

Business Law (Gehrett)

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I developed the new Business Law course to be used in the Business Management program at Western Technical College. This course is designed to introduce students to basic law terminology while connecting legal concepts to the world of business.

This project has great potential to eliminate unnecessary costs and time to students by offering them an overview of business law with readings, graphics, and videos all located in one convenient place. Students will have an opportunity to learn vocabulary, ethics, case studies, and see the law as it works in business with current events.

While creating this course, I was able to incorporate opportunities for students to learn in different ways. Finding current business cases to add to the readings will help students connect the material to the real world.

Overall, this project has been a great experience. I hope to hear positive feedback from faculty and students once this class begins.

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1.1: Key Ideas

Module 1: Key Ideas

- British Common Law
- Case Law
- Precedent
- Federal
- State
- Local
- The Constitution

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SECTION OVERVIEW

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1.2.1: Introduction

Learning Objectives

- Describe the foundation and sources that establish American law.



Figure 1.2.1.1: Introduction (Credit: MarkThomas /pixabay /Attribution 2.0 Generic (CC BY 2.0))

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1.2.2: Basic American Legal Principles

The American legal system has its roots in the British legal system. It was developed with the purpose of establishing standards for acceptable conduct, proscribing punishment for violations as a deterrent, establishing systems for enforcement, and peacefully resolving disputes. The ultimate goal of the American legal system is promotion of the common good.

Establishing Standards

The American legal system was developed with the goal of establishing a set of standards that outline what is to be considered minimally acceptable behavior. Broadly speaking, federal laws are those that all United States citizens are expected to follow. State and local laws may often be similar to federal laws, but they may also differ quite a bit, and only govern the state's citizens.



Figure 1.2.2.1: The American legal system is designed to establish a set of standards for acceptable behavior. (Credit: joergelman/pixabay/ License: CC0)

Promoting Consistency

The American legal system follows the British Common Law system, which is designed to leverage past judicial reasoning, while also promoting fairness through consistency. Judges in the Common Law system help shape the law through their rulings and interpretations. This body of past decisions is known as **case law**. Judges use case law to inform their own rulings. Indeed, judges rely on **precedent**, i.e., previous court rulings on similar cases, for ruling on their own cases.

All U.S. states, except Louisiana, have enacted “reception statutes,” stating that the judge-made common law of England is the law of the state to the extent that it does not conflict with the state’s current laws.

However, the body of American law is now so robust that American cases rarely cite English materials, except for a British classic or a famous old case. Additionally, foreign law is not cited as binding precedent. Therefore, the current American practice of the common law tradition refers more to the process of judges looking to the precedent set jurisdictionally, and substantially similar to, American case law.

Maintaining Order

Congruent with the goal of establishing standards and promoting consistency, laws are also used to promote, provide, and maintain order.

Resolving Disputes

Conflicts are to be expected given people’s varying needs, desires, objectives, values systems, and perspectives. The American legal system provides a formal means for resolving conflicts through the courts. In addition to the federal court and individual state systems, there are also several informal means for resolving disputes that are collectively called alternative dispute resolution (ADR). Examples of these are mediation and arbitration.

Protecting Liberties and Rights

The United States Constitution and state laws provide people with many liberties and rights. American laws operate with the purpose and function of protecting these liberties and rights from violations by persons, companies, governments, or other entities.

Based on the British legal system, the American legal system is divided into a federal system and a state and local system. The overall goal of both systems is to provide order and a means of dispute settlement, as well as to protect citizens' rights.

Clearly, the purposes of the American legal system are broad and well-considered.

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1.2.3: Sources and Types of Law

The American legal system is made up of many types of codified forms of law, with the United States Constitution being the pre-eminent source of American law. The Constitution establishes the boundaries of federal law, and it must be followed by all citizens, organizations, and entities. It includes Congressional acts, Senate-ratified treaties, executive regulations, and federal case law. The United States Code (“USC”) compiles these laws.

American law mainly originates from constitutional law, statutory law, treaties, administrative regulations, and common law (which includes case law).

The Constitution

The United States Constitution is the foremost law of the land. The Constitution’s first ten amendments are referred to as the Bill of Rights, which offers specific protections of individual liberty and justice. Additionally, the Bill of Rights restricts certain powers of government. The Constitution empowers federal law making by giving Congress the power to enact statutes for certain limited purposes, like regulating interstate commerce. The United States Code officially compiles and codifies the federal statutes.



Figure 1.2.3.1: The U.S. Constitution is known as the supreme law of the land. (Credit: lyn0101/ pixabay/ License: CC0)

American Common Law

As discussed in the previous section, the United States follows the common law legal tradition of English law. Judges in the Common Law system help shape the law through their rulings and interpretations. This body of past decisions is known as **case law**, which is used by judges to inform their own rulings. In fact, judges rely on **precedent**, i.e., previous court rulings on similar cases, when determining the ruling in their own cases.

An example of how case law works is the case of the State v. Wayfair Inc. (2017 SD 56, 901 N.W.2d 754 (S.D. 2017), cert. granted, 138 S. Ct. 735 (2018)), in which the South Dakota Supreme Court held that a state law requiring internet retailers without an in-state physical presence to remit sales tax was unconstitutional. Unless this ruling is overruled by the United States Supreme Court,

then it becomes part of the case law and precedent set in that state, and it will be followed by subsequent rulings when similar cases are filed.

Federal Law

The Constitution empowers federal law making by giving Congress the power to enact statutes for certain limited purposes, like regulating interstate commerce. Federal law preempts conflicting state and local laws. However, federal preemption is not without limits, insofar as states each have their own constitution and are considered sovereign. Therefore, federal law may only preempt state law if it is enacted within the limited powers that are enumerated and granted to Congress in the Constitution.

Broad interpretations of the Constitution's Commerce and Spending Clauses have expanded the reach of federal law into many areas. Indeed, its reach in some areas, such as aviation and railroads, is now so broad that it preempts virtually all state law. In others areas, such as family law, lawmaking continues to be left to the states. Finally, a number of powerful federal and state laws coexist in areas such as antitrust, trademark, employment law, and others.

Statutes

When a bill becomes a federal law, it is assigned a law number and prepared for publication by the Office of the Federal Register (OFR) of the National Archives and Records Administration (NARA). Public laws are also given legal statutory citation by the OFR and are incorporated into the United States Code (USC).

Regulations

Laws differ from regulations in that laws are passed by either the U.S. Congress or state congresses. Regulations, by contrast, are standards and rules adopted by administrative agencies that govern how laws will be enforced.

Federal agencies often enjoy broad rulemaking authority when Congress acts to grant them this power. Called "regulations," these agency rules normally carry the force of law, as long as they demonstrate a reasonable interpretation of the relevant statutes. For example, the Environmental Protection Agency (EPA) has established regulations for businesses and their emission and disposal of pollutants to protect the environment. The EPA has the authority to enforce these regulations when a business violates them, and such enforcement is usually done by fining the company or by using other means.

The Administrative Procedure Act (APA) enables the adoption of regulations, which are codified and incorporated into the Code of Federal Regulations (CFR). Federal agencies frequently draft and distribute forms, manuals, policy statements, letters, and rulings. Though these may be considered as persuasive authority by the courts, they do not carry the same force as law. In other words, if a person or business questions a regulation of a government agency, saying it is unconstitutional, and that party is successful in proving it, then the regulation is not enforced and the agency will need to revise it or remove it.

State Law

America, as diverse as its fifty states, is also governed by fifty different state constitutions, state governments, and state courts. Each has its own legislative, executive, and judicial branches. States are empowered to create legislation that is related to matters not preempted by the federal Constitution and federal laws. Most cases involve state law issues and are litigated in state courts.

Local Law

In addition to federal and state law, municipalities, towns or cities, and counties may enact their own laws that do not conflict with state or federal laws.

As demonstrated, American law does not draw from one source alone; instead, it is derived from many sources.

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1.2.4: Important Business Laws and Regulations

Business law is a very expansive area of the law. It primarily addresses issues related to the creation of new businesses, which arise as existing companies deal with the public, government, and other companies. Business law consists of many legal disciplines, including contracts, tax law, corporate law, intellectual property, real estate, sales, immigration law, employment law, bankruptcy, and others.



Figure 1.2.4.1: Contract law is just one type of law that businesses need to be concerned about. (Credit: edar/ pixabay/ License: CC0)

As noted, business law touches upon a number of other legal areas, practices, and concerns. Some of the most important of these, which are discussed in this section, are disputes and dispute settlement, business ethics and social responsibility, business and the United States Constitution, criminal liability, torts, contracts, labor and employment law, Unfair Trade Practices and the Federal Trade Commission, international law, and securities regulation. Though they are discussed in much more depth in later chapters, the following gives a brief overview.

Disputes and Dispute Settlement

In addition to the federal court and individual state systems, there are also a variety of mechanisms that companies can use to resolve disputes. They are collectively called alternative dispute resolution (“ADR”), and they include mediation, settlement, and arbitration. Many states now require companies to resolve legal disputes using ADR before the initiation of any lawsuit to encourage speedy resolution, cost and time containment, and reduced judicial dockets. Traditional litigation remains an option in most cases if other efforts fail or are refused.

Business Ethics and Social Responsibility

In the routine course of business, employees are often required to make decisions. Business ethics outline the ethical model, or framework, that companies expect employees to follow when making these decisions, as well as the behavior that the companies deem acceptable. Sound and ethical decision making can also help companies avoid legal liability and exposure. Typically, an

ethics code and/or a code of conduct details a company's requirements and guidelines, while also serving as a key corporate governance tool.

In addition to business ethics, companies must also consider their social responsibility and the laws related to it, such as consumer and investor protections, environmental ethics, marketing ethics, and ethical issues in financial management.

Business and the United States Constitution

Since the start of the 20th century, broad interpretations of the Constitution's Commerce and Spending Clauses have expanded the reach of federal law into many areas. Indeed, its reach in some areas is now so broad that it preempts virtually all state law. Thus, the Constitution's Commerce Clause has been interpreted to allow federal lawmaking and enforcement that applies to many aspects of business activity. Additionally, the Constitution's Bill of Rights extends some protections to business entities that are also constitutionally guaranteed to individuals

For example, on January 21, 2010, in *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010), the U.S. Supreme Court heard the issue of whether the government can ban political spending by corporations in candidate elections. The Court ruled that corporations have the same Constitutional right to free speech as individuals, and thus lifted the restrictions on contributions.

Criminal Liability

The imposition of criminal liability is one method used to regulate companies. The extent of corporate liability found in an offensive act determines whether a company will be held liable for the acts and omissions of its employees. Criminal consequences may include penalties, such as prison, fines and/or community service. In addition to criminal liability, civil law remedies are usually available, e.g., the award of damages and injunctions, which may include penalties. Most jurisdictions apply both criminal and civil systems.

Torts

Within the business law context, torts may involve either intentional torts or negligence. Additionally, companies involved in certain industries should consider the risk of product liability. Product liability involves a legal action against a company by a consumer for a defective product that caused loss or harm to the customer. There are several theories regarding recovery under product liability. These include contract theories that deal with the product warranty, which details the promises of the nature of the product sold to customers. The contract product warranty theories are Express Warranty, Implied Warranty of Merchantability, and Implied Warranty of Fitness. Tort theories deal with a consumer claim that the company was negligent, and therefore caused either bodily harm, emotional harm, or monetary loss to the plaintiff. The tort liability theories that can be used in this context are negligence (failure to take proper care in something), strict liability (imposition of liability without a finding of fault), and acts committed under Restatement (Third) of Torts (basic elements of the tort action for liability for accidental personal injury and property damage, as well as liability for emotional harm).

Contracts

The main function of a contract is to document promises that are enforceable by law. The key to an agreement or contract is that there must be an offer and acceptance of the terms of that offer. Sales contracts normally involve the sale of goods and include price terms, quantity and cost, how the terms of the contract will be performed, and method of delivery.

Employment and Labor Law

Employment and labor law is a very broad discipline that covers a broad array of laws and regulations involving employer/employee rights and responsibilities in the workplace. This law includes worker protection and safety laws, such as OSHA, and worker immigration laws, such as the Immigration Reform and Control Act, which imposes sanctions on employers for knowingly hiring illegal immigrants. Other notable areas of employment and labor law include, but are not limited to, the National Labor Relations Act, which deals with union and management relations, as well as Equal Opportunity in Employment laws, which provide workers with protections against discrimination in the workplace, e.g., Title VII, the Americans with Disabilities Act, Age Discrimination in Employment Act, and others.

Antitrust Law

Antitrust legislation includes both federal and state laws regulating companies' conduct and organization. The purpose of such regulation is to allow consumers to benefit from the promotion of fair competition. The main statutes implicated by antitrust law

are the Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914. These Acts discourage the restraint of trade by prohibiting the creation of cartels and other collusive practices. Additionally, they encourage competition by restricting the mergers and acquisitions of certain organizations. Finally, they prohibit the creation and abuse of monopoly power.

Actions may be brought in courts to enforce antitrust laws by the Federal Trade Commission (“FTC”), the U.S. Department of Justice, state governments, and private parties.

Unfair Trade Practices and the Federal Trade Commission

The term “unfair trade practices” is broadly used and refers to any deceptive or fraudulent business practice or act that causes injury to a consumer. Some examples include, but are not limited to, false representations of a good or service including deceptive pricing, non-compliance with manufacturing standards, and false advertising. The FTC investigates allegations of unfair trade practices raised by consumers and businesses, pre-merger notification filings, congressional inquiries, or reports in the media and may seek voluntary compliance by offending businesses through a consent order, administrative complaints, or federal litigation.

Securities Regulation

Securities regulation involves both federal and state regulation of securities and stocks by governmental regulatory agencies. At times, it may also involve the regulations of exchanges like the New York Stock Exchange, as well as the rules of self-regulatory organizations like the Financial Industry Regulatory Authority (FINRA).

The Securities and Exchange Commission (SEC) regulates securities on the federal level. Other instruments related to securities, such as futures and some derivatives, are regulated by the Commodity Futures Trading Commission (CFTC).

