 (1993).

[72] *Leichtman v. WLW Jacor Communications, Inc.*, 1994 Ohio App. LEXIS 198, *9-10 (1994).

THE AMERICANS WITH DISABILITIES ACT AND LOCAL NONPROFIT ORGANIZATIONS: CAN COMPLIANCE HURT THOSE WHO WERE SUPPOSED TO BE HELPED

by

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Preface

The Americans with Disabilities Act of 1990[1], which became effective in July, 1992, was enacted with the Congressional finding that "some 43,000,000 Americans have one or more physical or mental disabilities" and that an aging population was likely to produce an increasing number of citizens with such handicaps.[2] The 15.5 percent of the potential American workforce which is disabled has approximately a 60 percent unemployment rate.[3] With numbers of that magnitude, protective legislation was obviously required.

The Vocational Rehabilitation Act of 1973[4] preceded the Americans with Disabilities Act. Provisions of that statute prohibit federal agencies[5], contractors having contracts of $2,500 or more with the federal government[6] and recipients of federal financial assistance[7] from engaging in any form of employment discrimination based upon disability.

It requires no authority to state that the clear purpose of these statutes is to benefit those with disabilities. They both attempt to protect the disabled from avoidable employment barriers caused by their disability. It is the thesis of this paper that the effect may occasionally be otherwise. Compliance with the Americans with Disabilities Act[8], in particular, may result in organizations with the same avowed purpose of helping those with disabilities, and others in need, being hindered in their activities. That effect can occur even though hindsight may reveal that the steps that had to be taken to be in compliance were not especially costly. The perception of the cost and complexity of compliance may well divert energy and other resources from the goal of providing service. It would be tragic, not merely ironic, if that occurred.

We will focus on several smaller community based charities which provide services to those with various illnesses or conditions which have been defined as disabilities under the ADA.[9] The value of these organizations to the community at large and the fact that these organizations provide services which would otherwise have to be supplied by the federal and state governments is evidenced by the practice of exempting "many nonprofits...from the levies that finance government, primarily income, sales, and *ad*

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valorem taxes."[10] In a time of shrinking government involvement and funding, these service agencies frequently are the only lifeline available to those in need.

The Inclusive Nature of the Statute

While the Vocational Rehabilitation Act of 1973 applied only to those organizations receiving federal funding, the ADA has a much wider reach since it applies to all employers who have "15 or more employees for each working day in each of 20 or more calendar weeks in the current or preceding calendar year."[11] The ADA makes no exceptions for nonprofit[12] organizations. The only employers to whom the Americans with Disabilities Act does not apply are the United States, a federally owned corporation, an Indian Tribe or a private membership club.[13]

Testifying before the House Education and Labor Subcommittee on Select Education, which was considering the ADA, Steve Beebe (representing the American Health Care Association) sought an exemption from the Act for nonprofit medical facilities.[14] He argued that the inability of such organizations to raise "prices" to recoup the costs of compliance with the ADA and the large number of disabled persons served mandated such special treatment.[15] The details of his proposals need not be considered since none made their way into the statute nor was any exemption granted nonprofit entities. The only provision of the ADA which may ameliorate the most egregious effects is that which permits an application for relief from compliance based upon undue hardship.[16] The effectiveness of that section will have to be shown over time.

Perhaps the Committee was persuaded by the testimony of Nikki Van Hightower, the former director of a nonprofit social service center who told the Committee that her experience was that the cost of adding accommodations for the disabled, during a renovation, was not more than 1 percent of the total construction.[17] The experiences and expectations of others will be discussed later.

Accommodations Required by the Americans with Disabilities Act

The statute requires that employers covered by the statute must make "reasonable accommodations for those with disabilities."[18] Examples of necessary changes which must be made for an employer to be in compliance with the ADA include "making existing facilities used by employees readily accessible to and usable by individuals with disabilities"[19] and providing for "job restructuring, part-time or modified work schedules, reassignment to a vacant position, acquisition or modification of equipment or devices, appropriate adjustment or modifications of examinations, training materials or policies, the provision of qualified readers or interpreters, and other similar accommodations for individuals with disabilities."[20]

What is not specified are any parameters or limits as to the extent or the expense of the required accommodations. The word "reasonable" has only just begun to be tested and until a significant body of case law develops, owners, managers and operators will continue to operate in something of a vacuum as to their actual or potential liability.

The Concerns of Local Nonprofit Organizations

As a statute which has only recently become applicable to small organizations,[21] there are many uncertainties as to the effect it may have on those entities. The perception, expressed by the Small Business Legislative Council, is that "[m]ost small-business owners are very nervous about this law. There's a real sense of apprehension out there."[22] In particular, nonprofit, social service organizations are fearful as to the effect compliance may have on their operations or even their very survival. In an era of decreasing government and corporate support, these institutions are concerned that even the most modest expenditures they may have to incur will result in a diminution of services to their clients.

Methodology

A questionnaire was designed to sample the respondents' level of familiarity with the ADA and the impact the law has had on their nonprofit agencies. The survey consisted of eleven questions. The answers were a combination of "yes/no" check offs, two other check off questions which asked about the amount of time spent on ADA compliance and the participant's knowledge of ADA requirements, specific requests for greater detail where appropriate, and a general request for comments about the ADA and nonprofits. A cover letter explained that the purpose of the survey was to assess the impact of the ADA on the operation of nonprofit organizations.

The survey was sent to the heads of twenty one Family Service agencies in New Jersey. These agencies were chosen because they are small community based agencies (ranging in size from approximately $500,000 per year annual budgets to approximately $11,000,000) for whom compliance may be an economic burden. These organizations, which qualify for tax exempt status under Section 501(c)(3) of the Internal Revenue Code, have many clients who themselves may qualify as "disabled" but for whom government safety nets have diminished. Forcing these nonprofits to comply with the ADA may ultimately do more harm than good as valuable resources must be shifted away from providing services to providing accommodation.

Results

Of the twenty-one surveys sent, nine were returned for a total response rate of 43 percent. Two of the nine respondents (22 percent of those who responded) reported that the ADA did not apply to their organizations. All of the respondents had some degree of knowledge of the ADA, with three of the nine respondents (33 percent) considering themselves "very" familiar and the other six (67 percent) considering themselves "somewhat" familiar. All but two of the agency directors reported spending "some" time on compliance, but not "a great deal" of time.

While one respondent (11 percent) reported that the ADA had an impact on the organization's interviewing practices, none of the respondents' hiring decisions had been affected by the law. Given the breadth of the ADA requirements with regard to the interview and hiring process, these already overburdened nonprofit executives may not realize how much of a change is required in order to comply.

The Equal Employment Opportunity Commission recently issued "guidelines" for the appropriate questions to ask job applicants when trying to assess whether a candidate could perform the essential functions of the job.[23] However, small community based nonprofits do not have human resource professionals on their staffs whose task it is to ask the right questions during interviews. It is not likely that an executive director will intuitively recognize that it is permissible to ask a prospective employee, "Are you currently illegally using drugs?" while the seemingly more innocent, "What medications are you currently taking?" is not allowed.[24] Thus, the potential exists for innocent, yet costly mistakes.

A major concern for small nonprofit corporations today is the dwindling amount of financial resources available to meet the ever increasing need. When the ADA was enacted, the focus of concern of the business community was the cost of compliance. When Sears, Roebuck and Company reported average compliance costs of $121.00 per accommodation made, the business community breathed a collective sigh of relief.[25] However, while Sears, Roebuck numbers its employees in the thousands and its human resources budget in the millions, community based nonprofits count their employees one at a time and have budgets that barely exist. While flexible scheduling is an accommodation that may be possible to make at no cost (when dealing with a large workforce), many accommodations carry substantial price tags. One respondent reported spending $30,000 for a staircase with a wheelchair lift, and another respondent reported making "adaptations" that cost $20,000.

The ADA provides an exemption from compliance if an "undue hardship" would result.[26] However, there is no definitive rule about when a requested accommodation can be refused. The survey asked whether the agency directors were aware that this exemption exists. Five of the respondents (56 percent) knew of the exemption while four of them (44 percent) did not. One of the respondents had considered applying for the exemption, although none actually have applied.

The final questions sought the executives' opinions about whether the ADA places an unfair burden on charitable nonprofits and whether such institutions should be exempt. While most of the respondents did not have sharp objections to the ADA's applicability to their agencies, some of them indicated the need for additional funding or flexible rules to assist them with compliance. Three of the respondents (33 percent) said that the ADA was an unfair burden while five (56 percent) indicated it was not unfair. One respondent left the question unanswered.

Only one respondent (11 percent) stated that charitable nonprofits should be exempt from the ADA. Five respondents (56 percent) felt that their agencies should not be exempt. Three respondents left the question blank. Two of the responses to the question on exemption were accompanied by comments: one person indicated that "special considerations should be given" and the other said that "special funding" should be made available for compliance. The latter executive emphatically stressed, "Nonprofits have no money for this!"

Responding to the general request for comments, one agency director summed up the frustrations felt by many of her colleagues, "The hardship in compliance is trying to bring antiquated buildings into compliance due to financial burden and actual structure of the building - the budget is already stretched beyond limits..."

Recommendations

The ADA is an important law with laudable objectives. However, as this preliminary study indicates, at a time when small community based charitable nonprofits are struggling with reduced funding and greater need, the imposition of the requirements of the ADA upon this sector only adds additional stress to already overstretched resources. The ADA's impact on agencies whose mission it is to help those with disabilities must be studied further to ascertain whether the resource shifting which may be required by the statute ultimately results in a reduction of services to the community.

While the "undue hardship" exception may provide relief for financially pressed human services agencies, the imprecisely defined nature of this provision may only create additional confusion. The better choice may be to amend the law to create a definitive exemption for charitable nonprofits whose mission it is to assist those who are supposed to reap the benefits of the Americans with Disabilities Act. The very essence of those organizations is to assist the disabled and the agencies themselves, rather than the federal government should determine how to expend their resources.

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[1]42 USC § 12101-12213 (1990).

[2]*Id.* at (a) (1).

[3]DAWN D. BENNETT-ALEXANDER & LAURA B. PINCUS, Employment Law for Business 353 (1993).

[4]29 U.S.C. §§ 701-796 (1985).

[5]*Id.* at § 791.

[6]*Id.* at § 793.

[7]*Id.* at § 794.

[8]Sometimes cited as the ADA.

[9]42 U.S.C. § 12102 2(A) - (C). The term "disability" includes "a physical or mental impairment that substantially limits one or more of the major life activities" of an individual or "a record of such an impairment" or "being regarded as having such an impairment."

[10]JODY BLAZEK, Tax and Financial Planning for Tax-Exempt Organizations 1 (1990). Section 501(c)(3) of the Internal Revenue Code grants tax exempt status to organizations operated for, *inter alia*, religious, charitable, scientific or educational purposes.

[11]42 U.S.C. § 12111 (5)(B).