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1.2.5: End Notes

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1.2.E: Assessment Questions

1. What country is the United States legal system derived from?
 - a. Germany.
 - b. United Kingdom.
 - c. United States of America.
 - d. Canada.

Answer

b

2. What is the function of law in the United States?
 - a. Establish standards.
 - b. Promote consistency.
 - c. Promote, provide, and maintain order.
 - d. All of the above.
3. As a judge, Baxter applies common law rules. These rules develop from:
 - a. Decisions of the courts in legal disputes.
 - b. Regulations issued by administrative agencies.
 - c. Statutes enacted by Congress and the state legislatures.
 - d. Uniform laws drafted by legal scholars.

Answer

a

4. What is the difference between state and federal law?
5. The legislature of the state of Wyoming enacts a new statute that sets standards for the liability of businesses selling defective products. This statute applies in:
 - a. Wyoming only.
 - b. Only Wyoming and its bordering states.
 - c. All states.
 - d. All states but only to matters not covered by other states' laws.

Answer

a

6. Alex has been sued by Will for failure to pay rent for their apartment which source of law will govern this lawsuit?
 - a. Administrative law.
 - b. The Constitution.
 - c. Civil Law.
 - d. Criminal Law.
7. Four sources of law in the U.S. legal system are:
 - a. Constitutional law, criminal law, civil law, and maritime law.
 - b. Federal law, state law, international law, and maritime law.
 - c. Statutory law, case law, equity, and common law.
 - d. Constitutional law, judicial law, legislative law, and administrative law.

Answer

d

8. Where can you find a codification of federal laws?
 - a. The library.

- b. Federal Court.
- c. United States Code.
- d. U.S. Library of Congress.

9. What is the supreme law of the land? What are statutes? What are ordinances? What is an administrative rule?

Answer

What is the supreme law of the land? - The federal constitution is the supreme law of the land.

What are statutes? - Laws enacted by Congress or a state legislative body.

What are ordinances? - Laws enacted by local legislative bodies.

What are administrative rules? - Laws issued by administrative agencies under the authority given to them in statutes.

10. Regulations are:

- a. Laws passed by Congress.
- b. Rules made by local governments.
- c. Derived from decisions made by judges.
- d. Rules adopted by administrative agencies.

11. What is an Unfair Trade Practice and which Administrative Agency regulates it?

Answer

The term “unfair trade practices” is broadly used and refers to any deceptive or fraudulent business practice or act that causes injury to a consumer. Some examples include, but are not limited to, false representations of a good or service including deceptive pricing, non-compliance with manufacturing standards, and false advertising. The FTC investigates allegations of unfair trade practices raised by consumers and businesses, pre-merger notification filings, congressional inquiries, or reports in the media and may seek voluntary compliance by offending businesses through a consent order, administrative complaints, or federal litigation.

12. Some of the rights in the Constitution’s Bill of Rights extends to Corporations.

- a. True.
- b. False.

13. Forms of Alternative Dispute Resolution (“ADR”) include all of the following except:

- a. Mediation.
- b. Settlement.
- c. Litigation.
- d. Arbitration.

Answer

c

14. Consequences of being convicted a crime include all of the following except:

- a. Prison.
- b. Fines.
- c. Community service.
- d. Damages.

15. Securities are only regulated by federal laws.

- a. True.
- b. False.

Answer

b

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1.3: REVIEW- The Four Sources of Law



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SECTION OVERVIEW

1.4: Business and the United States Constitution

1.4.1: Business and the United States Constitution

1.4.1.1: Introduction

1.4.1.2: Commerce Clause

1.4.1.3: Constitutional Protections

1.4.1.4: End Notes

1.4.1.E: Assessment Questions

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SECTION OVERVIEW

1.4.1: Business and the United States Constitution

1.4.1.1: Introduction

1.4.1.2: Commerce Clause

1.4.1.3: Constitutional Protections

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1.4.1.1: Introduction

Learning Objectives

- Explain the impact of the U.S. Constitution on business.



Figure 1.4.1.1.1: Introduction (Credit: geralt/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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1.4.1.2: Commerce Clause

The Constitution and the Law

Federal and state constitutions are a major source of business law. **The United States Constitution** is the supreme law of the United States. In addition to the individual constitutions established in each state, the U.S. Constitution sets out the fundamental rules and principles by which the country and individual states are governed. Constitutional law is the term used to describe the powers and limits of the federal and state governments as established in the Constitution. The political system that divides authority to govern between the state and federal governments is known as **federalism**, and this too is established in the Constitution. The Tenth Amendment states that any area over which the federal government is not granted authority through the Constitution is reserved for the state. This statement means that any federal legislation impacting business and commerce must be established by an expressed constitutional **grant of authority**.



Figure 1.4.1.2.1: The United States Constitution is the supreme law of the land. (Credit: 1778011/ pixabay/ License: CC0)

Federal Preemption

The Founding Fathers created a federal system that would, at times, “preempt” state law through the **supremacy clause**, outlined in Article VI of the Constitution. In other words, since the U.S. Constitution is the “supreme law of the land,” if a state law conflicts with the U.S. Constitution, the state law is declared invalid. When the federal constitutional law prevails over the state law, it is said that the state law has been **preempted**. Before that determination is made, the courts try to determine if Congress intended to preempt state law in enacting the particular provision in question. If the answer is “no,” then those who are asserting protections of state law may make claims under state law. If the answer is “yes,” however, federal law prevails.

The Tenth Amendment to the Constitution gives the states powers over areas of law not held exclusively by the federal government through the U.S. Constitution, e.g., states can make laws about how to get married, who may get married, or how to dissolve a marriage, as well as which activities are crimes and how the crimes will be punished. If the U.S. Constitution does give the federal government some power, however, then the federal government may exercise it, free from state interference. For instance, the U.S. Congress (the legislative branch of the federal government) has the power, among other things, to coin money, to create a military, to establish post offices, and to declare war. Since there is specific mention of these powers, states may not create their own currency, military, or postal service, and they may not declare war.

The Commerce Clause and The Affordable Care Act

After much debate, negotiation, and political wrangling, Congress passed the Patient Protection and Affordable Care Act (PPACA) in 2010, which was designed to increase the number of Americans who had access to health insurance (a policy initiative known as Obamacare). The Act included a provision mandating that individuals not insured through employment or who were otherwise exempt from receiving health insurance obtain minimum essential health insurance or face a penalty issued through the Internal Revenue Service (IRS). The National Federation of Independent Business (NFIB), supported by 26 of the 50 states, challenged the constitutionality of this particular provision, known as the individual mandate. Their argument was upheld by the 11th Circuit Court of Appeals, which ruled that Congress did not have the authority to enact this provision. Later, however, the appellate court determined that the individual mandate was severable from the remainder of the PPACA, so ultimately the Act was upheld.

The main source of authority for the federal regulation of interstate and international commerce is the **commerce clause**. This clause is established in Article I, Section 8, of the Constitution. The Article grants Congress the power to “regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” Thus, the commerce clause serves to simultaneously empower the federal government, while limiting state power.

So long as a federal regulation impacts interstate commerce, that regulation can be described as constitutional, according to the commerce clause. However, since the Constitution was first written, there have often been occasions when the judiciary system has needed to step in to interpret the meaning and implications of the commerce clause. In particular, there have been disputes over the intended meaning of the phrase “among the several States.” Up until the 1930s, this phrase was interpreted in a literal way, so that activities subject to federal regulation were required to involve trade between the states. This strict interpretation actually served to limit the federal regulation of commerce.

The turning point in the interpretation of the commerce clause came with the 1937 case, *NLRB v. Jones & Laughlin Steel Corp.* The previous year, in the *Carter v. Carter Coal Co* case, the court invalidated a program, initiated under the New Deal, that had tried to regulate the labor practices of coal firms on the basis that these practices were local, and therefore had only an indirect impact on interstate commerce. In *NLRB v. Jones & Laughlin Steel Corp.*, the court deviated from that decision by ruling that Congress could regulate employment practices at a steel plant because any stoppages at that plant would have a serious, detrimental impact on interstate commerce. The court concluded that since the steel industry is a networked industry that incorporates mines, plants, and factories from Minnesota to Pennsylvania, the manufacturing of steel properly falls under the jurisdiction of the commerce clause. In summing up, the court concluded that:

“Although activities may be intrastate in character when separately considered, if they have such a close and substantial relationship to interstate commerce that their control is essential or appropriate to protect that commerce from burdens or obstructions, Congress cannot be denied the power to exercise that control” (NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 1937).

Challenges to and Reinterpretations of the Commerce Clause

Ever since the *NLRB v. Jones & Laughlin Steel Corp* case, Congress has invoked the commerce clause to rule on a diverse range of business and commercial activities, as well as to support social reforms that indirectly impact state commerce. Examination of the United States Code reveals that there are more than 700 legislative provisions that explicitly refer to foreign or interstate commerce. What is perhaps most remarkable is the sheer diversity of statutory areas covered by the commerce clause. Areas covered include the regulation of sporting activities, endangered species, energy regulation, gambling, firearms control, and even terrorism.

Examples of Federal Legislation Passed by Invoking the Commerce Clause

- The Controlled Substances Act
- The Federal Mine Safety and Health Act
- The Civil Rights Act
- Americans with Disabilities Act
- The Indian Child Welfare Act

While businesses have often challenged these statutes as existing outside of the realm of congressional authority, in most cases, the courts have upheld the statutes as being valid exercises of congressional power in line with the commerce clause. An exception is the 1995 case, *United States v. Lopez*. The case centered around the legality of the Gun-Free School Zone Act, which was a federal law that outlawed the possession of guns within 1,000 feet of a school. In a landmark case, the Court ruled that the Act was outside the scope of the commerce clause, and that Congress did not have the authority to regulate in an area that had “nothing to do with commerce, or any sort of enterprise.”

A recent controversy pertaining to the commerce clause relates to the passing of the Affordable Care Act, as described earlier. Protestors claimed that the individual mandate aspect of the ACA should be treated as a regulation that affects interstate commerce. According to their argument, after the Act was implemented, there would be an increase in the sale and purchase of health care insurance, such that the market for health care should be seen as being significantly impacted by the Act. However, the Chief Justice of the Supreme Court, Justice Roberts, ruled that actions that create new business activity do not affect interstate commerce.

Police Power and the Dormant Commerce Clause

The authority of the federal government to regulate interstate commerce has, at times, come into conflict with state authority over the same area of regulation. The courts have tried to resolve these conflicts with reference to the **police power** of the states.

Police power refers to the residual powers granted to each state to safeguard the welfare of their inhabitants. Examples of areas in which states tend to exercise their police power are zoning regulations, building codes, and sanitation standards for eating places. However, there are times when the states' use of police power impacts interstate commerce. If the exercise of the power interferes with, or discriminates against, interstate commerce, then the action is generally deemed to be unconstitutional. The limitation on the authority of states to regulate in areas that impact interstate commerce is known as the **dormant commerce clause**.

In using the dormant commerce clause to resolve conflicts between state and federal authority, the courts consider the extent to which the state law has a legitimate purpose. If it is determined that the state law has a legitimate purpose, then the court tries to determine whether the impact on interstate commerce is in the interest of the citizens of the state, and will rule accordingly. For instance, an ordinance that banned spray paint, issued in the city of Chicago, was challenged by paint manufacturers under the dormant commerce clause, but was ultimately upheld by the U.S. Court of Appeals because the ban was intended to reduce graffiti and related crimes.

Today, Congress uses its authority to regulate commercial activity in four general areas relating to the commerce clause:

1. Regulation of the channels of interstate commerce
2. Regulation of the instrumentalities of interstate commerce
3. Regulation of intangibles and tangibles that cross state lines
4. Regulation of activities that are deemed to be both economic and to have a substantial impact on interstate commerce

Table 1.4.1.2.1

Area of Regulation	Explanation	Examples
Regulation of the channels of interstate commerce	Channels of interstate commerce describe the passages of transportation between the states. Thus, the commerce clause authorizes Congress to regulate activities pertaining to the nation's airways, waterways, and roadways, and even where the activity itself takes place entirely in a single state.	For example, Congress can pass regulations that restrict what can be carried on airlines or on ships.
Regulation of the instrumentalities of interstate commerce	Instrumentalities of commerce are understood to be any resource employed in the carrying out of commerce. Examples of these resources are machines, equipment, vehicles, and personnel. Thus, Congress has the power to regulate these areas.	Congress could pass regulations mandating certain safety standards for equipment used in manufacturing plants.
Regulation of intangibles and tangibles that cross state lines	Any object, tangible or intangible, that crosses state lines can be regulated under the commerce clause. Tangible objects include goods purchased by consumers, as well as raw materials and equipment used in the production of goods for sale. Intangible objects include services, as well as electronic databases.	The Driver's Privacy Protection Act (DPPA) regulates the sale of information contained in the Department of Motor Vehicles' (DMV's) records.

Area of Regulation	Explanation	Examples
Regulation of activities that are deemed to have a substantial impact on interstate commerce	Federal regulation of economic commercial activity expected to have a significant (as opposed to minor) effect on interstate commerce is constitutional, according to the commerce clause. Noneconomic commercial activity is not covered.	The courts in the United States vs. Lopez case described earlier deemed the Act to be unconstitutional because its terms have “nothing to do with ‘commerce’ or any sort of economic enterprise.”

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1.4.1.3: Constitutional Protections

The Bill of Rights is the common term given to the first 10 amendments to the U.S. Constitution. These are not the only set of amendments to the Constitution, but they are considered together as impacting rights because they limit the ability of the federal government to infringe upon individual freedoms. In addition, a later amendment, the Fourteenth Amendment, extends the provisions set out in the Bill of Rights to the states, in addition to federal government. The Bill of Rights has a substantial impact upon government regulation of commercial activity, and therefore, it is important to fully understand it.

A summary of the provisions of the Bill of Rights is supplied below:

Table 1.4.1.3.1

Amendment	Provision
First	Ensures that U.S. citizens have the right to freedom of speech, press, religion, and peaceable assembly. Provides citizens with the right to appeal to government to redress grievances.
Second	Establishes that the government cannot infringe upon citizens' right to bear arms. Establishes the importance of a militia for national security.
Third	Establishes that the government cannot quarter soldiers in private houses during peacetime or wartime.
Fourth	States that government can only issue warrants with probable cause and protects U.S. citizens from unwarranted search and seizure.
Fifth	Establishes rights of due process. Ensures that indictment of a grand jury is necessary to put a citizen on trial and grants citizens the right not to testify against themselves.
Sixth	Provides citizens with the right to an expeditious public trial, the right to an attorney, and the right to an impartial jury.
Seventh	States that citizens have the right to a trial by jury for common lawsuits involving monetary value of \$20.
Eighth	Prohibits cruel and unusual punishment, prevents the imposition of excessive fines, and states that the government cannot set bail at excessive amounts.
Ninth	States that the rights set out in the Bill of Rights do not remove any other rights granted to citizens.
Tenth	States that any area over which the federal government is not granted authority through the Constitution is reserved for the states.

Application of the Bill of Rights to Commercial Activity

The protections afforded the citizenry in the Bill of Rights are also extended to corporations and commercial activities. In the next sections, some applications of the various amendments in the area of business are discussed.

The First Amendment

The freedom of speech provisions in the First Amendment have application to corporations. The courts distinguish between different types of speech, and each has implications for the power of the federal government and states to regulate in these areas:

1. **Corporate Political Speech.** Political speech is any speech used to support political agendas or candidates. Until the 1970s, several states prevented firms from financially supporting political advertising because they feared the power of corporate

assets. However, since the 1978 case *First National Bank of Boston v. Bellotti*, it has been established that corporate political speech is protected in the same way as citizens' free speech.

2. **Unprotected Speech.** The 1942 case *Chaplinsky v. New Hampshire* determined that certain types of speech—that which could “inflict injury or incite an immediate breach of the peace”—is not protected under the First Amendment. Therefore, obscenities, defamation, and slanderous speech are not protected.
3. **Commercial Speech.** This type of speech conveys information pertaining to the sale of goods and services. Ever since the 1980 case *Hudson Gas & Electric Corp v. Public Service Commission of New York*, a four-part test has been established to determine whether commercial speech should be regulated according to the First Amendment. This test is known as **The Central Hudson Test for Commercial Speech**.

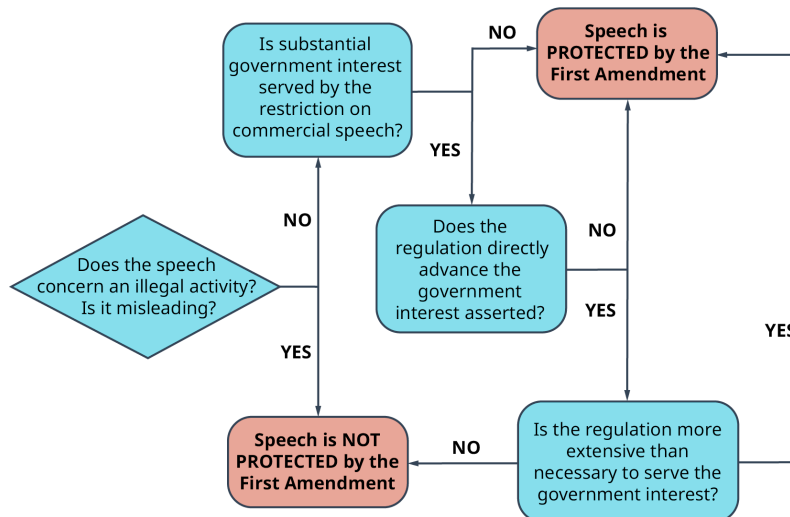


Figure 1.4.1.3.1 : Hudson Gas & Electric Corp v. Public Service Commission of New York established a four-part test to determine whether commercial speech should be regulated according to the First Amendment. (Modification of art by BNED/pixabay Credit: CC BY NC SA)

The **free exercise clause** of the First Amendment states that government is prohibited from making laws that prohibit the free exercise of religion. Issues pertaining to this clause often arise in organizational settings. For example, historically, there have been a number of cases in which government employees have challenged employers' attempts to inhibit their exercise of religious practice (e.g., the wearing of religious symbols) in the workplace.

The Fourth Amendment

The Fourth Amendment guarantees that citizens are free from unreasonable searches and seizures, and requires government officials to obtain **search warrants** to conduct searches. However, government officials can only request a search warrant if they have **probable cause** to believe that criminal activity is occurring at the location of the search, or that they will locate evidence of criminal activity during the search (except where the official believes items will be removed prior to obtaining a warrant). The Fourth Amendment protects individual organizations and places of business, as well as residences. However, under the terms of the **pervasive-regulation exception**, administrative agencies can conduct warrantless searches of businesses attached to industries that have a long history of pervasive regulation. For example, public health agencies are allowed to conduct warrantless searches of stone quarries, as authorized by the Federal Mine Safety and Health Act of 1977.

The Fifth Amendment

For commercial enterprises and businesspeople, it is the **due process clause** of the Fifth Amendment that offers the most extensive protection. The clause states that the government cannot take an individual's life, liberty, or property without due process of law. Specifically, there are two types of due process:

- **Substantive due process** means that laws that will deprive an individual of his or her life, liberty, or property must be fair and not arbitrary. Laws passed should not affect fundamental rights, and regulations are required to meet the **rational-basis test**. In other words, the government must demonstrate that the law bears a rational relationship to a legitimate state interest. Many regulations affecting commercial activity, such as banking regulations, minimum wage laws, and regulations inhibiting unfair trade, have been tested against the rational-basis test.

- **Procedural due process** means that governments must use fair procedures when depriving an individual of his or her life, liberty, or property. This status quo does not only apply to federal criminal proceedings. For example, if a government employer discharges an employee from his job, or if the government suspends the driver's license of a worker, the employer must follow procedural due process.

Another clause contained in the Fifth Amendment that is relevant to commercial enterprises is the **takings clause**. According to this clause, when the government seizes private property for public use, it is required that the government pay the owner **just compensation** for the property. Just compensation is understood to be equivalent to the market value of the property. This clause has been broadly interpreted. For example, if environmental or safety regulations significantly impact the way in which a property owner can use his or her land for economic gain, the regulation can essentially be deemed as depriving the owner of his or her land, and the owner is entitled to compensation.

It is important to note that the **privilege against self-incrimination**, established under the Fifth Amendment (usually interpreted as the right to remain silent), only applies to sole proprietorships that are not legally distinct from the individual who owns them. Custodians and agents of corporations do not enjoy this privilege.



Figure 1.4.1.3.2: The various protections afforded the citizenry in the Bill of Rights are also extended to corporations and commercial activities. (Credit: Anthony Garand/ unsplash/ License: Unsplash License)

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1.4.1.E: Assessment Questions

1. Explain Police Power and the Dormant Commerce Clause.

Answer

The authority of the federal government to regulate interstate commerce has, at times, come into conflict with state authority over the same area of regulation. The courts have tried to resolve these conflicts with reference to the police power of the states.

Police power refers to the residual powers granted to each state to safeguard the welfare of their inhabitants. Examples of areas in which states tend to exercise their police power are zoning regulations, building codes, and sanitation standards for eating places. However, there are times when the states' use of police power impacts interstate commerce. If the exercise of the power interferes with, or discriminates against, interstate commerce, then the action is generally deemed to be unconstitutional. The limitation on the authority of states to regulate in areas that impact interstate commerce is known as the dormant commerce clause.

In using the dormant commerce clause to resolve conflicts between state and federal authority, the courts consider the extent to which the state law has a legitimate purpose. If it is determined that the state law has a legitimate purpose, then the court tries to determine whether the impact on interstate commerce is in the interest of the citizens of the state, and will rule accordingly. For instance, an ordinance that banned spray paint, issued in the city of Chicago, was challenged by paint manufacturers under the dormant commerce clause, but was ultimately upheld by the U.S. Court of Appeals because the ban was intended to reduce graffiti and related crimes.

2. The Patient Protection and Affordable Care Act's (also known as Obamacare) provision that mandated that individuals not insured through employment obtain minimum essential health insurance or face a penalty was upheld as constitutional by the 11th Circuit.
 - a. True.
 - b. False.
3. The _____ gives the federal government the authority to regulate interstate and international commerce.
 - a. Supremacy Clause.
 - b. 10th Amendment.
 - c. Bill of Rights.
 - d. Commerce Clause.

Answer

d

4. The doctrine aimed at dividing the governing powers between the federal governments and the states is:
 - a. Judicial review.
 - b. Federalism.
 - c. Separation of powers.
 - d. Preemption.
5. The doctrine aimed at dividing the governing powers between the federal governments and the states is:
 - a. Commerce Clause.
 - b. Superior Clause.
 - c. Supremacy Clause.
 - d. Necessary and Proper Clause.

Answer

c

6. Describe the 2 types of Due Process.
7. The _____ of the constitution offers the most extensive protection for businesses.
 - a. Supremacy Clause.

- b. Equal Protection Clause.
- c. Due Process Clause.
- d. Freedom of Speech Clause.

Answer

c

8. The 14th Amendment is a part of the Bill of Rights.

- a. True.
- b. False.

9. Which of the following is correct with regards to the powers of state government in the United States?

- a. All powers not specifically enumerated to the federal government are reserved to the states.
- b. The power over crimes is reserved to the federal government.
- c. The power over the militia is reserved to the states.
- d. The powers over the federal government are superior to every state power.

Answer

a

10. All of the sections of the Bill of Rights apply to corporations and commercial activities.

- a. True.
- b. False.

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SECTION OVERVIEW

1.5: Government Regulation

1.5.1: Introduction

1.5.2: Administrative Law

1.5.3: Regulatory Agencies

1.5.4: End Notes

1.5.E: Assessment Questions

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1.5.1: Introduction

Learning Objectives

- Define the role of administrative bodies and regulation in the governmental rulemaking process.



Figure 1.5.1.1: Introduction (Credit: JamesDeMers/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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1.5.2: Administrative Law

Administrative law is also referred to as **regulatory** and **public law**. It is the law that is related to administrative agencies. Administrative agencies are established by statutes and governed by rules, regulations and orders, court decisions, judicial orders, and decisions.

Agencies are created by federal or state governments to carry out certain goals or purposes. Federal agencies are created by an act of Congress. Congress writes out a law called an **organic statute** that lays out the purpose and structure of the agency. The agency is charged with carrying out that purpose, as described by Congress. **Organic statutes** are utilized to create administrative agencies, as well as to define their responsibilities and authority.



Figure 1.5.2.1: Both federal and state legislators create agencies to fulfill a specific purpose, usually related to protecting the public from a potential threat. (Credit: kbhall17/ pixabay/ License: CC0)

Industrialization

Administrative agencies have been around almost since the founding of the United States. However, **industrialization** had a big impact on the development of administrative laws. As people moved from farms and rural areas to cities to find work and raise families, the economy changed. It became more complex. As a result of this economic change, the government saw a need to expand its regulation to protect and support the public. In the 20th century, the number of agencies expanded very quickly with the addition of the Food and Drug Administration (FDA) to regulate food and medication, the Federal Trade Commission (FTC) to regulate trade, and the Federal Reserve System (FRS) to regulate banks. These are just a few of the agencies created to regulate industries. Ultimately, this expansion occurred in response to the complexity of the economy.



Figure 1.5.2.2: Industrialization increased the number of administrative agencies in the United States. (Credit: Chevanon Photography/ pexels/ License: CC0)

Everyday Impact

Administrative law impacts the public on a daily basis. Administrative law is basically the delegated power granted to administrative agencies to carry out specific functions. Government agencies endeavor to protect the rights of citizens, corporations, and any other entity through administrative laws. Administrative agencies were developed to protect consumers and the community. As a result, they are present in all aspects of life, including medicine, food, environment, and trade.

One well-known federal agency is the Food and Drug Administration (FDA). The FDA was created to protect the public's health. The agency's responsibilities are very broad. The agency fulfills its role by ensuring the safety and effectiveness of drugs consumed by people and animals, biological products, medical devices, food, and cosmetics. Specifically, the FDA regulates the things that the public consumes, including supplements, infant formula, bottled water, food additives, eggs, some meat, and other food products. The FDA also regulates biological items and medical devices, including vaccines, cellular therapy products, surgical implants, and dental devices. This federal agency began in 1906 with the passing of the Pure Food and Drugs Act.



Figure 1.5.2.3: The Food and Drug Administration (FDA) oversees the safety and effectiveness of medication. (Credit: Rawpixel/pexels/ License: CC0)

EpiPens are automatic injection devices that deliver lifesaving medication that can save an individual in the event of exposure to an allergen, like a bee sting or peanuts. The United States faced a shortage of EpiPens, so in 2018, the FDA took action to address this issue. The FDA approved the extension of EpiPen expiration dates for four months on specific lots of the EpiPen. This extension impacted both the public and the organization that produces EpiPens. In the same year, the FDA approved the first generic EpiPen. The new generic version will be produced by a pharmaceutical company that has not previously produced the EpiPen. These two actions impact consumers by increasing the supply of lifesaving EpiPens.

Another well-known agency is the Federal Trade Commission (FTC). The FTC was formed in 1914 when President Woodrow Wilson signed the Federal Trade Commission Act into law. The goal of the agency is to protect the consumer, encourage business competition, and further the interests of consumers by encouraging innovation. The FTC works within the United States as well as internationally to protect consumers and encourage competition. The agency fulfills this role by developing policies, partnering with law enforcement to ensure consumer protection, and helping to ensure that markets are open and free. For instance, management and enforcement of the Do Not Call List is part of the FTC's consumer protection goals.

The FTC protects consumers from unfair or misleading practices. Phone scams are a common issue. Scammers go to great lengths to trick the public into donating to false charities, providing personal information, or giving access to financial information. The FTC is aware of these issues and has put rules in place to punish scammers and educate the public. The FTC created a phone scammer reporting process to help collect information about scammers so that they can be prosecuted. The agency also collects information about scammers and creates educational materials for the public. These materials are designed to help consumers identify possible phone scammers, avoid their tactics, and report their activities.