[12]Nonprofit, as opposed to not-for-profit, is the term used by most such organizations, though some statutory schemes, such as New York's, use the latter nomenclature. New York Not-For- Profit Corporation Law § 100 (McKinney 1993).

[13]42 U.S.C. § 12111 (5)(B)(i) and (ii).

[14]Comm. Print 1990 at 1788.

[15]*Id.* at 1790, 1791.

[16]42 U.S.C. § 12111(10). Undue hardship may result from "an action requiring significant difficulty or expense, when considered in light of" such factors as "the nature and cost of the accommodation" "the overall financial resources of the facility" and "the type of operation ... of the covered entity."

[17]Comm. Print 1990 at 1788.

[18]42 U.S.C. § 12111 (9).

[19]*Id.* at (9)(A).

[20]*Id.* at (9)(B).

[21]For two years after it was enacted, the Americans with Disabilities Act only applied to organizations with 25 or more employees. Effective July 26, 1994, its reach was expanded to those with 15 or more employees. 42 U.S.C. § 12111 (5)(A).

[22]Jeffrey A. Tannenbaum, *More Small Employees Must Adhere to Disabilities Act,* Wall St. J., July 25, 1994, at B 2.

[23]WADE LAMBERT, *Have You Ever? New EEOC Guidelines for Job Interviewing Baffle Employers,* Wall St. J., July 15, 1994, at B1.

[24]*Id.*

[25]BARBARA PRESLEY NOBLE, *A Level Playing Field, for Just $121,* N.Y. Times, March 5, 1995, at F21.

[26]42 U.S.C. § 12111 (10) (1990).

INTRODUCING THE NEW
LIMITED LIABILITY COMPANY
TO THE CLASSROOM*
by
Peter M. Edelstein**

Introduction

Prior to October 24, 1994, if a small group of individuals desired to form a business they were forced to select from a variety of traditional but less than ideal options. On that date, New York State's new Limited Liability Company ("LLC") law became effective.[1] The legislation was designed to make available in a single business form, a combination of the most attractive business, legal and tax features. Entrepreneurs no longer have to compromise their primary objectives due to the limited choice of business forms.

The Limited Liability Company statute offers instructors an opportunity to introduce students to a timely and rather momentous piece of legislation by interpreting and illustrating its features through a process of comparison with the traditional business forms.

This paper will briefly review the history of the LLC, describe the classic categories of features by which the traditional business forms are analyzed, review the particular characteristics of the conventional business forms, compare the new LLC to those business forms, and highlight other features of the LLC. Appendix "A" contains a chart summarizing the comparisons. The sequence of topics in the paper mirrors the author's order of presentation in the classroom. The teaching methodology is designed to refresh and reinforce the students' existing knowledge of partnerships and corporations, and to critically analyze those business forms, thereby illustrating the utility of the LLC. Repeated comparisons of the features of the conventional business forms to each other and to the LLC provide the framework for the new information. I submit that our students will find learning about the LLC to be a graceful and natural extension of their knowledge of law because of their familiarity with the conventional business units. They will appreciate that the new law is a logical response to a real business need.

Brief History of LLC Legislation

New York was not the leader in the LLC movement; in fact, in July 1994, when then Governor Cuomo signed the enabling legislation[2], it was somewhat of a latecomer.

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Forty five states and the District of Columbia had already passed similar laws.[3] Europe and South America for many years had enjoyed a limited liability business form which became the model for Wyoming, the first state to adopt an LLC statute in 1977.[4] Six years later Florida adopted its statute,[5] and then in 1988 the Internal Revenue Service issued a Revenue Ruling[6] which blessed the LLC form with favorable tax treatment. That Ruling provided the necessary impetus for other states to rapidly follow the lead of Wyoming and Florida.

Analyzing the Classic Characteristics of Business Forms

Business forms have traditionally been studied by reference to categories of characteristics[7]. Students who have studied partnerships and corporations will recognize the categories and the available options: (i) liability, (ii) transferability, (iii) management, (iv) duration, and (v) tax treatment. Using these categories as a constant reference throughout the study of the LLC provides students with a comfortable and familiar structure to which the new LLC information can be related.

(i) *Liability* addresses the question of whether an individual participant may be *personally* liable for the debts of or claims against the organization, or is the organization's liability limited?[8]

(ii) *Transferability* refers to whether a participant without the consent of the others may substitute for him or herself a person who is not a participant, or is such transfer restricted?[9]

(iii) *Management* refers to whether "centralized" management exists; that is, the ability of a person or group (not including all the participants) to have continuing authority to make the management decisions necessary for the conduct of the business, or do the participants retain the authority to make the management decisions?[10]

(iv) *Duration* refers to the life span of the business unit. The issue is whether upon death, insanity, bankruptcy, retirement, resignation or exclusion of its participants, the business dissolves or does it have continuity of life?[11]

(v) *Tax treatment* refers to whether the IRS will tax the business as a "partnership" or a "corporation".[12] A corporation is taxed (at the "entity level") when it earns income, *and* its shareholders are taxed when they receive that income in the form of dividends. A partnership is not taxed on its income which is "passed through"; its partners are taxed on their share thereof. For this reason a partnership is sometimes said to be "tax transparent". The IRS, holds that an unincorporated association, such as the new LLC, will be classified for federal income tax purpose as a partnership if the business form has "associates" (the LLC has) and an "objective to carry on a business and divide the gains among its association" (the LLC has) and *lacks* two or more of the following *corporate* characteristics: limited liability; continuity of life; free transferability of interest; and centralized management.[13]

Review of Features of Conventional Business Forms

The common field of choices of business units, historically consisted of: general partnership, limited partnership, "C" corporation, and "S" corporation. Their characteristics are:

1. General partnership (or "partnership")

- Liability: No limited liability. The individual partners are ultimately liable for the debts of the partnership.
- Transferability: Restricted. All partners must consent to the admission of a new partner, unless agreed to the contrary.
- Management: No centralized management. Each partner has an equal right to participate in the management of the business, unless agreed to the contrary.
- Duration: No continuity of life. It may be dissolved by the death, insanity, withdrawal or bankruptcy of any partner, unless agreed to the contrary.
- Tax treatment: Beneficial. The IRS affords the partnership favorable tax treatment by imposing no tax at the business level; the partners are taxed on their share of the income of the business.

2. Limited partnership

- Liability: Limited liability. The individual limited partners are not liable for the debts of the business. The general partner, however, is so liable. (To avoid this exposure many general partners exist in the corporate form).
- Transferability: Restricted. There is no free transferability of the limited partner's interest. Transfers must comply with the terms of the applicable statute and the limited partnership agreement.
- Management: Management is centralized in the general partner(s). Unlike the general partnership, the limited partners may *not* participate in the management of the business.

- Duration: Generally, the limited partnership is not dissolved upon the occurrence of the various events that cause the dissolution of the general partnership. It may be dissolved by agreement of the members or by court order.

- Tax treatment: Beneficial. The limited partnership is not taxed at the business level. The limited partners are taxed on their share of the income of the business.

3. C corporation (or "corporation")

   - Liability: Limited liability. The individual shareholders are not liable for the debts of the corporation.

   - Transferability: Free transferability. The interests of the shareholders are freely transferable, unless agreed to the contrary.

   - Management: Management is centralized. The shareholders elect the directors; the directors appoint the officers. The directors set the corporate policy; the officers carry out that policy in the day-to-day operations.

   - Duration: Continuity of life. The existence of the corporation is not affected by the death, insanity or bankruptcy of any shareholder.

   - Tax treatment: The corporation is taxed on its income; the shareholders are taxed on their income. The same dollar can therefore be taxed twice: once when earned by the corporation as income; and again when distributed to the shareholder as a dividend.

4. S corporation

   - Liability: Limited liability. The shareholders are not liable for the debts of the corporation.

   - Transferability: Limited free transferability. The shares may be transferred subject to Internal Revenue Code restrictions as to who or what qualifies as a shareholder, and as may be otherwise agreed. Management:

   - Management is centralized. The shareholders elect the board. The board appoints the officers. The board makes policy decisions; the officers carry out the policy.

   - Duration: Continuity. The S Corporation is not affected by the events that dissolve a partnership.

   - Tax treatment: Beneficial. The shareholders enjoy the same type of "pass-though" tax treatment afforded the partnership and limited partnership; that is, no tax at the entity level, only at the member level.

<u>Determination of Ideal Characteristics</u>

A review of the classic characteristics of the conventional business forms prompts the students to appreciate the relative advantages and disadvantages inherent in each type of business unit and to conclude that each of the existing forms includes one or more shortcomings. They can then list and identify the ideal characteristics of a business form for a small group of entrepreneurs:

- *Liability*: limited; no personal liability for the debts of the business. A feature of the C and S corporation and limited partnership.

- *Transferability*: free transferability, coupled with the ability to restrict transfers if desired. A feature of the C and, to a limited extent S corporations.

- *Management:* no centralized management; flexible and easy management, without layers of decision makers, mandatory meetings and recordkeeping. A feature of general partnership.

- *Duration*: continuous life; not subject to dissolution for reasons beyond the participant's reasonable control. A feature of the C and S corporations. Or, if subject to dissolution, capable of reconstitution or continuation by agreement. A feature of the partnership and limited partnership.

- *Tax treatment*: "pass-through" tax treatment; that is, no tax imposed at the business level, with tax imposed only on the members. A feature of general partnership, limited partnership and S corporation.

While each of the forms of business existing prior to the LLC offered some desirable feature or features, only the limited partnership and the S corporation offered the dual advantages of limited liability and favorable tax treatment. Each of them, however, was encumbered with substantial disincentives.

The limited partnership requires at least one general partner which or who is personally liable for the debts of the business. If, in an attempt to avoid personal liability the general partner was in the form of a corporation, two sets of books and tax returns are required, a state franchise tax is imposed on the corporate general partner, and record-keeping chores multiply and costs increase. If the limited partners participate in management they risk losing the shield of limited liability. The S Corporation, being a creature of federal law has several statutory limitations: it may have only one class of stock; it may not have more than 35 shareholders; it may not own more than 80% of another corporation; it may not have another corporation as a shareholder; and it may not have any non-resident alien as a shareholder.

Students can justly conclude that the time was right for a new and better business form.