A complete list of U.S. government agencies can be found at <https://www.usa.gov/federal-agencies/a>.

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1.5.3: Regulatory Agencies

The power of administrative agencies comes from the executive branch of the government. Congress passes laws to carry out specific **directives**. The passing of these laws often creates a need for a government agency that will implement and carry out these laws. The government is not able to perform the work itself or manage the employees who will do the work. Instead, it creates agencies to do this. Assigning this authority to agencies is called **delegation**. The agencies have focus and expertise in their specific area of authority. However, it is important to note that Congress gives these agencies just enough power to fulfill their responsibilities.

Although administrative agencies are created by Congress, most administrative agencies are part of the executive branch of the government. The executive branch of government of the United States is headed by the president of the United States. Administrative agencies are created to enforce and administer laws, and the executive branch was created to oversee administrative agencies. Administrative agencies conduct exams and investigations of the entities they regulate. As a result of being part of the executive branch of government, the leaders of administrative agencies are generally appointed by the executive branch.



Figure 1.5.3.1: Most administrative agencies are housed in the executive branch. The president of the United States appoints leaders to administrative agencies. (Credit: Aaron Kittredge/ pexels/ License: CC0)

Administrative agencies also have responsibilities that mirror the responsibilities of the judicial branch of government. Administrative law judges (ALJ) have two primary duties. First, they oversee procedural aspects, like depositions of witnesses related to a case. They have the ability to review rules and statutes and review decisions related to their agencies. They also determine the facts and then make a judgment related to whether or not the agency's rules were broken. They act like a trial judge in a court, but their jurisdiction is limited to evaluating if rules established by certain government agencies were violated. They can award money, other benefits, and punish those found guilty of violating the rules.

Federal Agencies

Well-known federal agencies include the Federal Bureau of Investigations (FBI), Environmental Protection Agency (EPA), Food and Drug Administration (FDA), Federal Trade Commission (FTC), Federal Election Commission (FEC), and the National Labor Relations Board (NLRB). These agencies were created to serve specific purposes. For instance, the FBI was created to investigate federal crimes. A federal crime is one that violates federal criminal law, rather than a state's criminal law. The EPA was created to combine federal functions that were instituted protect the environment. The NLRB was created to carry out the National Labor Relations Act of 1935.

The goal of federal agencies is to protect the public. The EPA was created in response to concerns about the dumping of toxic chemicals in waterways and about air pollution. It began when the Cuyahoga River in Ohio burst into flames without warning. President Richard Nixon presented a plan to reduce pollution from cars, end the dumping of pollutants into waterways, tax businesses for some environmentally unfriendly practices, and reduce pollution in other ways. The EPA was created by Congress in

response to these environmental concerns and President Richard Nixon's plan. It is given the authority and responsibility to protect the environment from businesses, so that the people can enjoy a clean and safe environment.

As mentioned in the previous section, the Federal Trade Commission (FTC) was created to protect the consumer. It investigates and addresses activities that limit competition between businesses. The organization enforces **antitrust laws** that prevent one organization from restraining competition or seeking to maintain full control over a market. In December of 2006, the FTC ruled on the merger of America Online, Inc. (AOL) and Time Warner, Inc. The FTC decided that the joining of these two companies would limit the ability of other organizations to compete in the cable internet marketplace. The FTC ordered the merged company, AOL Time Warner, to do certain things that permitted competitors to engage, including opening its system to competitors' internet services and not interfering with the transmission signal being passed through the system. Doing so prevented the large company from shutting out its competitors. These are just a few examples of administrative agencies that were created to protect the community from business activities that could negatively impact the environment or the consumer.



Figure 1.5.3.2: Although administrative agencies have a great deal of power, they are bound by the concept of due process as is described in the U.S. Constitution. (Credit: wynpnt/ pixabay/ License: CC0)

Agency Structure

Administrative agencies are made up of experts, and they are trusted by Congress to identify the agency structure that best serves their specific goals. Thus, each agency is structured differently.

The FTC is a well-known agency and is organized into bureaus. Each bureau is focused on an agency goal. The three bureaus are consumer protection, competition, and economics. The Bureau of Consumer Protection focuses on unfair and deceptive business practices by encouraging consumers to voice complaints, investigate, and file lawsuits against companies. It also develops rules to maintain fair practices and educates consumers and businesses about rights and responsibilities. The Bureau of Competition focuses on antitrust laws and, by doing so, supports lower prices and choices for the consumer. And, lastly, the Bureau of Economics concentrates on consumer protection investigation, rulemaking, and the economic impact of government regulations on businesses and consumers.

Administrative Procedure Act (APA)

These agencies are not unrestrained in their operations. First, there are due process requirements created in the Constitution. Rules must be reasonable and based on facts. Second, rules cannot violate anyone's constitutional rights or civil liberties. Third, there must be an opportunity for the public to voice its support, or lack of support, for a rule. In 1946, the **Administrative Procedure Act (APA)** was enacted. Under the APA, agencies must follow certain procedures to make their rules enforceable statutes. The Act set up a full system for the execution of administrative law by administrative agencies for the federal government. Although agencies have power, government agencies must still act within the structures in place, including the Constitution, span of authority, statutory limitations, and other restrictions. The APA outlines roles, powers, and procedures of agencies. It organizes administrative functions into rulemaking and adjudication.

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1.5.4: End Notes

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1.5.E: Assessment Questions

1. What is administrative law?

Answer

Administrative law is also referred to as regulatory and public law. It is the law that is related to administrative agencies. Administrative agencies are established by statutes and governed by rules, regulations and orders, court decisions, judicial orders, and decisions.

2. Administrative agencies are created by:

- a. The president.
- b. The judicial branch.
- c. The Constitution.
- d. Congress.

3. The FDA stands for:

- a. The First Drug Administration.
- b. The Federal Drug Administration.
- c. The Food and Drug Administration.
- d. The Food and Diet Administration.

Answer

c

4. Explain the goal of the Federal Trade Commission.

5. How does the FDA fulfill its role?

Answer

The FDA was created to protect the public's health. The agency's responsibilities are very broad. The agency fulfills its role by ensuring the safety and effectiveness of drugs consumed by people and animals, biological products, medical devices, food, and cosmetics.

6. Who appoints leaders to run administrative agencies?

- a. The President.
- b. Congress.
- c. The judges.
- d. None of these are correct.

7. The process of assigning authority to administrative agencies is called:

- a. An assignment.
- b. A directive.
- c. A passing.
- d. A delegation.

Answer

d

8. What's the role of an Administrative Law Judge (ALJ)?

9. The Bureau of Economics concentrates on all but the following:

- a. Consumer protection investigation.
- b. Rulemaking.
- c. Lower prices for consumers.
- d. Economic impact of government regulation.

Answer

c

10. Explain the purpose of the Administrative Procedure Act (“APA”).

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CHAPTER OVERVIEW

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2.3: WATCH - Types of Business Organizations (embedded quiz)

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2.1: Key Ideas

Module 2: Key Ideas

- Public Corporation
- Private Corporation
- Sole-Proprietorship
- Partnership
- Limited Liability Partnership (LLP)
- Corporation (C-Corp)
- Benefit Corporation (B-Corp)
- Limited Liability Corporation (LLC)
- Cooperative (Co-Op)
- Nonprofit

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SECTION OVERVIEW

2.2: Corporation—General Characteristics and Formation

Learning Objectives

After reading this chapter, you should understand the following:

- The historical background of the corporation
- How partnerships compare with corporations
- What the corporation is as a legal entity, and how corporate owners can lose limited liability by certain actions
- How corporations are classified

The corporation is the dominant form of the business enterprise in the modern world. As a legal entity, it is bound by much of the law discussed in the preceding chapters. However, as a significant institutional actor in the business world, the corporation has a host of relationships that have called forth a separate body of law.

2.2.1: Historical Background

2.2.2: Partnerships versus Corporations

2.2.3: The Corporate Veil- The Corporation as a Legal Entity

2.2.4: Classifications of Corporations

2.2.5: Corporate Organization

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2.2.8: Summary and Exercises

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2.2.1: Historical Background

Learning Objectives

By the end of this section, you will be able to:

- Comprehend the historical significance of corporate formation.
- Learn about key court decisions and their effect on interstate commerce and corporate formation.
- Become acquainted with how states formed their corporate laws.

A Fixture of Every Major Legal System

Like partnership, the corporation is an ancient concept, recognized in the Code of Hammurabi, and to some degree a fixture in every other major legal system since then. The first corporations were not business enterprises; instead, they were associations for religious and governmental ends in which perpetual existence was a practical requirement. Thus until relatively late in legal history, kings, popes, and jurists assumed that corporations could be created only by political or ecclesiastical authority and that corporations were creatures of the state or church. By the seventeenth century, with feudalism on the wane and business enterprise becoming a growing force, kings extracted higher taxes and intervened more directly in the affairs of businesses by refusing to permit them to operate in corporate form except by royal grant. This came to be known as the concession theory, because incorporation was a concession from the sovereign.

The most important concessions, or charters, were those given to the giant foreign trading companies, including the Russia Company (1554), the British East India Company (1600), Hudson's Bay Company (1670, and still operating in Canada under the name "the Bay"), and the South Sea Company (1711). These were joint-stock companies—that is, individuals contributed capital to the enterprise, which traded on behalf of all the stockholders. Originally, trading companies were formed for single voyages, but the advantages of a continuing fund of capital soon became apparent. Also apparent was the legal characteristic that above all led shareholders to subscribe to the stock: limited liability. They risked only the cash they put in, not their personal fortunes.

Some companies were wildly successful. The British East India Company paid its original investors a fourfold return between 1683 and 1692. But perhaps nothing excited the imagination of the British more than the discovery of gold bullion aboard a Spanish shipwreck; 150 companies were quickly formed to salvage the sunken Spanish treasure. Though most of these companies were outright frauds, they ignited the search for easy wealth by a public unwary of the risks. In particular, the South Sea Company promised the sun and the moon: in return for a monopoly over the slave trade to the West Indies, it told an enthusiastic public that it would retire the public debt and make every person rich.

In 1720, a fervor gripped London that sent stock prices soaring. Beggars and earls alike speculated from January to August; and then the bubble burst. Without considering the ramifications, Parliament had enacted the highly restrictive Bubble Act, which was supposed to do away with unchartered **joint-stock** companies. When the government prosecuted four companies under the act for having fraudulently obtained charters, the public panicked and stock prices came tumbling down, resulting in history's first modern financial crisis.

As a consequence, corporate development was severely retarded in England. Distrustful of the chartered company, Parliament issued few corporate charters, and then only for public or quasi-public undertakings, such as transportation, insurance, and banking enterprises. Corporation law languished: William Blackstone devoted less than 1 percent of his immensely influential *Commentaries on the Law of England* (1765) to corporations and omitted altogether any discussion of limited liability. In *The Wealth of Nations* (1776), Adam Smith doubted that the use of corporations would spread. England did not repeal the Bubble Act until 1825, and then only because the value of true incorporation had become apparent from the experience of its former colonies.

US Corporation Formation

The United States remained largely unaffected by the Bubble Act. Incorporation was granted only by special acts of state legislatures, even well into the nineteenth century, but many such acts were passed. Before the Revolution, perhaps fewer than a dozen business corporations existed throughout the thirteen colonies. During the 1790s, two hundred businesses were incorporated, and their numbers swelled thereafter. The theory that incorporation should not be accomplished except through special legislation began to give way. As industrial development accelerated in the mid-1800s, it was possible in many states to incorporate by

adhering to the requirements of a general statute. Indeed, by the late nineteenth century, all but three states constitutionally *forbade* their legislatures from chartering companies through special enactments.

The US Supreme Court contributed importantly to the development of corporate law. In *Gibbons v. Ogden*, *Gibbons v. Ogden*, 22 U.S. 1 (1824), a groundbreaking case, the Court held that the Commerce Clause of the US Constitution (Article I, Section 8, Clause 3) granted Congress the power to regulate interstate commerce. However, in *Paul v. Virginia*, *Paul v. Virginia*, 75 U.S. 168 (1868), the Court said that a state could prevent corporations not chartered there—that is, **out-of-state or foreign** corporations—from engaging in what it considered the local, and not interstate, business of issuing insurance policies. The inference made by many was that states could not bar foreign corporations engaged in *interstate* business from their borders.

This decision brought about a competition in corporation laws. The early general laws had imposed numerous restrictions. The breadth of corporate enterprise was limited, ceilings were placed on total capital and indebtedness, incorporators were required to have residence in the state, the duration of the company often was not perpetual but was limited to a term of years or until a particular undertaking was completed, and the powers of management were circumscribed. These restrictions and limitations were thought to be necessary to protect the citizenry of the chartering legislature's own state. But once it became clear that companies chartered in one state could operate in others, states began in effect to “sell” incorporation for tax revenues.

New Jersey led the way in 1875 with a general incorporation statute that greatly liberalized the powers of management and lifted many of the former restrictions. The Garden State was ultimately eclipsed by Delaware, which in 1899 enacted the most liberal corporation statute in the country, so that to the present day there are thousands of “Delaware corporations” that maintain no presence in the state other than an address on file with the secretary of state in Dover.

During the 1920s, the National Conference of Commissioners on Uniform State Laws drafted a Uniform Business Corporation Act, the final version of which was released in 1928. It was not widely adopted, but it did provide the basis during the 1930s for revisions of some state laws, including those in California, Illinois, Michigan, Minnesota, and Pennsylvania. By that time, in the midst of the Great Depression, the federal government for the first time intruded into corporate law in a major way by creating federal agencies, most notably the Securities and Exchange Commission in 1934, with power to regulate the interstate issuance of corporate stock.

Corporate Law Today

Following World War II, most states revised their general corporation laws. A significant development for states was the preparation of the Model Business Corporation Act by the American Bar Association's Committee on Corporate Laws. About half of the states have adopted all or major portions of the act. The 2005 version of this act, the Revised Model Business Corporation Act (RMBCA), will be referred to throughout our discussion of corporation law.

Key Takeaway

Corporations have their roots in political and religious authority. The concept of limited liability and visions of financial rewards fueled the popularity of joint-stock companies, particularly trading companies, in late-seventeenth- and early eighteenth-century England. The English Parliament successfully enacted the Bubble Act in 1720 to curb the formation of these companies; the restrictions weren't loosened until over one hundred years later, after England viewed the success of corporations in its former colonies. Although early corporate laws in the United States were fairly restrictive, once states began to “sell” incorporation for tax revenues, the popularity of liberal and corporate-friendly laws caught on, especially in Delaware beginning in 1899. A corporation remains a creature of the state—that is, the state in which it is incorporated. Delaware remains the state of choice because more corporations are registered there than in any other state.

Exercises

1. If the English Parliament had not enacted the Bubble Act in 1720, would the “bubble” have burst? If so, what would have been the consequences to corporate development?
2. What were some of the key components of early US corporate laws? What was the rationale behind these laws?
3. In your opinion, what are some of the liberal laws that attract corporations to Delaware?

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2.2.2: Partnerships versus Corporations

Learning Objectives

By the end of this section, you will be able to:

- Distinguish basic aspects of partnership formation from those of corporate formation.
- Explain ownership and control in partnerships and in publicly held and closely held corporations.
- Know how partnerships and corporations are taxed.

Let us assume that three people have already formed a partnership to run a bookstore business. Bob has contributed \$80,000. Carol has contributed a house in which the business can lawfully operate. Ted has contributed his services; he has been managing the bookstore, and the business is showing a slight profit. A friend has been telling them that they ought to incorporate. What are the major factors they should consider in reaching a decision?

Ease of Formation

Partnerships are easy to form. If the business is simple enough and the partners are few, the agreement need not even be written down. Creating a corporation is more complicated because formal documents must be placed on file with public authorities.

Ownership and Control

All general partners have equal rights in the management and conduct of the business. By contrast, ownership and control of corporations are, in theory, separated. In the publicly held corporation, which has many shareholders, the separation is real. Ownership is widely dispersed because millions of shares are outstanding and it is rare that any single shareholder will own more than a tiny percentage of stock. It is difficult under the best of circumstances for shareholders to exert any form of control over corporate operations. However, in the closely held corporation, which has few shareholders, the officers or senior managers are usually also the shareholders, so the separation of ownership and control may be less pronounced or even nonexistent.

Transferability of Interests

Transferability of an interest in a partnership is a problem because a transferee cannot become a member unless all partners consent. The problem can be addressed and overcome in the partnership agreement. Transfer of interest in a corporation, through a sale of stock, is much easier; but for the stock of a small corporation, there might not be a market or there might be contractual restrictions on transfer.

Financing

Partners have considerable flexibility in financing. They can lure potential investors by offering interests in profits and, in the case of general partnerships, control. Corporations can finance by selling freely transferable stock to the public or by incurring debt. Different approaches to the financing of corporations are discussed in “Legal Aspects of Corporate Finance”.

Taxation

The partnership is a conduit for income and is not taxed as a separate entity. Individual partners are taxed, and although limited by the 1986 Tax Reform Act, they can deduct partnership losses. Corporate earnings, on the other hand, are subject to double taxation. The corporation is first taxed on its own earnings as an entity. Then, when profits are distributed to shareholders in the form of dividends, the shareholders are taxed again. (A small corporation, with no more than one hundred shareholders, can elect S corporation status. Because S corporations are taxed as partnerships, they avoid double taxation.) However, incorporating brings several tax benefits. For example, the corporation can take deductions for life, medical, and disability insurance coverage for its employees, whereas partners or sole proprietors cannot.

Key Takeaway

Partnerships are easier to form than corporations, especially since no documents are required. General partners share both ownership and control, but in publicly held corporations, these functions are separated. Additional benefits for a partnership include flexibility in financing, single taxation, and the ability to deduct losses. Transfer of interest in a partnership can be difficult if not addressed in the initial agreement, since all partners must consent to the transfer.

Exercises

1. Provide an example of when it would be best to form a partnership, and cite the advantages and disadvantages of doing so.
2. Provide an example of when it would be best to form a corporation, and cite the advantages and disadvantages of doing so.

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2.2.3: The Corporate Veil- The Corporation as a Legal Entity

Learning Objectives

By the end of this section, you will be able to:

- Know what rights a corporate “person” and a natural person have in common.
- Recognize when a corporate “veil” is pierced and shareholder liability is imposed.
- Identify other instances when a shareholder will be held personally liable.

In comparing partnerships and corporations, there is one additional factor that ordinarily tips the balance in favor of incorporating: the corporation is a legal entity in its own right, one that can provide a “veil” that protects its shareholders from personal liability.

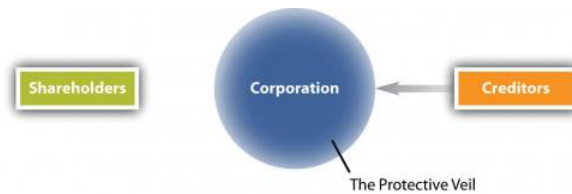


Figure 21.1 The Corporate Veil

This crucial factor accounts for the development of much of corporate law. Unlike the individual actor in the legal system, the corporation is difficult to deal with in conventional legal terms. The business of the sole proprietor and the sole proprietor herself are one and the same. When a sole proprietor makes a decision, she risks her own capital. When the managers of a corporation take a corporate action, they are risking the capital of others—the shareholders. Thus accountability is a major theme in the system of law constructed to cope with legal entities other than natural persons.

The Basic Rights of the Corporate “Person”

To say that a corporation is a “person” does not automatically describe what its rights are, for the courts have not accorded the corporation every right guaranteed a natural person. Yet the Supreme Court recently affirmed in *Citizens United v. Federal Election Commission* (2010) that the government may not suppress the First Amendment right of political speech because the speaker is a corporation rather than a natural person. According to the Court, “No sufficient governmental interest justifies limits on the political speech of nonprofit or for-profit corporations.” *Citizens United v. Federal Election Commission*, 558 U.S. ____ (2010).

The courts have also concluded that corporations are entitled to the essential constitutional protections of due process and equal protection. They are also entitled to Fourth Amendment protection against unreasonable search and seizure; in other words, the police must have a search warrant to enter corporate premises and look through files. Warrants, however, are not required for highly regulated industries, such as those involving liquor or guns. The Double Jeopardy Clause applies to criminal prosecutions of corporations: an acquittal cannot be appealed nor can the case be retried. For purposes of the federal courts’ diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business (often, the corporate “headquarters”).

Until relatively recently, few cases had tested the power of the state to limit the right of corporations to spend their own funds to speak the “corporate mind.” Most cases involving corporate free speech address advertising, and few states have enacted laws that directly impinge on the freedom of companies to advertise. But those states that have done so have usually sought to limit the ability of corporations to sway voters in public referenda. In 1978, the Supreme Court finally confronted the issue head on in *First National Bank of Boston v. Bellotti* (Section 21.7.1 “Limiting a Corporation’s First Amendment Rights”). The ruling in *Bellotti* was reaffirmed by the Supreme Court in *Citizens United v. Federal Election Commission*. In *Citizens United*, the Court struck down the part of the McCain-Feingold Act/The Bipartisan Campaign Reform Act of 2002 (BCRA, McCain–Feingold Act, Pub.L. 107-155, 116 Stat. 81, enacted March 27, 2002, H.R. 2356). that prohibited all corporations, both for-profit and not-for-profit, and unions from broadcasting “electioneering communications.”

Absence of Rights

Corporations lack certain rights that natural persons possess. For example, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. In any legal proceeding, the courts may

force a corporation to turn over incriminating documents, even if they also incriminate officers or employees of the corporation. As we explore in Chapter 25, corporations are not citizens under the Privileges and Immunities Clause of the Constitution, so that the states can discriminate between domestic and foreign corporations. And the corporation is not entitled to federal review of state criminal convictions, as are many individuals.

Piercing the Corporate Veil

Given the importance of the corporate entity as a veil that limits shareholder liability, it is important to note that in certain circumstances, the courts may reach beyond the wall of protection that divides a corporation from the people or entities that exist behind it. This is known as piercing the corporate veil, and it will occur in two instances: (1) when the corporation is used to commit a fraud or an injustice and (2) when the corporation does not act as if it were one.

Fraud

The Felsenthal Company burned to the ground. Its president, one of the company's largest creditors and also virtually its sole owner, instigated the fire. The corporation sued the insurance company to recover the amount for which it was insured. According to the court in the Felsenthal case, "The general rule of law is that the willful burning of property by a stockholder in a corporation is not a defense against the collection of the insurance by the corporation, and...the corporation cannot be prevented from collecting the insurance because its agents willfully set fire to the property without the participation or authority of the corporation or of all of the stockholders of the corporation." *D. I. Felsenthal Co. v. Northern Assurance Co., Ltd.*, 284 Ill. 343, 120 N.E. 268 (1918). But because the fire was caused by the beneficial owner of "practically all" the stock, who also "has the absolute management of [the corporation's] affairs and its property, and is its president," the court refused to allow the company to recover the insurance money; allowing the company to recover would reward fraud. *Felsenthal Co. v. Northern Assurance Co., Ltd.*, 120 N.E. 268 (Ill. 1918).

Failure to Act as a Corporation

In other limited circumstances, individual stockholders may also be found personally liable. Failure to follow corporate formalities, for example, may subject stockholders to personal liability. This is a special risk that small, especially one-person, corporations run. Particular factors that bring this rule into play include inadequate capitalization, omission of regular meetings, failure to record minutes of meetings, failure to file annual reports, and commingling of corporate and personal assets. Where these factors exist, the courts may look through the corporate veil and pluck out the individual stockholder or stockholders to answer for a tort, contract breach, or the like. The classic case is the taxicab operator who incorporates several of his cabs separately and services them through still another corporation. If one of the cabs causes an accident, the corporation is usually "judgment proof" because the corporation will have few assets (practically worthless cab, minimum insurance). The courts frequently permit plaintiffs to proceed against the common owner on the grounds that the particular corporation was inadequately financed.

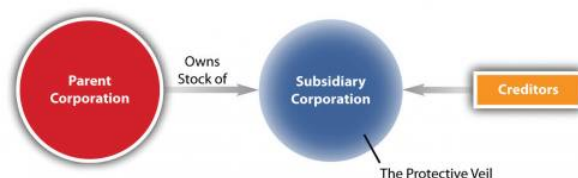


Figure 21.2 The Subsidiary as a Corporate Veil

When a corporation owns a subsidiary corporation, the question frequently arises whether the subsidiary is acting as an independent entity (see Figure 21.2). The Supreme Court addressed this question of derivative versus direct liability of the corporate parent vis-à-vis its subsidiary in *United States v. Bestfoods*, (see Section 21.7.2 "Piercing the Corporate Veil").

Other Types of Personal Liability

Even when a corporation is formed for a proper purpose and is operated as a corporation, there are instances in which individual shareholders will be personally liable. For example, if a shareholder involved in company management commits a tort or enters into a contract in a personal capacity, he will remain personally liable for the consequences of his actions. In some states, statutes give employees special rights against shareholders. For example, a New York statute permits employees to recover wages, salaries, and debts owed them by the company from the ten largest shareholders of the corporation. (Shareholders of public companies whose stock is traded on a national exchange or over the counter are exempt.) Likewise, federal law permits the IRS to recover from the "responsible persons" any withholding taxes collected by a corporation but not actually paid over to the US Treasury.

Key Takeaway

Corporations have some of the legal rights of a natural person. They are entitled to the constitutional protections of due process and equal protection, Fourth Amendment protection against unreasonable search and seizure, and First Amendment protection of free speech and expression. For purposes of the federal courts' diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business. However, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. Further, corporations are not free from liability. Courts will pierce the corporate veil and hold a corporation liable when the corporation is used to perpetrate fraud or when it fails to act as a corporation.

Exercises

1. Do you think that corporations should have rights similar to those of natural persons? Should any of these rights be curtailed?
2. What is an example of speaking the "corporate mind"?
3. If Corporation BCD's president and majority stockholder secretly sells all of his stock before resigning a few days later, and the corporation's unexpected change in majority ownership causes the share price to plummet, do corporate stockholders have a cause of action? If so, under what theory?

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2.2.4: Classifications of Corporations

Learning Objectives

By the end of this section, you will be able to:

- Distinguish the “public,” or municipal, corporation from the publicly held corporation.
- Explain how the tax structure for professional corporations evolved.
- Define the two types of business corporations.

Nonprofit Corporations

One of the four major classifications of corporations is the nonprofit corporation (also called not-for-profit corporation). It is defined in the American Bar Association’s Model Non-Profit Corporation Act as “a corporation no part of the income of *which* is distributable to its members, directors or officers.” Nonprofit corporations may be formed under this law for charitable, educational, civil, religious, social, and cultural purposes, among others.

Public Corporations

The true public corporation is a governmental entity. It is often called a municipal corporation, to distinguish it from the publicly held corporation, which is sometimes also referred to as a “public” corporation, although it is in fact private (i.e., it is not governmental). Major cities and counties, and many towns, villages, and special governmental units, such as sewer, transportation, and public utility authorities, are incorporated. These corporations are not organized for profit, do not have shareholders, and operate under different statutes than do business corporations.

Professional Corporations

Until the 1960s, lawyers, doctors, accountants, and other professionals could not practice their professions in corporate form. This inability, based on a fear of professionals’ being subject to the direction of the corporate owners, was financially disadvantageous. Under the federal income tax laws then in effect, corporations could establish far better pension plans than could the self-employed. During the 1960s, the states began to let professionals incorporate, but the IRS balked, denying them many tax benefits. In 1969, the IRS finally conceded that it would tax a professional corporation just as it would any other corporation, so that professionals could, from that time on, place a much higher proportion of tax-deductible income into a tax-deferred pension. That decision led to a burgeoning number of professional corporations.