The LLC and its Characteristics

The LLC is a non-corporate form of business. Participants are "members," not partners or shareholders. It offers in a single business unit, a composite of the most desirable business features without the customary limitations and drawbacks associated with the traditional business forms. The characteristics of the LLC are:

- Liability: Limited liability. Members enjoy the benefits of limited liability. The LLC is liable for its debts and obligations.[14] Members are liable only to the extent of their capital contributions.[15]

- Transferability: Limited. A member may assign his or her interest but the assignee only receives the right to the assignor's share to distributions and profit and loss.[16] An assignee does not become a member without the consent of a majority in interest of the members.[17]

- Management: No centralized management. Members may manage the business themselves[18] or the members may vest management in a manager who or which does not have to be a member of the LLC.[19]

- Duration: No continuity of life. Dissolution occurs upon the happening of death, retirement, resignation, bankruptcy, dissolution or incompetence of a member, subject to the right, to be exercised within 180 days of any such event, to continue by unanimous consent of the remaining members.[20]

- Tax treatment: Beneficial. There is "pass-through" tax treatment--no tax at the business level; the members are taxed at their personal rates.[21]

Other Features of the LLC

Formation. The LLC is formed by filing Articles of Organization[22] with the Secretary of State and paying a $200 filing fee.[23] The LLC must have at least one member.[24] Within 120 days of the filing there must be six consecutive weekly publications in two newspapers of general circulation.[25] An annual fee is imposed equal to $50 times the number of members with a $325 minimum and $10,000 maximum.[26]

Name of LLC. The name of the business shall contain the words: "Limited Liability Company", "L.L.C." or "LLC".[27]

Operating Agreement. The members of the LLC shall adopt a written Operating Agreement that contains provisions not inconsistent with law or the LLC's Articles of Organization relating to (i) the business of the LLC, (ii) the conduct of its affairs, and (iii) the rights, powers, preferences, limitations or responsibilities of its members, managers, employees or agents, as the case may be.[28] This agreement is analogous to a partnership agreement and to corporate by-laws.

Voting rights of members. Unless agreed to the contrary in the Operating Agreement, each member shall vote in proportion to such member's share of the current profits.[29]

Consideration for membership interest. The form of capital contribution may be in cash, property or services rendered or a promissory note or other obligation to contribute cash or property or to render services.[30]

Nature of membership interest. The member's interest in the LLC is personal property. A member has no interest in specific property of the LLC.[31]

Withdrawal. Unless agreed otherwise in the Operating Agreement, a member may withdraw upon the vote or written consent of two-thirds in interest of the other members. Absent such vote or consent, a withdrawing member must give six months prior written notice. If such withdrawal violates the provisions of the Operating Agreement, the withdrawing member may be liable for damages.[32]

Professional LLC's and Professional Limited Liability Partnerships. Both variations of the LLC are available.[33]

Foreign LLC's. LLC's will be deemed domestic or foreign, as with corporations. Qualification is necessary for a foreign LLC to do business in New York.[34]

Flexibility in drafting. The LLC statute is designed to afford an opportunity to customize the statutory scheme to meet the needs or desires of a particular venture.[35] Substantial latitude and flexibility is available in many areas including management, transferability of interests and continuity. If there is no agreement to the contrary, the statutory rules apply by default. In the default language of the statute, the corporate characteristics of continuous life and free transferability are sacrificed to invite the beneficial tax treatment. Because the New York statute is not "bullet-proof", extreme care must be taken when deviating from the statutory provisions. Since, by definition, the LLC will have limited liability, in order to enjoy the beneficial tax treatment of a "partnership", under IRC regulations, it must not have more than one more characteristic of a corporation.[36]

Conclusion

The LLC is a good thing. It illustrates the logic and responsiveness of our legal process. A need was perceived and a solution was proffered. Our students should enjoy studying the LLC. Learning the material is at the same time a review and solidification of their existing knowledge and a new, yet continuing and natural learning experience.

While the LCC is not perfect,[37] it is a business form that must be seriously considered by all entrepreneurs interested in forming a small or closely held business venture.

ENDNOTES

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[1]Chapter 34 of the Consolidated Laws of New York State.

[2]Senate Bill No. 7511-A/Assembly Bill No. 11317-A.

[3]The only states without LLC legislation are Pennsylvania, Massachusetts, Vermont and Hawaii.

[4]Wyo. Stat. Ann. Sections 17-15-101 to 136 (Michie 1977).

[5]Fla. Stat. Ann. Sections 608.40 to -.471 (West Supp. 1990).

[6]88-76, 1988-2 C.B. 360.

[7]See for example, "Smith and Roberson's Business Law," Ninth Edition, Mann and Roberts, West Publishing.

[8]See Treas. Reg. 301.7701-2(d).

[9]See Treas. Reg. 301.7701-2(e)(1).

[10]See Treas. Reg. 301.7701-2(c)(1).

[11]See Treas. Reg. 301.7701-(2)(b)(1).

[12]See Internal Revenue Code of 1986, as amended, Section 7701 and Treas. Reg. Sec. 301.7701-2(a)(1), *et seq.*

[13]Treas. Reg. Sec. 301.7701-2(a)(1).

[14]Ltd. Liab. Co. L. Sec. 201(m).

[15]Ltd. Liab. Co. L. Sec. 502.

[16]Ltd. Liab. Co. L. Sec. 603.

[17]Ltd. Liab. Co. L. Sec. 603(a)(3), 604.

[18]Ltd. Liab. Co. L. Sec. 401.

[19]Ltd. Liab. Co. L. Sec. 410.

[20]Ltd. Liab. Co. L. Sec. 701.

[21]The New York statute's default provisions would qualify the LLC as a partnership for tax purposes based on similar statutes and Revenue Rulings in other states. To date there is no Revenue Ruling as to the New York LLC.

[22]Ltd. Liab. Co. L. Sec. 206.

[23]Ltd. Liab. Co. L. Sec. 203.

[24]Ltd. Liab. Co. L. Sec. 203(c).

[25]Ltd. Liab. Co. L. Sec. 206(8)(c).

[26]Ltd. Liab. Co. L. Sec. 1101.

[27]Ltd. Liab. Co. L. Sec. 204(a).

[28]Ltd. Liab. Co. L. Sec. 417.

[29]Ltd. Liab. Co. L. Sec. 402.

[30]Ltd. Liab. Co. L. Sec. 501.

[31]Ltd. Liab. Co. L. Sec. 601.

[32]Ltd. Liab. Co. L. Sec. 606.

[33]Ltd. Liab. Co. L. Sec. 1203.

[34]Ltd. Liab. Co. L. Sec. 802.

[35]Ltd. Liab. Co. L. Sec. 401-420.

[36]Treas. Reg. Sec. 301.7701-2(a)(1).

[37]Some reservations concerning the LLC are as follows: (i) the LLC form in New York State is authorized to have only one shareholder; there has been no Revenue Ruling to date as to how this may affect the tax treatment; (ii) the publication requirement is cumbersome, and can be costly if, for example, publication is required in the New York Law Journal and the New York Times; (iii) the form is not readily suitable to large organizations due to the limitations on free transferability; (iv) there is still a question as to how the states without similar legislation will treat LLC's; (v) there is no established body of law to afford comfort and guidance to students or lawyers.

SIGNIFICANT REVISIONS IN SEC REGULATIONS A & D

by

Arthur M. Magaldi*

The Depression of the 1930's and its traumatic effects had many ramifications in American society. Economists and those who have studied that period differ on the issue of the role of the stock market crash of 1929 as a cause or effect of the Depression. One view sees the market crash as the catalyst or start of the Depression. Another view sees the crash as a symptom of an overall economic decline. There is no doubt, however, that the stock market crash was an integral part of the severe economic decline that gripped the United States during the 1930's.

The suddenness of the precipitous market decline signalled the end of an era of prosperity and ushered in a time of economic hardship for millions. As the New York Times recorded in its October 30, 1929 edition, "Stock Prices collapsed yesterday, swept downward with gigantic losses in the most disastrous day in the stock market's history. Billions of dollars in open market values were wiped out as prices crumbled under the pressure of liquidation of securities which had to be sold at any price...Banking support, which would have been impressive and successful under ordinary circumstances, was swept violently aside, as block after block of stock, tremendous in proportions, deluged the market. Bid prices placed by bankers, industrial leaders and brokers trying to halt the decline were crashed through violently, their orders were filled, and quotations plunged downward in a day of disorganization, confusion and financial impotence."

The effects of the stock market crash were not limited to those who directly lost money from the falling prices of equities. The economic foundation of the United States was severely shaken. "From 1930 to 1933, prices of industrial stocks fell about 80 percent. Large numbers of banks had invested the money of their depositors in stocks. When stock values fell, many of these banks lost such money and had to close because they could not return it to the depositors.

Bank failures increased as the depression continued. About 1,350 banks failed during 1930. Approximately 2,300 more banks failed during 1931, and an additional 1,456 went under in 1932. The bank failures wiped out the savings of millions of people."[1]

As the most dramatic illustration of the economic malaise into which the United States had fallen, the stock market crash drew intense scrutiny. The analysis revealed that

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many schemes, frauds, and manipulations contributed to the problem. It became clear that investors of that time did not have available to them sufficient truthful information upon which to base investment decisions. Investors were therefore vulnerable to fraudulent schemes and manipulations and market excesses. The conclusion was reached that the integrity and effectiveness of the securities markets could only be assured by the introduction of new strict statutory safeguards. Exercising its power to regulate interstate commerce, the Securities Act of 1933[2] ("Securities Act") and the Securities Exchange Commission Act of 1934[3] ("Exchange Act") were passed to promote and insure the honesty and integrity of the securities markets. Both statutes are disclosure statutes with strong anti-fraud prohibitions.

New issues of securities to be sold in interstate commerce or by means of interstate commerce, e.g., the mails, are regulated by the Securities Act. The statute requires that any issue of securities that is being sold to the public for the first time, i.e., new issues, must be registered with the SEC and each purchaser of the new issue must be provided a prospectus before the sale or at the time of the sale. The registration statement, Form S-1, must contain extremely detailed and definite information about the issuer, the issuer's business, financial structure, relevant contracts, and officers. The filing must include an audited financial statement and any other information the SEC deems relevant. The prospectus which is generally part of the registration statement, contains in abbreviated form a substantial amount of the same information. In addition to the seventeen items specifically required in the registration statement, it is common for the SEC to call for additional disclosures and clarifications in the form of amendments. Unless the SEC extends the time frame, twenty days after filing the registration statement or twenty days after any mandated amendments, the registration statement is deemed effective and the securities may be sold.

It is, of course, a violation of the law to offer to sell or to sell unregistered securities unless the issue is the subject of a relevant exemption. Civil liability attaches to innocent or negligent violations and willful violations can be prosecuted as criminal offenses.

The provisions and enforcement of the Securities Act have been relatively successful in encouraging fair, accurate, and complete disclosure about new issues of securities; the securities markets have prospered to the point where it is not uncommon to see 300 million shares traded on the New York Stock Exchange on a single day.

One important difficulty with the detailed disclosure required by the Securities Act has been the substantial costs involved with compliance. "Due to the intricacy of the regulations, it is virtually impossible to achieve registration without the help of attorneys expert in the field. Accounting requirements and costs are likewise considerable. Substantial accounting and legal expenses and the accompanying "red tape" involved in compliance may discourage companies and entrepreneurs from going public."[4] The expenses involved in registering new issues have been particularly burdensome to smaller companies, especially companies with no established market for their securities.

Over the years the SEC has been mindful of the sometimes prohibitive costs of registering securities, and exercising its rule-making powers has passed rules exempting certain sales of securities from these requirements. The exemptions have applied where the SEC has determined that there existed no substantial danger to the public in the exempted sales. The purpose of this paper is to consider significant changes to two of the more important exemptions, Regulation A[5] and Regulation D, Rule 504.[6] In order to do this, some background on the Exchange Act is required.