Business Corporations

The Two Types

It is the business corporation proper that we focus on in this unit. There are two broad types of business corporations: publicly held (or public) and closely held (or close or private) corporations. Again, both types are private in the sense that they are not governmental.

The publicly held corporation is one in which stock is widely held or available for wide public distribution through such means as trading on a national or regional stock exchange. Its managers, if they are also owners of stock, usually constitute a small percentage of the total number of shareholders and hold a small amount of stock relative to the total shares outstanding. Few, if any, shareholders of public corporations know their fellow shareholders.

By contrast, the shareholders of the closely held corporation are fewer in number. Shares in a closely held corporation could be held by one person, and usually by no more than thirty. Shareholders of the closely held corporation often share family ties or have some other association that permits each to know the others.

Though most closely held corporations are small, no economic or legal reason prevents them from being large. Some are huge, having annual sales of several billion dollars each. Roughly 90 percent of US corporations are closely held.

The giant publicly held companies with more than \$1 billion in assets and sales, with initials such as IBM and GE, constitute an exclusive group. Publicly held corporations outside this elite class fall into two broad (nonlegal) categories: those that are quoted on stock exchanges and those whose stock is too widely dispersed to be called closely held but is not traded on exchanges.

Key Takeaway

There are four major classifications of corporations: (1) nonprofit, (2) municipal, (3) professional, and (4) business. Business corporations are divided into two types, publicly held and closely held corporations.

Exercises

1. Why did professionals, such as doctors, lawyers, and accountants, wait so long to incorporate?
2. Distinguish a publicly held corporation from a closely held one.
3. Are most corporations in the US publicly or closely held? Are closely held corporations subject to different provisions than publicly held ones?

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2.2.5: Corporate Organization

Learning Objectives

By the end of this section, you will be able to:

- Recognize the steps to issue a corporate charter.
- Know the states' rights in modifying a corporate charter.
- Discuss factors to consider in selecting a state in which to incorporate.
- Explain the functions and liability of a promoter.
- Understand the business and legal requirements in executing and filing the articles of incorporation.

As discussed in Section 21.4, corporate status offers companies many protections. If the owners of a business decide to incorporate after weighing the pros and cons of incorporation, they need to take the steps explained in this section.

The Corporate Charter

Function of the Charter

The ultimate goal of the incorporation process is issuance of a corporate charter. The term used for the document varies from state to state. Most states call the basic document filed in the appropriate public office the “articles of incorporation” or “certificate of incorporation,” but there are other variations. There is no legal significance to these differences in terminology.

Chartering is basically a state prerogative. Congress has chartered several enterprises, including national banks (under the National Banking Act), federal savings and loan associations, national farm loan associations, and the like, but virtually all business corporations are chartered at the state level.

Originally a legislative function, chartering is now an administrative function in every state. The secretary of state issues the final indorsement to the articles of incorporation, thus giving them legal effect.

Charter as a Contract

The charter is a contract between the state and the corporation. Under the Contracts Clause of Article I of the Constitution, no state can pass any law “impairing the obligation of contracts.” In 1816, the question arose whether a state could revoke or amend a corporate charter once granted. The corporation in question was Dartmouth College. The New Hampshire legislature sought to turn the venerable private college, operating under an old royal charter, into a public institution by changing the membership of its board. The case wound up in the Supreme Court. Chief Justice John Marshall ruled that the legislature’s attempt was unconstitutional, because to amend a charter is to impair a contract. *Trustees of Dartmouth College v. Woodward*, 17 U.S. 518 (1819).

This decision pleased incorporators because it implied that once a corporation had been created, the state could never modify the powers it had been granted. But, in addition, the ruling seemed to favor monopolies. The theory was that by granting a charter to, say, a railroad corporation, the state was barred from creating any further railroad corporations. Why? Because, the lawyers argued, a competitor would cut into the first company’s business, reducing the value of the charter, hence impairing the contract. Justice Joseph Story, concurring in the *Dartmouth* case, had already suggested the way out for the states: “If the legislature mean to claim such an authority [to alter or amend the charter], it must be reserved in the grant. The charter of Dartmouth College contains no such reservation....” The states quickly picked up on Justice Story’s suggestion and wrote into the charter explicit language giving legislatures the authority to modify corporations’ charters at their pleasure. So the potential immutability of corporate charters had little practical chance to develop.

Selection of a State

Where to Charter

Choosing the particular venue in which to incorporate is the first critical decision to be made after deciding to incorporate. Some corporations, though headquartered in the United States, choose to incorporate offshore to take advantage of lenient taxation laws. Advantages of an offshore corporation include not only lenient tax laws but also a great deal of privacy as well as certain legal protections. For example, the names of the officers and directors can be excluded from documents filed. In the United States, over

half of the *Fortune* 500 companies hold Delaware charters for reasons related to Delaware's having a lower tax structure, a favorable business climate, and a legal system—both its statutes and its courts—seen as being up to date, flexible, and often probusiness. Delaware's success has led other states to compete, and the political realities have caused the Revised Model Business Corporation Act (RMBCA), which was intentionally drafted to balance the interests of all significant groups (management, shareholders, and the public), to be revised from time to time so that it is more permissive from the perspective of management.

Why Choose Delaware?

Delaware remains the most popular state in which to incorporate for several reasons, including the following: (1) low incorporation fees; (2) only one person is needed to serve the incorporator of the corporation; the RMBCA requires three incorporators; (3) no minimum capital requirement; (4) favorable tax climate, including no sales tax; (5) no taxation of shares held by nonresidents; and (5) no corporate income tax for companies doing business outside of Delaware. In addition, Delaware's Court of Chancery, a court of equity, is renowned as a premier business court with a well-established body of corporate law, thereby affording a business a certain degree of predictability in judicial decision making.

The Promoter

Functions

Once the state of incorporation has been selected, it is time for promoters, the midwives of the enterprise, to go to work. Promoters are the individuals who take the steps necessary to form the corporation, and they often will receive stock in exchange for their efforts. They have four principal functions: (1) to seek out or discover business opportunities, (2) to raise capital by persuading investors to sign stock subscriptions, (3) to enter into contracts on behalf of the corporation to be formed, (4) and to prepare the articles of incorporation.

Promoters have acquired an unsavory reputation as fast talkers who cajole investors out of their money. Though some promoters fit this image, it is vastly overstated. Promotion is difficult work often carried out by the same individuals who will manage the business.

Contract Liability

Promoters face two major legal problems. First, they face possible liability on contracts made on behalf of the business before it is incorporated. For example, suppose Bob is acting as promoter of the proposed BCT Bookstore, Inc. On September 15, he enters into a contract with Computogram Products to purchase computer equipment for the corporation to be formed. If the incorporation never takes place, or if the corporation is formed but the corporation refuses to accept the contract, Bob remains liable.

Now assume that the corporation is formed on October 15, and on October 18 it formally accepts all the contracts that Bob signed prior to October 15. Does Bob remain liable? In most states, he does. The ratification theory of agency law will not help in many states that adhere strictly to agency rules, because there was no principal (the corporation) in existence when the contract was made and hence the promoter must remain liable. To avoid this result, Bob should seek an express novation, although in some states, a novation will be implied. The intention of the parties should be stated as precisely as possible in the contract, as the promoters learned in *RKO-Stanley Warner Theatres, Inc. v. Graziano*, (see Section 21.7.3 "Corporate Promoter").

The promoters' other major legal concern is the duty owed to the corporation. The law is clear that promoters owe a fiduciary duty. For example, a promoter who transfers real estate worth \$250,000 to the corporation in exchange for \$750,000 worth of stock would be liable for \$500,000 for breach of fiduciary duty.

Preincorporation Stock Subscriptions

One of the promoter's jobs is to obtain preincorporation stock subscriptions to line up offers by would-be investors to purchase stock in the corporation to be formed. These stock subscriptions are agreements to purchase, at a specified price, a certain number of shares of stock of a corporation, which is to be formed at some point in the future. The contract, however, actually comes into existence *after* formation, once the corporation itself accepts the offer to subscribe. Alice agrees with Bob to invest \$10,000 in the BCT Bookstore, Inc. for one thousand shares. The agreement is treated as an offer to purchase. The offer is deemed accepted at the moment the bookstore is incorporated.

The major problem for the corporation is an attempt by subscribers to revoke their offers. A basic rule of contract law is that offers are revocable before acceptance. Under RMBCA, Section 6.20, however, a subscription for shares is irrevocable for six months unless the subscription agreement itself provides otherwise or unless all the subscribers consent to revocation. In many states that have not adopted the model act, the contract rule applies and the offer is always revocable. Other states use various common-law

devices to prevent revocation. For example, the subscription by one investor is held as consideration for the subscription of another, so that a binding contract has been formed.

Execution and Filing of the Articles of Incorporation

Once the business details are settled, the promoters, now known as incorporators, must sign and deliver the articles of incorporation to the secretary of state. The articles of incorporation typically include the following: the corporate name; the address of the corporation's initial registered office; the period of the corporation's duration (usually perpetual); the company's purposes; the total number of shares, the classes into which they are divided, and the par value of each; the limitations and rights of each class of shareholders; the authority of the directors to establish preferred or special classes of stock; provisions for preemptive rights; provisions for the regulation of the internal affairs of the corporation, including any provision restricting the transfer of shares; the number of directors constituting the initial board of directors and the names and addresses of initial members; and the name and address of each incorporator. Although compliance with these requirements is largely a matter of filling in the blanks, two points deserve mention.

First, the choice of a name is often critical to the business. Under RMBCA, Section 4.01, the name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The name is not allowed to deceive the public about the corporation's purposes, nor may it be the same as that of any other company incorporated or authorized to do business in the state.

These legal requirements are obvious; the business requirements are much harder. If the name is not descriptive of the business or does not anticipate changes in the business, it may have to be changed, and the change can be expensive. For example, when Standard Oil Company of New Jersey changed its name to Exxon in 1972, the estimated cost was over \$100 million. (And even with this expenditure, some shareholders grumbled that the new name sounded like a laxative.)

The second point to bear in mind about the articles of incorporation is that drafting the clause stating corporate purposes requires special care, because the corporation will be limited to the purposes set forth. In one famous case, the charter of Cornell University placed a limit on the amount of contributions it could receive from any one benefactor. When Jennie McGraw died in 1881, leaving to Cornell the carillon that still plays on the Ithaca, New York, campus to this day, she also bequeathed to the university her residuary estate valued at more than \$1 million. This sum was greater than the ceiling placed in Cornell's charter. After lengthy litigation, the university lost in the US Supreme Court, and the money went to her family. *Cornell University v. Fiske*, 136 U.S. 152 (1890). The dilemma is how to draft a clause general enough to allow the corporation to expand, yet specific enough to prevent it from engaging in undesirable activities.

Some states require the purpose clauses to be specific, but the usual approach is to permit a broad statement of purposes. Section 3.01 of the RMBCA goes one step further in providing that a corporation automatically "has the purpose of engaging in any lawful business" unless the articles specify a more limited purpose. Once completed, the articles of incorporation are delivered to the secretary of state for filing. The existence of a corporation begins once the articles have been filed.

Organizational Meeting of Directors

The first order of business, once the certificate of incorporation is issued, is a meeting of the board of directors named in the articles of incorporation. They must adopt bylaws, elect officers, and transact any other business that may come before the meeting (RMBCA, Section 2.05). Other business would include accepting (ratifying) promoters' contracts, calling for the payment of stock subscriptions, and adopting bank resolution forms, giving authority to various officers to sign checks drawn on the corporation.

Section 10.20 of the RMBCA vests in the directors the power to alter, amend, or repeal the bylaws adopted at the initial meeting, subject to repeal or change by the shareholders. The articles of incorporation may reserve the power to modify or repeal exclusively to the shareholders. The bylaws may contain any provisions that do not conflict with the articles of incorporation or the law of the state.

Typical provisions in the bylaws include fixing the place and time at which annual stockholders' meetings will be held, fixing a quorum, setting the method of voting, establishing the method of choosing directors, creating committees of directors, setting down the method by which board meetings may be called and the voting procedures to be followed, determining the offices to be filled by the directors and the powers with which each officer shall be vested, fixing the method of declaring dividends, establishing a fiscal year, setting out rules governing issuance and transfer of stock, and establishing the method of amending the bylaws.

Section 2.07 of the RMBCA provides that the directors may adopt bylaws that will operate during an emergency. An emergency is a situation in which “a quorum of the corporation’s directors cannot readily be assembled because of some catastrophic event.”

Key Takeaway

Articles of incorporation represent a corporate charter—that is, a contract between the corporation and the state. Filing these articles, or “chartering,” is accomplished at the state level. The secretary of state’s final approval gives these articles legal effect. A state cannot change a charter unless it reserves the right when granting the charter.

In selecting a state in which to incorporate, a corporation looks for a favorable corporate climate. Delaware remains the state of choice for incorporation, particularly for publicly held companies. Most closely held companies choose to incorporate in their home states.

Following the state selection, the promoter commences his or her functions, which include entering into contracts on behalf of the corporation to be formed (for which he or she can be held liable) and preparing the articles of incorporation.

The articles of incorporation must include the corporation’s name and its corporate purpose, which can be broad. Finally, once the certificate of incorporation is issued, the corporation’s board of directors must hold an organizational meeting.

Exercises

1. Does the Contracts Clause of the Constitution, which forbids a state from impeding a contract, apply to corporations?
2. What are some of the advantages of selecting Delaware as the state of incorporation?
3. What are some of the risks that a promoter faces for his or her actions on behalf of the corporation? Can he or she limit these risks?
4. What are the dangers of limiting a corporation’s purpose?
5. What is the order of business at the first board of directors’ meeting?

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2.2.6: Effect of Organization

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between a de jure and a de facto corporation.
- Define the doctrine of corporation by estoppel.

De Jure and De Facto Corporations

If promoters meet the requirements of corporate formation, a de jure corporation, considered a legal entity, is formed. Because the various steps are complex, the formal prerequisites are not always met. Suppose that a company, thinking its incorporation has taken place when in fact it hasn't met all requirements, starts up its business. What then? Is everything it does null and void? If three conditions exist, a court might decide that a de facto corporation has been formed; that is, the business will be recognized as a corporation. The state then has the power to force the de facto corporation to correct the defect(s) so that a de jure corporation will be created.