Securities Exchange Commission Act

The Exchange Act created the SEC as a "securities watchdog." While the Securities Act regulates the issuance of new securities, the Exchange Act regulates the ongoing trading of securities.

The Exchange Act functions as a disclosure statute. It requires that corporations with 500 shareholders and $5 million in assets as well as any corporation traded on a national securities exchange file disclosure reports with the SEC.[7] These so-called reporting companies must file annual reports (Form 10-K), quarterly reports (Form 10-Q), and monthly reports (Form 8-K) for any month in which there is a material change in the affairs of the corporation.

The Exchange Act also condemns fraud and fraudulent activities in securities dealings. The famous Section 10b and Rule 10b-5 declare unlawful "any device, scheme or artifice to defraud." The rule makes it unlawful to make untrue or misleading statements or to omit to state material facts necessary to keep other facts from being misleading. Rule 10b-5 also declares illegal any act, practice or course of conduct which operates as a fraud upon anyone in regard to the sale or purchase of securities.

Rule 504

Prior to the revision of Rule 504, a non-reporting company, i.e., a small company which was not subject to the reporting provisions of the Exchange Act, could raise up to one-half million dollars in a twelve month period through the sale of a new issue of securities without the necessity of complying with the registration provisions of the Securities Act. The requirement that a prospectus be provided to purchasers was likewise dispensed with and the issuer of the securities was not required to make disclosure to the purchasers. Under the 504 exemption, the securities could be sold to any number of offerees or purchasers. The rationale for the Rule 504 exemption is that there is no substantial danger to the investment public where the total of the issue is a relatively modest $500,000. The intent of the Rule 504 exemption is to allow small issuers access to modest amounts of capital through the sale of a new issue without the expense of registration.

The Rule did not dispense with all investor safeguards; the anti-fraud provisions of the Act are not suspended. Moreover, the SEC has to be notified within fifteen days of the first sale of the securities.

There were many drawbacks to the use of Rule 504. To utilize the exemption, Rule 504 required a private placement, i.e., no advertising or general solicitation of the public was permitted. Further, purchasers of the securities under the exemption received "restricted securities," i.e., securities which were not available for resale without registration. It was the responsibility of the issuer to determine that the purchasers were purchasing the securities as an investment and the securities had to bear a legend indicating that they had not been registered and were therefore restricted as to resale.

Revised Rule 504

Newly revised Rule 504 makes three significant changes to the rule. Under the revision, the amount of securities which can be sold has been raised to $1 million[8] during a twelve month period. There is no longer any prohibition against advertising or solicitation of the public.[9] The issuer or underwriter may advertise in any medium deemed appropriate. Purchasers of securities under this exemption no longer receive restricted securities.[10] The securities purchased are fully transferable and can be re-sold immediately after purchase.

While the other provisions of Rule 504 outlined above remain substantially intact, the net result of the changes appears to be that an issuer which remains within the $1 million monetary guideline may, in effect, make a public offering of that amount without restrictions or registration.

Regulation A

Regulation A is a conditional small issues exemption from registration under the Securities Act. The Regulation A exemption may be considered a quasi-exemption inasmuch as the issuer must file with the SEC an offering statement[11] (Form 1-A) instead of a full registration statement. No securities may be offered for sale under Regulation A until an offering statement is filed with the SEC and no sales may be made until the Form 1-A offering statement has been deemed qualified by the SEC. Each purchaser of securities must be delivered a final offering circular[12] before or at the time of the confirmation of sale.

Regulation A has, in effect, substituted the offering statement and offering circular for the registration statement and prospectus of the traditional Securities Act registration. The value to the issuer is that the disclosure required to qualify for Regulation A exemption is somewhat less than that required for a full registration. Regulation A exemption can ouly be used by companies that are not required to report under the Exchange Act.

Revised Regulation A

Prior to revision, the monetary limit of $1.5 million of sales within a twelve month period was in effect. This monetary limitation effectively limited the exemption's usefulness to small companies because the costs of compliance with this modified registration, although reduced from the costs of full registration, are still burdensome. In many cases, there was little to gain from Regulation A transactions in light of the substantial expenses required to be incurred to qualify the offering statement and to prepare and distribute the offering circular. Moreover, many of the expenses had to be borne by the issuer before knowing whether there was a market for the securities because the first step in the Regulation A process is the filing of the offering circular. The SEC framed the problem in this manner, "..., one of the major impediments to a Regulation A financing for a small start-up company with no established market for its securities, is the cost of preparing the mandated offering statement. The full costs of compliance would be incurred without knowing whether there will be any investor interest in the company."[13]

The revisions enacted by the SEC retain the basic structure of Regulation A but change major portions of the regulation. The revisions recognize the need for small companies, those not subject to the reporting provisions of the Exchange Act, to have access to capital markets through the sale of limited amounts of securities with a lessened amount of red tape. The revised regulation raises the dollar limit of sales to $5 million during a twelve month period.[14] Equally important, revised Regulation A allows the issuer to circulate solicitation of interest documents prior to the filing of the offering statement.[15] This "testing of the waters" may also include radio or television advertising.[16] Such a solicitation of interest writing is specifically declared not to be an illegal prospectus. "Any written document under this section may include a coupon, returnable to the issuer indicating interest in a potential offering, revealing the name, address, and telephone number of the prospective investor."[17] This procedure allows the issuer to determine whether there is interest in the proposed issue and encourages an informed decision on the advisability of proceeding or terminating the proposed offering.

The written solicitation of interest document or script of the broadcast soliciting interest must be filed with the SEC at the time of first use. Following the submission, oral communications with prospective investors may take place. If the respouse to the test the waters solicitations of interest are positive, the issuer will then be able to proceed with the expense of the offering statement and offering circular which continue to be required before sales may take place.

An additional aid to small business issuers under Regulation A allows for good faith projections of future performance in the disclosure documents provided there is a reasonable basis for such projections. "The Commission's safe harbor provisions relating to forward looking information have been specifically made applicable to Regulation A. Therefore, good faith projections, with a reasonable basis, of revenues, income, earnings per share, capital expenditures, dividends, capital structure and other financial items may

be made in Regulation A filings and the "test the water" submissions and fall within the protections of the Commission's safe harbor rules, ..."[18]

Conclusion

The liberalization of Regulation A and Regulation D, Rule 504, seems reasonable. It appears to be a worthwhile attempt to open capital markets to small businesses from which they had been unnecessarily excluded by stringent regulations. There appears to be little danger to the public since safeguards, notably the anti-fraud provisions, remain in effect. Raising dollar figures in the exemptions to more realistic amounts reflective of the 1990's seems to be an appropriate measure for the SEC. It is refreshing to learn of initiatives by a powerful regulatory body which encourage legitimate business activities without abandoning the public trust.

ENDNOTES

1. The World Book Encyclopedia (New York: World Book - Childcraft International, Inc.), Vol. G, p. 340, 1979.
2. 15 U.S.C. Sec. 77a *et seq.*
3. 15 U.S.C. Sec. 78a *et seq.*
4. The Legal Environment of Business (Cincinnati: South-Western Publishing Co.), p. 639, 1987.
5. 17 CFR 230.251-262.
6. 17 CFR 230.501-508.
7. *Supra* at 3.
8. 17 CFR 230.504(b)(2)(i).
9. 17 CFR 230.504(b)(2)(2).
10. 17 CFR 230.504(b)(2)(3).
11. 17 CFR 203.252.
12. 17 CFR 203.253.
13. 51 SEC Docket 2615.
14. 17 CFR 230.251(b).
15. 17 CFR 230.254(a).
16. *Id.*
17. *Supra* at 12.
18. 57 Fed. Reg., No. 157 at 36444.

NEW TAX AMORTIZATION RULES
GOOD NEWS FOR GOODWILL - SOME BAD NEWS

by

Martin H. Zern *

BACKGROUND

Prior to 1934, taxpayers had considerable freedom in selecting a useful life for the purposes of depreciating assets. Then, to help finance public works during The Depression, the Treasury Department began to require taxpayers to prove that the useful life selected was appropriate based upon their particular facts and circumstances. This often proved an untenable and, in any event, a costly proposition for many. In 1942, the Treasury Department prescribed detailed useful lives for specific assets.[1] These lives in many cases were more conservative than the lives taxpayers were using. The 1954 Internal Revenue Code liberalized matters significantly by permitting accelerated methods of depreciation, such as, sum-of-the-years-digit and 200% declining balance, although the useful lives previously prescribed were retained. In 1962, the Treasury Department promulgated new useful-life guidelines. Essentially, the new guideline system created extensive industry classifications and specific asset descriptions within each such classification.[2] Moreover, a complicated reserve ratio test was introduced to ensure that actual retirement and replacement of assets was consistent with the useful life selected. Ultimately, the reserve ratio test proved administratively difficult and impracticable.

Due to the problems with the existing system, it was abandoned by the Treasury Department in 1971 and a new system, effective for assets acquired after 1970, was introduced - the Class Life Asset Depreciation Range System (ADR) which eliminated the reserve ratio test.[3] However, the new system also was set up by industry classifications with specific assets listed within each classification. For each asset, the Treasury Department prescribed a range of useful lives ranging from 20% below to 20% above the basic guideline lives under the prior system. Understandably, most taxpayers, desiring as quick a write off as possible, selected 20% below.

Modern Times. Our present depreciation system originated as part of President Ronald Reagan's tax package enacted shortly after he took office which was advertised as an economic stimulus to push the economy out of recession.[4] This system, known as the Accelerated Cost Recovery System (ACRS), significantly simplified tax depreciation by abandoning the lengthy lists of assets under the ADR system. ACRS established just a few classifications (for most taxpayers, only two to three classifications were relevant) and adopted considerably shortened useful lives which did not necessarily have any relationship to the actual useful life of an asset, a major departure from the prior systems. Moreover, a highly accelerated method of depreciation (200% declining balance) for most tangible personal property was permitted. A major change was to allow a very fast write off for real estate (15 years as compared to the 40 years that generally prevailed). An accelerated method of depreciation (175% declining balance) was also permitted for real estate. As is common knowledge, the economy did accelerate during the 80's, with real estate in particular booming. Modifications to the depreciation rules were made over the years increasing the real estate write-off period to 18 years,[5] and later to 19 years.[6]

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The major tax changes enacted in 1986 in honor of which the tax law was re-christened the Internal Revenue Code of 1986 (previously, 1954), modified the ACRS system creating new classifications and conventions and, accordingly, it became known as the Modified Accelerated Cost Recovery System (MACRS).[7] Insofar as depreciation is concerned, the major change affected real estate with the adoption of longer useful lives (27.5 years for residential property and 31.5 years for commercial), elimination of the 175% declining balance and, in lieu thereof, adoption of the straight-line method of depreciation. Arguably, the adoption of these longer useful lives with straight-line depreciation, together with enactment of the passive loss rules, were a significant, if not the predominant factor, for the devaluation of real estate in the late 80's, the failure of many savings and loan institutions and the resulting bail out by the Federal Government. President Clinton's recent tax package, the Revenue Reconciliation Bill of 1993 (RRB '93), increased the write-off period for commercial real estate to 39 years.[8]

Intangibles. The depreciation rules discussed above applied and currently apply only to tangible property. For intangible assets, no prescribed write-off periods were in general enacted.[9] However, a Treasury regulation of long standing permitted amortization for an intangible asset used in a trade or business or in the production of income (e.g., and investment activity) provided experience showed the intangible to be of use for only a limited period, "the length of which can be estimated with reasonable accuracy." [10] The regulation specifically states that "no allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

This regulation has been the linchpin behind the IRS denying a deduction for amortization of goodwill, going concern value and assorted other affiliated categories that inventive taxpayers have created in an attempt to differentiate from goodwill what they acquired when purchasing the assets of an operating business. Despite a consistent policy by the IRS in trying to maintain the integrity of the regulation's opposition to the amortization of intangibles, taxpayers over the years have attained some success. The key to circumventing the regulation was within it - namely, showing the intangible, however designated, had a useful life which could be estimated with reasouable accuracy. However, the explication had to be made not to the IRS but to a court because, rest assured, the IRS would litigate the issue. Although the courts were on occasion obliging to taxpayers in this area, the path to success was difficult. A highly litigated item in this area was the cost an acquiring taxpayer of business assets might allocate to customer or subscriber lists.

Historically, when a going business was acquired, the courts denied an amortization deduction for the acquisition cost allocated to customer lists because their useful life could not be estimated with reasonable accuracy. Commonly, this was called the "mass asset" rule (i.e., the customer lists were a mass self-regenerating asset). Thus, customer and subscriber lists, location contracts, insurance expirations and similar items were held to be indistinguishable from non amortizable goodwill.[11] However, when a customer list was acquired separately, it was possible to amortize if a determinable life and value were established.[12] But overall, amortization of subscription lists was denied. In 1973, a seminal case in this area, *Houston Chronicle Publishing Co. v. U.S.*,[13] established that subscription lists could be amortized if the taxpayer could prove (1) an ascertainable value separate and distinct from goodwill, and (2) a limited useful life ascertainable with reasonable accuracy. Ultimately, the IRS acquiesced to this decision.[14]

Numerous cases arose after *Houston* with various fact patterns. Innovative taxpayers purchasing the assets of a going business conceived of diverse purported asset classifications in an attempt to differentiate from goodwill what was acquired. The result was extensive litigation and a large and growing backlog of cases. [15] The major hurdle to amortization was taxpayer failure to meet the burden of proof outlined in Houston. The culmination of taxpayer efforts in this area, and a major loss for the IRS, was the recent decision of the U.S. Supreme Court in *Newark Morning Ledger v. U.S.*[16] At issue was $3 million of stipulated value of subscribers acquired in a takeover. *Newark* held the taxpayer must establish that public tastes or socioeconomic forces will cause the intangible to be retired and must establish a reasonable date by which the event will occur. If the taxpayer is able to sustain this burden of proof, the intangible can be separated from goodwill regardless of how much the intangible appears to reflect expectancy of continued patronage. At the trial, the Government presented no proof to contradict the taxpayer's experts and relied on the principal argument that as a matter of law the lists were indistinguishable from goodwill. The District Court found for the taxpayer and the 3rd Circuit reversed in favor of the Government. The Supreme Court, however, held for the taxpayer, finding that the lists were not self-regenerating - i.e., they had a limited useful life, the duration of which could be calculated with reasonable accuracy, that taxpayer properly calculated its value and that it was separate and apart from goodwill. "Petitioner has borne successfully its substantial burden of proving 'paid subscribers' constitutes an intangible asset with an ascertainable value and a limited nseful life, the duration of which can be ascertained with reasonable accuracy." It was noted, "...that burden often will prove too great to bear." The Supreme Court stated that had the Government presented credible evidence challenging taxpayer's experts, the District Court would have had a more difficult time deciding the case. Rather, the Government relied on a legal argument (i.e., the lists were indistinguishable from goodwill) which the Supreme Court rejected.[17] *Newark* seems to point up the fact that previous taxpayer losses in this area were due to evidentiary failure, in large part because of the considerable expense of establishing the evidentiary foundation and of correlative qualified expert testimony.

The loss in *Newark* and the considerable backlog of pending cases prompted the Treasury Department to seek a change in the law by way of statutory enactment.[18] Further, the existing rules were perceived as distorted in that they favored the acquisition of a business with hard assets as opposed to a service business which has primarily soft assets (e.g., customer lists, valuable employees under contract, information bases). Also, the existing rules favored created intangibles over acquired intangibles since the former arise out of currently deductible expenses (e.g., advertising, employee training, development of know-how, customer service expenditures, etc.). Finally, resource-rich taxpayers had a decided advantage in meeting the substantial burden of proving the value and the limited life of the intangible. Consequently, for the foregoing reasons, a new section (**IRC §197**) dealing with intangibles was added to the Internal Revenue Code as part of RRB '93. As will be seen, the new law is not all favorable to taxpayers. In certain cases, taxpayers may have fared better under the prior law, especially in light of *Newark*. Under the new law, bowever, the amortization period for prescribed intangibles is a mandatory 15 years even though a shorter period previously may have been attainable based upon the particular facts and circumstances if the taxpayer litigated the issue.

RESIDUAL ALLOCATION METHOD - IRC §1060

When the assets of a going business are acquired,[19] the price paid is often higher than the fair market value of the tangible assets. The premium paid is generally attributable to the perceived advantages of a going concern, such as, goodwill, a trained workforce, a customer base, below-market-rate lease, prime location and other assorted intangibles. In order to assure that the value assigned to tangible assets which can be depreciated, cash-equivalent intangibles (e.g., receivables) and amortizable intangibles (e.g., a covenant-not-to-compete) is not overstated, the tax law requires that the purchase price be allocated among the assets acquired using a residual method of allocation.[20] The purpose of this method of allocation is to ensure that the premium paid over and above the tangible assets and intangibles mentioned above is allocated to goodwill or going concern value which, prior to RRB '93, were not amortizable - at least in the view of the IRS.

The residual method of allocation is required when there is an "applicable asset acquisition."[21] This term is defined as meaning any transfer of assets which constitutes a trade or business and where the basis in such assets is determined by the consideration paid.[22] Treasury regulations provide that assets are deemed to constitute a trade or business if goodwill or going concern value could under any circumstances attach to the assets acquired. In making this determination all of the facts and circumstances surrounding the transaction must be taken into account.[23] Under the regulations, assets acquired are categorized by classes: Class I (cash, demand deposits and similar items); Class II (certificates of deposit, U.S. Government securities, marketable securities, foreign currency and similar items); Class III (tangible and intangible assets, such as, furniture and fixtures, land, buildings, equipment, covenant-not-to-compete and accounts receivable); and Class IV (intangible assets such as goodwill and going concern value).[24] The purchase price is first allocated to Class I assets, then to Class II assets, then to Class III assets and anything remaining to Class IV assets. The purchase price allocated to an asset class other than Class IV cannot exceed the fair market value of that asset on the purchase date.[25] Thus, the purchase price, if any, paid over and above what is fairly allocable to the first three classes necessarily must be allocated to Class IV. Understandably, the IRS in examining a return may challenge the taxpayer's determination of the fair market value of any asset. For example, the IRS may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.[26] So that the IRS is apprised of the allocation made when assets are acquired, the regulations contain reporting requirements.[27]

NEW INTERNAL REVENUE CODE § 197

Because of the tremendous amount of litigation pending concerning amortization of intangibles, the major loss by the Government in *Newark*, the consequent possibility of further losses and the general uncertainty and arguably unfairness of the then existing situation, the Treasury Department promoted the enactment of IRC §197 which permits the amortization of goodwill, going concern value and other prescribed intangibles over a 15-year period. Although it would appear that by sanctioning amortization of intangibles that heretofore were not amortizable the Government would be losing revenue, interestingly, IRC §197 was estimated to be a revenue raiser.[28] Apparently, mandating a 15-year write-off was perceived to be more favorable to the Government than the shorter amortization periods taxpayers were likely to obtain, in light of *Newark*, by litigation. Moreover, as will be discussed hereafter, the new treatment of covenants-not-to-compete is highly disadvantageous to taxpayers.

It is expected that the present Treasury regulations under IRC §1060 will be amended to reflect the fact that IRC §197 now allows amortization for intangibles in the nature of goodwill, going concern value and other intangibles. It is anticipated that all assets delineated in IRC §197 will be categorized as Class IV assets to be amortized over 15 years.[29]

In general, IRC §197 allows an amortization deduction with respect to the capitalized costs of any amortizable §197 intangible. As will be discussed in more detail hereafter, the term "amortizable §197 intangible" means any §197 intangible acquired and held by the taxpayer in connection with the conduct of a trade or business or an activity described in §212.[30] Thus IRC §197 applies whether the intangible is acquired separately or as part of the acquisition of the assets of a trade or business. However, as will be seen, major exceptions are applicable for certain intangibles acquired separately, and in some cases even if acquired as part of the acquisition of the assets of a trade or business. The section does not apply, however, to self-created intangibles (with some exceptions) provided such intangible is not created in connection with a transaction (or series of related transactions) that involves the acquisition of the assets of a trade or business.[31] Thus, the section does not affect the current deductibility of expenses that create intangible value (e.g. expenses for advertising, employee training, customer relations, creation of data base information systems, creation of know how, etc.). However, if the

intangible is created ancillary to the acquisition of the assets of a trade or business, then IRC §197 is applicable and such created intangible would have to be amortized over 15 years. An example of an ancillary intangible is a covenant-not-to-compete which is created concurrent with and incident to an asset acquisition. Thus, despite the fact that the covenant may run for only a few years, it will nevertheless have to be amortized over 15 years. It is important to recognize that IRC §197 is exclusive. Accordingly, taxpayers will fare worse under the new law since no depreciation or amortization is permitted for amortizable §197 intangibles except as permitted by the section.[32] On the other hand, if the asset is not an amortizable §197 intangible, the law prior to the enactment of the section would control.

Definition of "§197 Intangible." The term "amortizable §197 asset" is defined as any "§197 intangible" acquired after enactment of RRB '93 (i.e., after 8/10/93) and either held for use in business or in a §212 activity (e.g., investment). As stated, excluded are "self-created intangibles" except if created in connection with a transaction involving the acquisition of the assets of a trade or business.[33] Moreover, certain §197 intangibles are automatically considered as not self-created and consequently must be amortized over 15 years even if not acquired in connection with a transaction involving the acquisition of the assets of a trade or business.[34] In other words, certain intangibles, even if acquired or created separately, would have to be amortized over the 15-year period. Specifically, the assets required to be amortized over 15 years whether acquired separately, as part of the assets of a business, or created ancillary to the acquisition of the assets of a trade or business (e.g., a covenant-not-to-compete), are:

1. **Licenses.** Any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof.[35] Thus, the costs incurred in obtaining (or renewing) a liquor license, a taxi medallion, airport slot, regulated airline route, or television or radio broadcasting license are amortizable over 15 years even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period.[36] Previously, the IRS was generally successful in barring amortization of these items, despite the fact that the license was for a fixed period, unless the taxpayer could prove that the license was unlikely to be renewed.