The three traditional conditions are the following: (1) a statute must exist under which the corporation could have been validly incorporated, (2) the promoters must have made a bona fide attempt to comply with the statute, and (3) corporate powers must have been used or exercised.

A frequent cause of defective incorporation is the promoters' failure to file the articles of incorporation in the appropriate public office. The states are split on whether a de facto corporation results if every other legal requirement is met.

Corporation by Estoppel

Even if the incorporators omit important steps, it is still possible for a court, under estoppel principles, to treat the business as a corporation. Assume that Bob, Carol, and Ted have sought to incorporate the BCT Bookstore, Inc., but have failed to file the articles of incorporation. At the initial directors' meeting, Carol turns over to the corporation a deed to her property. A month later, Bob discovers the omission and hurriedly submits the articles of incorporation to the appropriate public office. Carol decides she wants her land back. It is clear that the corporation was not de jure at the time she surrendered her deed, and it was probably not de facto either. Can she recover the land? Under equitable principles, the answer is no. She is estopped from denying the existence of the corporation, because it would be inequitable to permit one who has conducted herself as though there were a corporation to deny its existence in order to defeat a contract into which she willingly entered. As *Cranson v. International Business Machines Corp.* indicates (Section 21.7.4 "De Jure and De Facto Corporations"), the doctrine of corporation by estoppel can also be used by the corporation against one of its creditors.

Key Takeaway

A court will find that a corporation might exist under fact (de facto), and not under law (de jure) if the following conditions are met: (1) a statute exists under which the corporation could have been validly incorporated, (2) the promoters must have made a bona fide attempt to comply with the statute, and (3) corporate powers must have been used or exercised. A de facto corporation may also be found when a promoter fails to file the articles of incorporation. In the alternative, the court may look to estoppel principles to find a corporation.

Exercises

1. What are some of the formal prerequisites to forming a de jure corporation?
2. Are states in agreement over what represents a de facto corporation if a promoter fails to file the articles of incorporation?
3. What is the rationale for corporation by estoppel?

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2.2.7: Cases

Limiting a Corporation's First Amendment Rights

First National Bank of Boston v. Bellotti

435 U.S. 765 (1978)

MR. JUSTICE POWELL delivered the opinion of the Court.

In sustaining a state criminal statute that forbids certain expenditures by banks and business corporations for the purpose of influencing the vote on referendum proposals, the Massachusetts Supreme Judicial Court held that the First Amendment rights of a corporation are limited to issues that materially affect its business, property, or assets. The court rejected appellants' claim that the statute abridges freedom of speech in violation of the First and Fourteenth Amendments. The issue presented in this context is one of first impression in this Court. We postponed the question of jurisdiction to our consideration of the merits. We now reverse.

The statute at issue, Mass. Gen. Laws Ann., Ch. 55, § 8 (West Supp. 1977), prohibits appellants, two national banking associations and three business corporations, from making contributions or expenditures "for the purpose of...influencing or affecting the vote on any question submitted to the voters, other than one materially affecting any of the property, business or assets of the corporation." The statute further specifies that "[no] question submitted to the voters solely concerning the taxation of the income, property or transactions of individuals shall be deemed materially to affect the property, business or assets of the corporation." A corporation that violates § 8 may receive a maximum fine of \$50,000; a corporate officer, director, or agent who violates the section may receive a maximum fine of \$10,000 or imprisonment for up to one year, or both. Appellants wanted to spend money to publicize their views on a proposed constitutional amendment that was to be submitted to the voters as a ballot question at a general election on November 2, 1976. The amendment would have permitted the legislature to impose a graduated tax on the income of individuals. After appellee, the Attorney General of Massachusetts, informed appellants that he intended to enforce § 8 against them, they brought this action seeking to have the statute declared unconstitutional.

The court below framed the principal question in this case as whether and to what extent corporations have First Amendment rights. We believe that the court posed the wrong question. The Constitution often protects interests broader than those of the party seeking their vindication. The First Amendment, in particular, serves significant societal interests. The proper question therefore is not whether corporations "have" First Amendment rights and, if so, whether they are coextensive with those of natural persons. Instead, the question must be whether § 8 abridges expression that the First Amendment was meant to protect. We hold that it does. The speech proposed by appellants is at the heart of the First Amendment's protection.

The freedom of speech and of the press guaranteed by the Constitution embraces at the least the liberty to discuss publicly and truthfully all matters of public concern without previous restraint or fear of subsequent punishment. Freedom of discussion, if it would fulfill its historic function in this nation, must embrace all issues about which information is needed or appropriate to enable the members of society to cope with the exigencies of their period. *Thornhill v. Alabama*, 310 U.S. 88, 101-102 (1940).

The referendum issue that appellants wish to address falls squarely within this description. In appellants' view, the enactment of a graduated personal income tax, as proposed to be authorized by constitutional amendment, would have a seriously adverse effect on the economy of the State. The importance of the referendum issue to the people and government of Massachusetts is not disputed. Its merits, however, are the subject of sharp disagreement.

We thus find no support in the First or Fourteenth Amendment, or in the decisions of this Court, for the proposition that speech that otherwise would be within the protection of the First Amendment loses that protection simply because its source is a corporation that cannot prove, to the satisfaction of a court, a material effect on its business or property. The "materially affecting" requirement is not an identification of the boundaries of corporate speech etched by the Constitution itself. Rather, it amounts to an impermissible legislative prohibition of speech based on the identity of the interests that spokesmen may represent in public debate over controversial issues and a requirement that the speaker have a sufficiently great interest in the subject to justify communication.

Section 8 permits a corporation to communicate to the public its views on certain referendum subjects—those materially affecting its business—but not others. It also singles out one kind of ballot question—individual taxation as a subject about which corporations may never make their ideas public. The legislature has drawn the line between permissible and impermissible speech according to whether there is a sufficient nexus, as defined by the legislature, between the issue presented to the voters and the business interests of the speaker.

In the realm of protected speech, the legislature is constitutionally disqualified from dictating the subjects about which persons may speak and the speakers who may address a public issue. If a legislature may direct business corporations to “stick to business,” it also may limit other corporations—religious, charitable, or civic—to their respective “business” when addressing the public. Such power in government to channel the expression of views is unacceptable under the First Amendment. Especially where, as here, the legislature’s suppression of speech suggests an attempt to give one side of a debatable public question an advantage in expressing its views to the people, the First Amendment is plainly offended.

Because that portion of § 8 challenged by appellants prohibits protected speech in a manner unjustified by a compelling state interest, it must be invalidated. The judgment of the Supreme Judicial Court is reversed.

Case Questions

1. According to the court, does § 8 abridge a freedom that the First Amendment is intended to protect? If so, which freedom(s)?
2. Must a corporation prove a material effect on its business or property to maintain protection under the First Amendment?
3. Can a state legislature dictate the subjects on which a corporation may “speak”?

Piercing the Corporate Veil

United States v. Bestfoods

113 F.3d 572 (1998)

SOUTER, JUSTICE

The United States brought this action under §107(a)(2) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) against, among others, respondent CPC International, Inc., the parent corporation of the defunct Ott Chemical Co. (Ott II), for the costs of cleaning up industrial waste generated by Ott II’s chemical plant. Section 107(a)(2) authorizes suits against, among others, “any person who at the time of disposal of any hazardous substance owned or operated any facility.” The trial focused on whether CPC, as a parent corporation, had “owned or operated” Ott II’s plant within the meaning of §107(a)(2). The District Court said that operator liability may attach to a parent corporation both indirectly, when the corporate veil can be pierced under state law, and directly, when the parent has exerted power or influence over its subsidiary by actively participating in, and exercising control over, the subsidiary’s business during a period of hazardous waste disposal. Applying that test, the court held CPC liable because CPC had selected Ott II’s board of directors and populated its executive ranks with CPC officials, and another CPC official had played a significant role in shaping Ott II’s environmental compliance policy.

The Sixth Circuit reversed. Although recognizing that a parent company might be held directly liable under §107(a)(2) if it actually operated its subsidiary’s facility in the stead of the subsidiary, or alongside of it as a joint venturer, that court refused to go further. Rejecting the District Court’s analysis, the Sixth Circuit explained that a parent corporation’s liability for operating a facility ostensibly operated by its subsidiary depends on whether the degree to which the parent controls the subsidiary and the extent and manner of its involvement with the facility amount to the abuse of the corporate form that will warrant piercing the corporate veil and disregarding the separate corporate entities of the parent and subsidiary. Applying Michigan veil-piercing law, the court decided that CPC was not liable for controlling Ott II’s actions, since the two corporations maintained separate personalities and CPC did not utilize the subsidiary form to perpetrate fraud or subvert justice.

Held:

1. When (but only when) the corporate veil may be pierced, a parent corporation may be charged with derivative CERCLA liability for its subsidiary’s actions in operating a polluting facility. It is a general principle of corporate law that a parent corporation (so-called because of control through ownership of another corporation’s stock) is not liable for the acts of its subsidiaries. CERCLA does not purport to reject this bedrock principle, and the Government has indeed made no claim that a corporate parent is liable as an owner or an operator under §107(a)(2) simply because its subsidiary owns or operates a polluting facility. But there is an equally fundamental principle of corporate law, applicable to the parent-subsidiary relationship as well as generally, that the corporate veil may be pierced and the shareholder held liable for the corporation’s conduct when, *inter alia*, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder’s behalf. CERCLA does not purport to rewrite this well-settled rule, either, and against this venerable common-law backdrop, the congressional silence is audible. Cf. *Edmonds v. Compagnie Generale Transatlantique*, 443 U.S. 256, 266-267. CERCLA’s failure to speak to a matter as fundamental as the liability implications of corporate ownership demands application of the rule that, to abrogate a common-law principle, a statute must speak directly to the question addressed by the common law. *United States v. Texas*, 507 U.S. 529, 534.

2. A corporate parent that actively participated in, and exercised control over, the operations of its subsidiary's facility may be held directly liable in its own right under §107(a)(2) as an operator of the facility.

(a) Derivative liability aside, CERCLA does not bar a parent corporation from direct liability for its own actions. Under the plain language of §107(a)(2), any person who operates a polluting facility is directly liable for the costs of cleaning up the pollution, and this is so even if that person is the parent corporation of the facility's owner. Because the statute does not define the term "operate," however, it is difficult to define actions sufficient to constitute direct parental "operation." In the organizational sense obviously intended by CERCLA, to "operate" a facility ordinarily means to direct the workings of, manage, or conduct the affairs of the facility. To sharpen the definition for purposes of CERCLA's concern with environmental contamination, an operator must manage, direct, or conduct operations specifically related to the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations.

(b) The Sixth Circuit correctly rejected the direct liability analysis of the District Court, which mistakenly focused on the relationship between parent and subsidiary, and premised liability on little more than CPC's ownership of Ott II and its majority control over Ott II's board of directors. Because direct liability for the parent's operation of the facility must be kept distinct from derivative liability for the subsidiary's operation of the facility, the analysis should instead have focused on the relationship between CPC and the facility itself, *i.e.*, on whether CPC "operated" the facility, as evidenced by its direct participation in the facility's activities. That error was compounded by the District Court's erroneous assumption that actions of the joint officers and directors were necessarily attributable to CPC, rather than Ott II, contrary to time-honored common-law principles. The District Court's focus on the relationship between parent and subsidiary (rather than parent and facility), combined with its automatic attribution of the actions of dual officers and directors to CPC, erroneously, even if unintentionally, treated CERCLA as though it displaced or fundamentally altered common-law standards of limited liability. The District Court's analysis created what is in essence a relaxed, CERCLA-specific rule of derivative liability that would banish traditional standards and expectations from the law of CERCLA liability. Such a rule does not arise from congressional silence, and CERCLA's silence is dispositive.

(c) Nonetheless, the Sixth Circuit erred in limiting direct liability under CERCLA to a parent's sole or joint venture operation, so as to eliminate any possible finding that CPC is liable as an operator on the facts of this case. The ordinary meaning of the word "operate" in the organizational sense is not limited to those two parental actions, but extends also to situations in which, *e.g.*, joint officers or directors conduct the affairs of the facility on behalf of the parent, or agents of the parent with no position in the subsidiary manage or direct activities at the subsidiary's facility. Norms of corporate behavior (undisturbed by any CERCLA provision) are crucial reference points, both for determining whether a dual officer or director has served the parent in conducting operations at the facility, and for distinguishing a parental officer's oversight of a subsidiary from his control over the operation of the subsidiary's facility. There is, in fact, some evidence that an agent of CPC alone engaged in activities at Ott II's plant that were eccentric under accepted norms of parental oversight of a subsidiary's facility: The District Court's opinion speaks of such an agent who played a conspicuous part in dealing with the toxic risks emanating from the plant's operation. The findings in this regard are enough to raise an issue of CPC's operation of the facility, though this Court draws no ultimate conclusion, leaving the issue for the lower courts to reevaluate and resolve in the first instance.

113 F.3d 572, vacated and remanded.

Case Questions

1. In what ways can operator liability attach to a parent corporation? How did the Sixth Circuit Court disagree with the district court's analysis?
2. Is direct liability for a parent company's operation of the facility distinct from derivative liability for the subsidiary's operation of the facility? Should the focus be on parent and subsidiary or on parent and facility?
3. What norms of corporate behavior does the court look to in determining whether an officer or a director is involved in the operation of a facility?

Corporate Promoter

RKO-Stanley Warner Theatres, Inc. v. Graziano

355 A.2d. 830 (1976)

EAGEN, JUSTICE.

On April 30, 1970, RKO-Stanley Warner Theatres, Inc. [RKO], as seller, entered into an agreement of sale with Jack Jenofsky and Ralph Graziano, as purchasers. This agreement contemplated the sale of the Kent Theatre, a parcel of improved commercial real

estate located at Cumberland and Kensington Avenues in Philadelphia, for a total purchase price of \$70,000. Settlement was originally scheduled for September 30, 1970, and, at the request of Jenofsky and Graziano, continued twice, first to October 16, 1970, and then to October 21, 1970. However, Jenofsky and Graziano failed to complete settlement on the last scheduled date.