2. **Covenants-Not-To-Compete and Similar Arrangements.** As mentioned, the Government expects IRC §197 to be an overall revenue raiser and this is accomplished only because the section is bad news for taxpayers in certain cases. The most noteworthy example is an amount paid for a covenant-not-to-compete (or other arrangement to the extent such arrangement has the same effect as a covenant-not-to-compete) entered into in connection with the acquisition (directly or indirectly) of an interest in a trade or business.[37] Although often created incident to an asset acquisition, a covenant is not part of the assets of the business acquired. Under prior law, if part of the purchase price of the business was allocated to a *bona fide* covenant, the allocated amount could be amortized over the life of the covenant, which typically ran for no more than 5 years. Accordingly, there was an incentive to allocate to a covenant rather than non-amortizable goodwill. Of course, whether the amount allocated was bona fide or simply a scheme to amortize what

was substantively goodwill was a matter to be resolved based upon the particular facts and circumstances. For example, an amount paid to a 70-year old retiring seller moving to another part of the country (who clearly had no intention of competing) for his covenant would no doubt have been characterized by the IRS as in substance a payment for goodwill if it became aware of the facts. Now, under the new law, despite the actual term of the covenant, the allocated amount must be amortized over 15 years. This is true whether the amount is paid to the corporation selling the assets and/or directly to the principals involved.[38] Accordingly, it should now make no difference to the buyer whether an amount is allocated to goodwill or a covenant since both are amortizable over 15 years. However, it may make a difference to the seller.[39] Obviously, the new rules prevent taxpayer deception in this area.

As stated, the initial payment under a covenant is to be amortized over 15 years. However, subsequent payments (such as, contingent payments geared to gross revenue or earnings), if any, are to be amortized ratably over the remaining months in the initial 15-year amortization period as of the beginning of the month that the subsequent amount is paid or incurred.[40]

Generally, IRC §197 is not applicable to a stock acquisition (unless a deemed election under IRC §338 is made). However, amortization of a covenant over 15 years is required where it is paid for separately (to the stockholders) ancillary to a stock acquisition or the acquisition of an interest in a partnership.[41]

In both asset and stock acquisitions, it was commonplace to enter into a management or consulting agreement (employment arrangement) with the former owner(s) of the business. In many cases, the employment arrangement was a sham with the contracted consultant and/or manager rendering little or no services. The obvious purpose underlying this type of pretextual allocation was to carve out an amount that would otherwise be allocable to non-amortizable goodwill (or a covenant to be amortized over a period of time) and get an immediate deduction for the payments under the employment arrangement. To prevent abuse in this area, IRC §197(d)(1)(E) refers to arrangements that have "substantially the same effect as a covenant." Accordingly, the Government will scrutinize arrangements that require the former owner(s) of a business to provide services to the business, or to lease property to it, to ensure that the arrangements are bona fide and that the amounts paid to the former owners are reasonable. To the extent compensation paid under an employment arrangement to the former owner(s), or lease payments, are not reasonable, they will be constructively considered as payments for a covenant-not-to-compete.[42] Accordingly, rather than an immediate deduction for compensation and/or lease payments, amortization over 15 years will be required for such payments. As under present law, to the extent that an amount paid for a covenant (or similar arrangement) is substantively additional consideration for stock, such amount cannot be amortized under the new law but, instead, is to be added to the acquirer's basis in the stock.[43] Consequently, it is clear that the IRS will carefully scrutinize employment arrangements and covenants entered into ancillary to a stock acquisition to determine whether they are bona fide.

3. **Franchises, Trademarks and Trade Names.** IRC §197 defers to IRC §1253(d)(1) if the latter provision governs the treatment of these items.[44] If it does not, IRC §197 is applicable. IRC §1253(d)(1) deals with contingent payments and permits immediate deductibility of franchise payments contingent on the productivity, use or disposition of the franchise, trademark or trade name that are paid as part of a series of payments paid not less than annually throughout the term of the franchise agreement, including renewals, and which are substantially equal in amount, or paid under a fixed formula. Prior to RRB '93, lump sum payments were deductible over 10 years; any other payments (i.e., not formula based, substantially equal or lump sum) had to be capitalized and amortized over 25 years.

IRC §197 defers only to the provisions of IRC §1253(d)(1) which deal with contingent payments based on a formula or payments that are substantially equal. Thus, an immediate deduction for such payments is continued. However, lump sum payments that were deductible over 10 years and other payments not formula based or substantially equal, which heretofore were amortizable over 25 years, are now amortizable over 15 years. If payments (not formula based or substantially equal) relating to the original issuance of the franchise, etc., are paid in following years, they are to be amortized over the period remaining in the 15-year period. However, payments to renew a franchise, etc., would start a new 15-year period running.[45] For purposes of defining the term "franchise," IRC §197 defers to IRC §1253(b)(1).[46]

Specific §197 Intangible Classifications. As mentioned, taxpayers over the years have been resourceful in creating and carving out from goodwill allegedly separate categories of assets which were then asserted to have a limited life and thereby were amortizable. Consequently, the Government appears to have attempted to bring within the scope of IRC §197 a myriad of classifications, no doubt based upon its experiences with taxpayer creativity. Thus, the term "§197 intangible" includes:[47] (i) goodwill, (ii) going concern value, (iii) workforce in place, including composition and terms and conditions of employment, (iv) information base, including business books and records, operating systems, or any other information base such as lists or other information with respect to current or prospective customers, (v) any patent, copyright, formula, process, design, pattern, know-how, format or similar item, (vi) any customer-based intangible, including composition of market, market share and any other value resulting from future provision of goods and services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers; and for financial institutions, deposit base and similar items, (vii) any supplier-based intangible, defined as any value resulting from future acquisition of goods and services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer, (viii) any item similar to (iii) to (vii) (as a catchall), (ix) any license, permit or other right granted by a governmental unit or an agency or instrumentality thereof (not included if acquired separately is any right to receive tangible property or services under a contract granted by a governmental unit or agency or instrumentality thereof), (x) a covenant not to compete (or other arrangement substantially the same) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and (xi) any franchise, trademark or tradename.

Goodwill and Going Concern Value. Goodwill is the expectation of continued customer patronage whether due to the name of the business, reputation or any other factor. Going concern value is purportedly the additional value of a business attributable to the fact that it is a going concern that can function and generate income despite a change of ownership. Additionally, the value of earnings that would otherwise not be available if the business were not operational are part of going concern value.[48] Is there really a distinction between goodwill and going concern value? The fact that a business can successfully survive a change in ownership and that it is expected to produce earnings is arguably attributable to expected customer patronage.

Workforce, Information Base, Know-How, Customer-Based Intangibles, Supplier-Based Intangibles and Other Similar Items. The new law evidently attempts to address every element of value that might be envisioned by creative taxpayers involved in the acquisition of the assets of a going business. There are obviously many reasons why more than the value of the tangible assets may be paid for a going business. No doubt the Government in the administration of the tax laws and in litigation has come across the foregoing items which taxpayers have carved out in an attempt to obtain amortization deductions.

Workforce. It is recognized that an experienced, educated and trained workforce in place is a valuable element of a business. Therefore, if any part of the purchase price of a business is attributable to a highly-skilled workforce, to acquiring an existing employment contract or to acquiring an important relationship, such as with a "key employee," such part of the purchase price must be amortized over 15 years.[49]

Information Base. Much litigation has been spawned by taxpayer attempts to amortize items that may be classified as "information base."[50] Included under this caption are customer lists (whether current or prospective), technical and training manuals, data files, accounting or inventory systems, insurance expirations, patient or client files, subscription lists and lists of advertisers in the newspaper, magazine, radio and television industries. All of the foregoing to which value may be ascribed when acquiring a business must be amortized over 15 years.[51]

Know-How. If value is ascribed to what is commonly categorized as "know how," such value must be amortized over 15 years. Included are patents, copyrights, formulas, processes, designs, patterns, package designs, computer software and any interest in a film, sound recording, video tape, book or similar property. However, there is an important exception for patents and copyrights as further explained hereafter.[52]

Customer- and Supplier-Based Intangibles. Value attributed to "customer-based" and "supplier-based" intangibles must also be amortized over 15 years. Customer-based intangibles refers to value assigned to composition of market, market share, or any relationship with customers (contractual or otherwise). More specific examples are:

Insurance in force, mortgage servicing contracts, investment management contracts or other relationships with customers involving the future provision of goods or services. Insofar as financial institutions are concerned, included are deposit base and any value relative to checking accounts, savings accounts and escrow accounts, for example. All of the foregoing must be amortized over 15 years. However, it is made clear that the portion of the purchase price of the assets of a business allocable to accounts receivable or any similar right to income is not covered under the new law.[53] Value attributed to supplier-based intangibles acquired with the assets of a business must also be written off over the 15-year period, examples being the existence of a favorable relationship with persons that provide distribution services (such as, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating and the existence of favorable supply contracts.[54]

Catch-all. The authors of IRC §197 recognized that in drafting the section they may not have set forth every conceivable element of value that might arise in connection with the acquisition of the assets of a business (or that might be acquired separately). Accordingly, the term "§197 intangible" is also defined to include any other property similar to workforce, information base, know-how, customer-based intangibles or supplier-based intangibles.[55]

Although the foregoing items are usually acquired in connection with (or created incident to) the acquisition of the assets of a trade or business, it is important to recognize that even if acquired separately (if feasible), IRC §197 would be applicable. However, it appears that a separately created covenant-not-to-compete would not be covered by IRC §197 since the pertinent part of the section refers to a covenant entered into in connection with the acquisition (directly or indirectly) of an interest in a trade or business.[56] For example, an amount might be paid to a resigning employee for his contractual agreement not to compete for a period of time. Since not incident to the acquisition of an interest in a trade or business, it appears that such a payment would be amortizable over its term.

Since the cost of acquiring the above intangibles must be amortized over 15 years, it may be more economically viable to develop such intangibles. For instance, the costs of training a work force and developing an information base, know how and customer and supplier-based intangibles would be deductible currently.

Exceptions.[57] The term "§197 intangible" does not include the following items:

(i) financial interests in a corporation, partnership, trust, or estate, or under an existing futures contract, foreign currency contract, notional principal contract, or other similar financial contract,

(ii) land,

(iii) computer software readily available to the general public, subject to a nonexclusive license, and not substantially modified, and other computer software provided not acquired in a transaction involving the purchase of the assets of a trade or business. The term "computer software" does not include a data base or similar item unless the data base is in the public domain and is incidental to the operation of otherwise qualifying computer software, and

(iv) certain interests or rights acquired separately and not acquired in a transaction (or series of related transactions) involving the acquisition of the assets of a trade or business. This category includes (I) any interest in a film, sound recording, video tape, book or similar item, (II) any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof, (III) any interest in a patent or copyright, (IV) to the extent provided in regulations, any right under a contract (or granted by a governmental unit or agency or instrumentality thereof) if such right has a fixed duration of less than 15 years, or is fixed as to amount and, without regard to IRC §197, would be recoverable under a method similar to the unit-of-production method.

(v) certain interests under existing leases and indebtedness.

(vi) a franchise to engage in professional sports, and any item connected therewith.

(vii) residential mortgage servicing contracts (provided not acquired in connection with the acquisition of the assets of a trade or business), and

(viii) fees for professional services, and any transaction costs incurred in connection with tax free reorganizations.

Interests in a Corporation, Partnership, Trust or Estate. The new law does not apply to the cost of acquiring an interest in these entities, even though they are intangibles, whether or not such interests are traded on an established market.[58] Accordingly, if you buy stock in a corporation paying a premium over the value of the tangible assets owned by the corporation, no amortization of such premium is permitted (unless a deemed asset election is made under IRC §338). Intangibles on the books of the corporation acquired prior to the new law would continue to be amortized, if amortizable at all, under whatever method was extant.

Interests Under Certain Financial Contracts. The term "§197 intangible" does not include such items as: An interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not regularly traded on an established market.

Interests in Land. The cost of acquiring land is to be taken into account under present law. Included in this category are fee interests, life estates, remainders, easements, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and similar rights with respect to land. However, an interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television. These items apparently will be amortizable over 15 years. The cost of licenses and permits relating to building construction are to be accounted for in accordance with prior law (i.e., part of the cost of the property).[59] As under prior law, no amortization or depreciation is allowed for land.

Computer Software. Software the public can buy that is subject to a non-exclusive license (typically store-bought or mail order software), and not substantially modified, is not a §197 intangible, whether acquired as part of the assets of a trade of business or

otherwise. If such software is not currently deductible under IRC §174 (Research and Experimental Expenditures) or amortizable over the depreciation period of the associated hardware where the cost is not separately stated,[60] it is to be amortized over 36 months beginning in the month placed in service.[61] Other computer software that is purchased as part of the assets of a trade or business is a §197 intangible, whereas if purchased separately it is not a §197 intangible. The term "computer software" is defined as any program designed to cause a computer to perform a desired function. However, it does not include a data base or similar item unless the data base is in the public domain and is incidental to the operation of the software.[62] An example of an incidental data base would be a dictionary or thesaurus. Since a data base (not in the public domain and incidental) acquired separately is not within the exception, it is a §197 intangible and subject to 15-year amortization. Other computer software acquired separately can be written off over 36 months.[63]

What is meant by "readily available to the public," "not substantially modified," and "in the public domain?" Unless clarified by regulations, these terms, which call for factual determinations, will sooner or later result in disagreement between taxpayers and the Government.

Since certain computer software acquired as part of the assets of a trade or business, and even a data base acquired separately, would have to be amortized over 15 years, a leasing arrangement may be preferable.

Separately Acquired Rights. The new law has numerous exceptions to the definition of a §197 intangible, provided the intangible is not acquired along with the assets of a trade or business or a substantial portion thereof. However, it is expected that regulations will address the situation where the separately acquired intangible is in and of itself a trade or business.[64] Facts and circumstances will determine whether acquired assets constitute a substantial portion of a trade or business. However, the value of assets acquired relative to the value of assets retained by the transferor will not be determinative. For purposes of determining whether a group of assets constitutes a trade or business, IRC §197 defers to IRC §1060 (i.e., if goodwill or going concern value attach to the assets acquired). Importantly, as noted above, the acquisition of a franchise, trademark, tradename or license automatically is deemed to constitute the acquisition of a business.[65] Under these rules, it is clear that the acquisition of even a single intangible asset could be a trade or business requiring 15-year amortization, thereby eviscerating the separately acquired asset exception. The Government is aware of the possibility of manipulation of the new rules by splitting up assets among related parties. Accordingly, in determining whether an acquired intangible asset is part of a trade or business, assets acquired by the taxpayer (and persons related to the taxpayer) from the same person (and related persons) are to be taken into account. Moreover, continuation of employee relationships and covenants-not-to-compete are to be considered in determining whether the transferred assets constitute a trade or business.[66]

- *Rights to Receive Tangible Property or Services.* Provided not acquired together with the assets of a trade or business, any right to receive tangible property or services granted by any governmental unit is not a §197 intangible. If a depreciation deduction is allowed for such rights, it will be determined by regulations to be promulgated by the Treasury Department. It is expected that if a non-renewable right is acquired, it will be amortizable over its life. With respect to a right to receive a fixed amount of tangible property or services, it is expected that amortization for the taxable year of the cost of acquiring the right will be based upon the relative value received during the year to the total value to be received under the right. It is also expected that the regulations, in appropriate circumstances, will require amortization of the cost of acquiring a renewable right over a period that includes all renewal options exercisable at less than fair market value.[67] Note that this exception pertains only to the right to receive tangible property or services. Thus, the exception does not cover the right to receive intangible property, such as know how.

- *Any Interest in a Patent or Copyright.* Patents and copyrights not acquired with the assets of a trade or business are not a §197 intangible. The amortization period of such items will be determined in accordance with Treasury Department regulations to be promulgated.[68] It is expected that the regulations will provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of revenue, that the depreciation deduction will be equal to the amount of royalty paid or incurred.[69]

- *Regulations Regarding Rights of Fixed Term or Duration.* Regulatory authority is granted to the Treasury Department to issue regulations excluding a contract right (whether to receive tangible or intangible property or services), including one granted by a governmental unit, from the definition of §197 intangible if the right is not acquired in connection with the assets of a trade or business, and the right has either (A) a fixed duration of less than 15 years, or (B) is fixed as to amount and the cost is properly recoverable under a method similar to the unit-of-production method. An example is an emission allowance granted to a public utility under Title IV of the Clean Air Act Amendments of 1990 since each allowance grants a right to a fixed amount of emissions. It is anticipated that in determining whether a contract is of fixed duration, the mere fact that the taxpayer will have the opportunity to renew on the same terms as others in a competitive auction in which the taxpayer does not have any advantage will not be taken into account. The facts and circumstances relative to an actual practice of renewals or expectancy of renewals will also be considered in determining whether a contract is of fixed duration. The regulations are also to prescribe rules concerning the extent to which renewal options are to be considered in determining whether rights are fixed as to duration or amount. Finally, such regulations are to prescribe the method of amortizing the cost of rights excluded from the definition of §197 intangible.[70]

Certain Interests Under Existing Leases and Indebtedness. The term §197 intangible does not include any interest as a lessor or lessee (or sublessee) under any existing lease of tangible personal property (real or personal). For example, the portion of the purchase

price of an office building attributable to favorable leases is excluded and is to be taken into account as part of the basis of the office building and depreciated accordingly. The cost of acquiring an interest as a lessee under an existing lease of tangible property is to be taken into account under existing law,[71] even if acquired with other assets of a trade or business. An example is a lease of a gate at an airport for the purpose of loading and unloading passengers and cargo. An interest as a creditor or debtor under any indebtedness in existence when the interest was acquired is also excluded. So, the value of an existing indebtedness because of a below-market interest rate is to be taken into account under prior law (i.e., over the term of the debt). A premium paid to acquire a debt with an above-market interest rate is to be taken into account under IRC §171 (amortization on a yield to maturity basis). The exception for existing indebtedness does not apply to the deposit base and other similar items of a financial institution for which 15-year amortization is apparently required.[72]

Professional Sports Franchises. Excluded are any franchise to engage in any professional sport, and any item acquired in connection with such franchise. Consequently, the cost of such franchise and related assets (including goodwill, going concern value, or other §197 intangibles) is to be allocated among the assets acquired as provided under prior law (i.e., under IRC §1060) and is to be taken into account under provisions of prior law.[73] This means that the purchase price allocable to the franchise and related assets may not be amortized (unless successfully litigated).[74] Player contracts, however, are a §197 intangible. Presumptively, no more than 50% of the consideration paid may be allocated to player contracts unless the taxpayer can convince the IRS that more should be allocable.[75]

Mortgage Servicing Contracts. Mortgage servicing contracts are any right to service debt secured by residential property. They are not covered under IRC §197 unless acquired with the assets of a trade or business.[76] If acquired separately, they can be amortized over 9 years.[77]

Transactional Costs. Excluded are the amount of professional fees paid in connection with corporate organizations and reorganizations. Organization costs are amortizable over 60 months.[78] Costs of a reorganization required to be capitalized have historically not been deductible nor amortizable because such costs do not relate to any asset with a readily identifiable useful life. The exception is provided solely to clarify that IRC §197 is not to be construed as allowing 15-year amortization for reorganization costs.[79]

Loss on Disposition. If a taxpayer disposes of an acquired §197 intangible and retains other §197 intangibles acquired in the same (or a series of related transactions), no loss on the disposition is allowed. Rather, the adjusted bases of the retained intangibles are to be increased by the disallowed loss in proportion to the relative amount of the bases of the retained intangibles. For purposes of this rule, corporations that are a member of a controlled group are treated as one person. Thus, one member of the controlled group cannot take a loss deduction on disposition of an acquired intangible if another member of the controlled group retains an intangible(s) acquired in the same transaction. It is expected that the Treasury Department will promulgate regulations permitting the loss on the disposition in such case to be amortized over the remaining time in the 15-year period.[80]

Abandonment. Greatly ameliorating the requirement of amortization over 15 years is the fact that abandonment of a §197 intangible or any other event that renders such intangible worthless is to be considered a disposition. Accordingly, if a §197 intangible is separately acquired, its unamortized cost may be written off if it is abandoned or becomes worthless. However, in no event can the worthlessness of a portion of a §197 intangible be considered the disposition of a separately acquired §197 intangible. For instance, the termination of one or more customers from a customer list or the worthlessness of some information from a data base is not to be considered the disposition of a separately acquired §197 intangible. Query? Will a write-off of the unamortized cost of a customer list be permitted where every customer on the original list is no longer on it? Hopefully, regulations will clarify this point. Of course, as noted, if one of a number of acquired intangibles becomes worthless or is abandoned, the unamortized cost would have to be allocated among the retained intangibles and no loss deduction would be permitted unless everything acquired in the same transaction was abandoned or became worthless.[81] Thus, it would appear, for example, that if an amount is allocated to goodwill and a covenant-not-to-compete for 5 years, both arising out of the same asset acquisition, both items would have to be amortized over 15 years. No loss deduction would be allowed for the unamortized cost of the covenant when it became worthless upon the expiration of the 5-year term; rather, such unamortized cost would have to be added to the unamortized basis of the goodwill and amortized along with it over the time remaining in the 15-year period. With respect to a covenant-not-to-compete created incident to a stock acquisition, it is made clear that the covenant will not be considered worthless or abandoned unless the stock becomes worthless, or all of the businesses acquired through the stock acquisition are also disposed of or become worthless.[82]

Not a Capital Asset. An amortizable §197 intangible is to be treated as depreciable property and consequently is not a capital asset. Thus gain or loss on disposition will be treated under IRC §1231 and any gain on disposition will be subject to recapture as ordinary income pursuant to IRC §1245, and IRC §1239 will apply to any gain recognized on a sale or exchange between related persons.[83]

Anti-Churning Rules. IRC §197 contains special rules to prevent taxpayers from converting existing intangibles that were not amortizable under prior law into amortizable property under the new law.[84] The anti-churning rules apply back to July 25, 1991. The rules address the following situations: (a) the taxpayer or a related person used the intangible at any time beginning on July 25, 1991, and ending on the date of enactment of the new law (i.e., after 8/10/93), (b) the taxpayer acquired the intangible from a person that held such intangible at any time beginning on July 25, 1991, and ending on the date of enactment and, as part of the transaction, the user of the intangible does not change, or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) at any time during the period beginning on July 25, 1991, and ending on the date

of enactment. In the above situations, the intangible in question will not be considered an amortizable §197 intangible. However, the anti-churning rules do not apply to inherited intangibles.[85] Relationships will be determined pursuant to IRC §§ 267(b)(1), 707(b)(1), relaxing ownership by substituting 20% for 50%, and 41(f)(1). Further details on the anti-churning rules are contained in the Conference Report.[86] Further, to make sure that ingenious taxpayers are not permitted to somehow circumvent the anti-churning rules or otherwise avoid the requirement that only intangibles acquired after the date of enactment of the new law may be amortized, a general anti-abuse provision is part of the new law.[87]

Certain Transfers. If the transferor of any §197 intangible is not allowed an amortization deduction with respect to any property classified under the new law, then the transferee of the property will not be allowed to amortize the property to the extent the transferee's basis is determined by reference to the transferor's basis pursuant to certain non-recognition transaction.[88]

CONCLUSION

With the enactment of IRC §197, the Government has taken a major step in eliminating and simplifying a very controversial area of the tax law. The Government was concerned about the severe backlog of cases in this area pending in audit and litigation. Accordingly, the IRS was urged in the strongest possible terms to expedite the settlement of cases that arose under the old law. To this end, the IRS was encouraged to take into account the principles of the new law so as to produce consistent results for taxpayers similarly situated.[89] Hopefully, since more than a year has gone by since enactment of the new law and the writing of this article, the IRS has made a dent in the backlog. Although the new law was enacted to simplify a controversial area, IRC §197 is not so simple, as the foregoing analysis clearly shows. As previously noted in a number of instances, the Treasury Department has been directed to issue explanatory regulations. Further, regulatory authority is specifically given to the Treasury Department to promulgate regulations as may be appropriate to prevent avoidance of the purposes of the new law through related persons or otherwise.[90] Since IRC §197 is lengthy and obviously intricate, it is certain that taxpayers can look forward to regulations that will be protracted and complex.

In determining whether the purchase of the assets of a going business makes economic sense, the fact that intangibles that heretofore were not amortizable (at least not without a fight) may now be amortized will, of course, have to be considered. Consequently, deals that were not financially feasible may now be so due to the reduced economic cost of acquiring such intangibles.

ENDNOTES

[1] Bulletin F - 1942.

[2] Rev. Proc. 62-21, 1962-2 CB 418.

[3] 1971 Revenue Act, P.L. 92-178.

[4] Economic Recovery Tax Act of 1981, P.L. 97-34.

[5] Tax Reform Act of 1984, P.L. 98-369.

[6] Public Law 99-21 (1985).

[7] Tax Reform Act of 1986, P.L. 99-514.

[8] Revenue Reconciliation Bill of 1993, P.L. 103-66, effective for commercial real estate acquired after May 13, 1993. The Revenue Reconciliation Bill is referred to herein as RRB '93.

[9] *For exceptions see, e.g.,* IRC § 178 (lease acquisition costs); IRC §174 (research and experimental expenditures); IRC §248 and IRC §709 (organizational expenses) and IRC §195 (start-up expenses). References herein to "IRC §" are to the applicable sections of the Internal Revenue Code of 1986, as amended.

[10] Treas. Reg. § 1.167(a)-3 (1960). References herein to "Treas. Reg. §" are to the applicable sections of the Treasury Regulations under the Internal Revenue Code of 1986.

[11] *See, e.g., Daniel J. Klein v. Comm.,* TC Memo 1965-207, *aff'd per curiam* 372 F.2d 261 (2d Cir. 1966).

[12] *Panichi v. U.S.,* 834 F.2d 300 (2d Cir. 1987).

[13] *Houston Chronicle Publishing Co. v. U.S.,* 481 F.2d 1240, 1249 (5th Cir. 1973), *cert. denied* 414 U.S. 1129 (1974)

[14] Rev. Rul 74-456, 1974-2 CB 65.

[15] In 1991, the General Accounting Office estimated that there were $8 billion in deficiencies asserted against taxpayers attempting to amortize intangibles (GGD-91-88, *"Tax Policy: Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets,* " (8/9/91)). A later estimate upped the ante to $14.4 billion of asserted adjustments related to amortization of intangible that were either in the audit or litigation pipeline (*Tax Notes Today* (10/4/93)).

[16] *Newark Morning Ledger Co. v. U.S.,* 945 F.2d 555 (3rd Cir. 1991), *rev'd* 113 S.Ct. 1670 (1993).

[17] Certiorari was granted in Newark to settle a perceived conflict in the circuit courts. *See, e.g., Donrey, Inc. v. U.S.,* 809 F.2d 534 (8th Cir. 1987) and *Citizens and Southern Corp. v. Comm.,* 91 TC 463 (1988), *aff'd* 919 F.2d 1492 (11th Cir. 1990).

[18] Conference Report, at 211 and 232. All references to the " Conference Report" herein are to the Conference Report on the RRB '93, H.R. Rep. No. 103-213, P.L. 103-66 (1993). Page references are to the Commerce Clearing House version of the Report (CCH Special 10).

[19] As most legal and tax advisers are aware, it is generally preferable to purchase the assets of a business rather than the stock of the corporation owning the assets since with a stock acquisition the purchaser is acquiring the corporate liabilities, known, unknown and contingent.

[20] IRC §1060.

[21] IRC §1060(a).

[22] IRC §1060(c).

[23] Temp. Treas. Reg. §1-1060-1T(b)(1). Facts and circumstances to be considered under the Regulations are an excess of total consideration over the aggregate book value of the tangible and intangible assets acquired, other than goodwill and going concern value, as shown in the financial and accounting records; and related transactions, including lease agreements, licenses, covenants-not-to-compete, employment contracts and similar arrangements between the purchaser and seller (or managers, directors, owners, or employees or the seller).

[24] Temp. Treas. Reg. §1.1060-T(d)(2).

[25] Temp. Treas. Reg. §1.1060-T(e)(1).

[26] Temp. Treas. Reg. §1.1060-T(e)(4).

[27] Temp. Treas. Reg. §1.1060-T(h). Form 8594, Asset Acquisition Statement, is required to be completed for any applicable asset acquisition and attached to the applicable tax form.

[28] The text of the Conference Report explaining §197 is contained in the revenue raising part of the Report.

[29] Conference Report, at 231.

[30] IRC §197(c). The section also applies to a stock purchase treated as an asset acquisition under

IRC § 338.

[31] IRC §197(c)(2)(B). IRC §197 expands on the term " trade or business" to include a "substantial portion thereof."

[32] IRC §197(b).

[33] IRC §197(c)(2)(B).

[34] IRC §197(c)(2)(A).

[35] IRC §197(d)(1)(D).

[36] Conference Report, at 215.

[37] IRC §197(d)(1)(E).

[38] In many cases a covenant-not-to-compete is obtained both from the corporate seller of the assets and the owners of the corporation. Usually, any consulting or employment agreement is entered into directly with the owners.

[39] However, as under prior law, it may make a difference to the seller since the amount received for selling goodwill qualifies for capital gain treatment whereas the amount receive for a covenant is ordinary income.

[40] Conference Report, at 216.

[41] *See* reference in IRC §197(d)(2)(E) of language "directly or indirectly" and Conference Report, at 216.

[42] Conference Report, at 216.

[43] *Id.*

[44] IRC §197(f)(4)(C).

[45] IRC §197(f)(4)(B).

[46] IRC §197(f)(4)(A).

[47] *IRC* §197(d) lists the various IRC §197 intangible assets.

[48] Conference Report, at 213.

[49] *Id.,* at 213.

[50] *See* Newark, *supra.*

[51] Conference Report, at 213-214.

[52] *Id.,* at 214.

[53] *Id.,* at 214.

[54] *Id.,* at 215.

[55] *Id.,* at 215.

[56] IRC §197(d)(1)(E).

[57] The exceptions to IRC §197 intangibles is contained in IRC §197(e).

[58] Conference Report, at 218.

[59] *Id.,* at 219

[60] *See* Rev. Proc. 69-21, 1969-2 CB 303.

[61] IRC §167(f)(1), as added by RRB '93; Conference Report, at 220.

[62] IRC §197(e)(3)(B).

[63] IRC §167(f)(1), as added by RRB '93.

[64] Conference Report, at 217.

[65] *Id.,* at 218.

[66] *Id.*

[67] *Id.,* at 220-221

[68] IRC §167(f)(2).

[69] Conference Report, at 221; *See* Associated Patentees, Inc., 4 T.C. 979 (1945) and Rev. Rul. 67-136, 1967-1 C.B. 58.

[70] Conference Report, at 223-225; IRC 167(f)(2), as added by RRB '93.

[71] *See* IRC §178 and Treas. Reg. § 1.162-11(a).

[72] Conference Report, at 221-223.

[73] *Id.,* at 223.

[74] *See* Committee Report to 1976 Tax Reform Act, P.L. 94-455 (1976), 1976-3 CB 49, 807.

[75] IRC §1056(d).

[76] IRC §197(e)(7).

[77] IRC §167(f)(3). *Also, see* IRC §1286 and the Conference Report, at 237. *Also, see* Conference Report, at 229, regarding assumption reinsurance contracts.

[78] IRC §248.

[79] Conference Report, at 223.

[80] *Id.,* at 226.

[81] *Id.*

[82] *Id.,* at 237-238; IRC §197(f)(1)(B).

[83] Conference Report, at 230.

[84] IRC § 197(f)(9).

[85] IRC §197(f)(9)(D).

[86] Conference Report, at 234-235.

[87] IRC §197 (f)(9)(A); Conference Report, at 235-236.

[88] Conference Report, at 236; IRC §197(f)(2).

[89] *Id.*, at 232.

[90] IRC §197(g).