Subsequently, on November 13, 1970, RKO filed a complaint in equity seeking judicial enforcement of the agreement of sale. Although Jenofsky, in his answer to the complaint, denied personal liability for the performance of the agreement, the chancellor, after a hearing, entered a decree nisi granting the requested relief sought by RKO.... This appeal ensued.

At the time of the execution of this agreement, Jenofsky and Graziano were engaged in promoting the formation of a corporation to be known as Kent Enterprises, Inc. Reflecting these efforts, Paragraph 19 of the agreement, added by counsel for Jenofsky and Graziano, recited:

It is understood by the parties hereto that it is the intention of the Purchaser to incorporate. Upon condition that such incorporation be completed by closing, all agreements, covenants, and warranties contained herein shall be construed to have been made between Seller and the resultant corporation and all documents shall reflect same.

In fact, Jenofsky and Graziano did file Articles of Incorporation for Kent Enterprises, Inc., with the State Corporation Bureau on October 9, 1971, twelve days prior to the scheduled settlement date. Jenofsky now contends the inclusion of Paragraph 19 in the agreement and the subsequent filing of incorporation papers, released him from any personal liability resulting from the non-performance of the agreement.

The legal relationship of Jenofsky to Kent Enterprises, Inc., at the date of the execution of the agreement of sale was that of promoter. As such, he is subject to the general rule that a promoter, although he may assume to act on behalf of a projected corporation and not for himself, will be held personally liable on contracts made by him for the benefit of a corporation he intends to organize. This personal liability will continue even after the contemplated corporation is formed and has received the benefits of the contract, unless there is a novation or other agreement to release liability.

The imposition of personal liability upon a promoter where that promoter has contracted on behalf of a corporation is based upon the principle that one who assumes to act for a nonexistent principal is himself liable on the contract in the absence of an agreement to the contrary.

[T]here [are] three possible understandings that parties may have when an agreement is executed by a promoter on behalf of a proposed corporation:

When a party is acting for a proposed corporation, he cannot, of course, bind it by anything he does, at the time, but he may (1) take on its behalf an offer from the other which, being accepted after the formation of the company, becomes a contract; (2) make a contract at the time binding himself, with the stipulation or understanding, that if a company is formed it will take his place and that then he shall be relieved of responsibility; or (3) bind himself personally without more and look to the proposed company, when formed, for indemnity.

Both RKO and Jenofsky concede the applicability of alternative No. 2 to the instant case. That is, they both recognize that Jenofsky (and Graziano) was to be initially personally responsible with this personal responsibility subsequently being released. Jenofsky contends the parties, by their inclusion of Paragraph 19 in the agreement, manifested an intention to release him from personal responsibility upon the mere formation of the proposed corporation, provided the incorporation was consummated prior to the scheduled closing date. However, while Paragraph 19 does make provision for recognition of the resultant corporation as to the closing documents, it makes no mention of any release of personal liability. Indeed, the entire agreement is silent as to the effect the formation of the projected corporation would have upon the personal liability of Jenofsky and Graziano. Because the agreement fails to provide expressly for the release of personal liability, it is, therefore, subject to more than one possible construction.

In *Consolidated Tile and Slate Co. v. Fox*, 410 Pa. 336, 339, 189 A.2d 228, 229 (1963), we stated that where an agreement is ambiguous and reasonably susceptible of two interpretations, "it must be construed most strongly against those who drew it."... Instantly, the chancellor determined that the intent of the parties to the agreement was to hold Jenofsky personally responsible until such time as a corporate entity was formed and until such time as that corporate entity adopted the agreement. We believe this construction represents the only rational and prudent interpretation of the parties' intent.

As found by the court below, this agreement was entered into on the financial strength of Jenofsky and Graziano, alone as individuals. Therefore, it would have been illogical for RKO to have consented to the release of their personal liability upon the mere formation of a resultant corporation prior to closing. For it is a well-settled rule that a contract made by a promoter, even though made for and in the name of a proposed corporation, in the absence of a subsequent adoption (either expressly or impliedly)

by the corporation, will not be binding upon the corporation. If, as Jenofsky contends, the intent was to release personal responsibility upon the mere incorporation prior to closing, the effect of the agreement would have been to create the possibility that RKO, in the event of non-performance, would be able to hold no party accountable: there being no guarantee that the resultant corporation would ratify the agreement. Without express language in the agreement indicating that such was the intention of the parties, we may not attribute this intention to them.

Therefore, we hold that the intent of the parties in entering into this agreement was to have Jenofsky and Graziano personally liable until such time as the intended corporation was formed and ratified the agreement. [And there is no evidence that Kent Enterprises ratified the agreement. The decree is affirmed.]

Case Questions

1. Does a promoter's personal liability continue even after the corporation is formed? Can he or she look to the corporation for indemnity after the corporation is formed?
2. In what instance(s) is a contract made by a promoter not binding on a corporation?
3. In whose favor does a court construe an ambiguous agreement?

De Jure and De Facto Corporations

Cranson v. International Business Machines Corp.

234 Md. 477, 200 A.2d 33 (1964)

HORNEY, JUDGE

On the theory that the Real Estate Service Bureau was neither a *de jure* nor a *de facto* corporation and that Albion C. Cranson, Jr., was a partner in the business conducted by the Bureau and as such was personally liable for its debts, the International Business Machines Corporation brought this action against Cranson for the balance due on electric typewriters purchased by the Bureau. At the same time it moved for summary judgment and supported the motion by affidavit. In due course, Cranson filed a general issue plea and an affidavit in opposition to summary judgment in which he asserted in effect that the Bureau was a *de facto* corporation and that he was not personally liable for its debts.

The agreed statement of facts shows that in April 1961, Cranson was asked to invest in a new business corporation which was about to be created. Towards this purpose he met with other interested individuals and an attorney and agreed to purchase stock and become an officer and director. Thereafter, upon being advised by the attorney that the corporation had been formed under the laws of Maryland, he paid for and received a stock certificate evidencing ownership of shares in the corporation, and was shown the corporate seal and minute book. The business of the new venture was conducted as if it were a corporation, through corporate bank accounts, with auditors maintaining corporate books and records, and under a lease entered into by the corporation for the office from which it operated its business. Cranson was elected president and all transactions conducted by him for the corporation, including the dealings with I.B.M., were made as an officer of the corporation. At no time did he assume any personal obligation or pledge his individual credit to I.B.M. Due to an oversight on the part of the attorney, of which Cranson was not aware, the certificate of incorporation, which had been signed and acknowledged prior to May 1, 1961, was not filed until November 24, 1961. Between May 17 and November 8, the Bureau purchased eight typewriters from I.B.M., on account of which partial payments were made, leaving a balance due of \$4,333.40, for which this suit was brought.

Although a question is raised as to the propriety of making use of a motion for summary judgment as the means of determining the issues presented by the pleadings, we think the motion was appropriate. Since there was no genuine dispute as to the material facts, the only question was whether I.B.M. was entitled to judgment as a matter of law. The trial court found that it was, but we disagree.

The fundamental question presented by the appeal is whether an officer of a defectively incorporated association may be subjected to personal liability under the circumstances of this case. We think not.

Traditionally, two doctrines have been used by the courts to clothe an officer of a defectively incorporated association with the corporate attribute of limited liability. The first, often referred to as the doctrine of *de facto* corporations, has been applied in those cases where there are elements showing: (1) the existence of law authorizing incorporation; (2) an effort in good faith to incorporate under the existing law; and (3) actual use or exercise of corporate powers. The second, the doctrine of estoppel to deny the corporate existence, is generally employed where the person seeking to hold the officer personally liable has contracted or otherwise dealt with the association in such a manner as to recognize and in effect admit its existence as a corporate body.

* * *

There is, as we see it, a wide difference between creating a corporation by means of the *de facto* doctrine and estopping a party, due to his conduct in a particular case, from setting up the claim of no incorporation. Although some cases tend to assimilate the doctrines of incorporation *de facto* and by estoppel, each is a distinct theory and they are not dependent on one another in their application. Where there is a concurrence of the three elements necessary for the application of the *de facto* corporation doctrine, there exists an entity which is a corporation *de jure* against all persons but the state.

On the other hand, the estoppel theory is applied only to the facts of each particular case and may be invoked even where there is no corporation *de facto*. Accordingly, even though one or more of the requisites of a *de facto* corporation are absent, we think that this factor does not preclude the application of the estoppel doctrine in a proper case, such as the one at bar.

I.B.M. contends that the failure of the Bureau to file its certificate of incorporation debarred *all* corporate existence. But, in spite of the fact that the omission might have prevented the Bureau from being either a corporation *de jure* or *de facto*, *Jones v. Linden Building Ass'n*, we think that I.B.M. having dealt with the Bureau as if it were a corporation and relied on its credit rather than that of Cranson, is estopped to assert that the Bureau was not incorporated at the time the typewriters were purchased. In *1 Clark and Marshall, Private Corporations*, § 89, it is stated:

The doctrine in relation to estoppel is based upon the ground that it would generally be inequitable to permit the corporate existence of an association to be denied by persons who have represented it to be a corporation, or held it out as a corporation, or by any persons who have recognized it as a corporation by dealing with it as such; and by the overwhelming weight of authority, therefore, a person may be estopped to deny the legal incorporation of an association which is not even a corporation *de facto*.

In cases similar to the one at bar, involving a failure to file articles of incorporation, the courts of other jurisdictions have held that where one has recognized the corporate existence of an association, he is estopped to assert the contrary with respect to a claim arising out of such dealings.

Since I.B.M. is estopped to deny the corporate existence of the Bureau, we hold that Cranson was not liable for the balance due on account of the typewriters.

Judgment reversed; the appellee to pay the costs.

Case Questions

1. What is the fundamental question presented by the case?
2. What are the differences between creating a corporation *de facto* and by estoppel?

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2.2.8: Summary and Exercises

Summary

The hallmark of the corporate form of business enterprise is limited liability for its owners. Other features of corporations are separation of ownership and management, perpetual existence, and easy transferability of interests. In the early years of the common law, corporations were thought to be creatures of sovereign power and could be created only by state grant. But by the late nineteenth century, corporations could be formed by complying with the requirements of general corporation statutes in virtually every state. Today the standard is the Revised Model Business Corporation Act.

The corporation, as a legal entity, has many of the usual rights accorded natural persons. The principle of limited liability is broad but not absolute: when the corporation is used to commit a fraud or an injustice or when the corporation does not act as if it were one, the courts will pierce the corporate veil and pin liability on stockholders.

Besides the usual business corporation, there are other forms, including not-for-profit corporations and professional corporations. Business corporations are classified into two types: publicly held and closely held corporations.

To form a corporation, the would-be stockholders must choose the state in which they wish to incorporate. The goal of the incorporation process is issuance of a corporate charter. The charter is a contract between the state and the corporation. Although the Constitution prohibits states from impairing the obligation of contracts, states reserve the right to modify corporate charters.

The corporation is created by the incorporators (or promoters), who raise capital, enter into contracts on behalf of the corporation to be formed, and prepare the articles of incorporation. The promoters are personally liable on the contracts they enter into before the corporation is formed. Incorporators owe a fiduciary duty to each other, to investors, and to the corporation.

The articles of incorporation typically contain a number of features, including the corporate name, corporate purposes, total number of shares and classes into which they are divided, par value, and the like. The name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The articles of incorporation must be filed with the secretary of state. Once they have been filed, the board of directors named in the articles must adopt bylaws, elect officers, and conduct other necessary business. The directors are empowered to alter the bylaws, subject to repeal or change by the shareholders.

Even if the formal prerequisites to incorporation are lacking, a de facto corporation will be held to have been formed if (1) a statute exists under which the corporation could have been validly incorporated, (2) the promoters made a bona fide attempt to comply with the statute, and (3) a corporate privilege was exercised. Under appropriate circumstances, a corporation will be held to exist by estoppel.

Exercises

1. Two young business school graduates, Laverne and Shirley, form a consulting firm. In deciding between the partnership and corporation form of organization, they are especially concerned about personal liability for giving bad advice to their clients; that is, in the event they are sued, they want to prevent plaintiffs from taking their personal assets to satisfy judgments against the firm. Which form of organization would you recommend? Why?
2. Assume that Laverne and Shirley in Exercise 1 must negotiate a large loan from a local bank in order to finance their firm. A friend advises them that they should incorporate in order to avoid personal liability for the loan. Is this good advice? Why?
3. Assume that Laverne and Shirley decide to form a corporation. Before the incorporation process is complete, Laverne enters into a contract on behalf of the corporation to purchase office furniture and equipment for \$20,000. After the incorporation process has been completed, the corporation formally accepts the contract made by Laverne. Is Laverne personally liable on the contract before corporate acceptance? After corporate acceptance? Why?
4. Assume that Laverne and Shirley have incorporated their business. One afternoon, an old college friend visits Shirley at the office. Shirley and her friend decide to go out for dinner to discuss old times. Shirley, being short of cash, takes money from a petty cash box to pay for dinner. (She first obtains permission from Laverne, who has done the same thing many times in the past.) Over dinner, Shirley learns that her friend is now an IRS agent and is investigating Shirley's corporation. What problems does Shirley face in the investigation? Why?
5. Assume that Laverne and Shirley prepare articles of incorporation but forget to send the articles to the appropriate state office. A few months after they begin to operate their consulting business as a corporation, Laverne visits a client. After her meeting,

in driving out of a parking lot, Laverne inadvertently backs her car over the client, causing serious bodily harm. Is Shirley liable for the accident? Why?

6. Ralph, a resident of Oklahoma, was injured when using a consumer product manufactured by a corporation whose principal offices were in Tulsa. Since his damages exceeded \$10,000, he filed a products-liability action against the company, which was incorporated in Delaware, in federal court. Does the federal court have jurisdiction? Why?
7. Alice is the president and only shareholder of a corporation. The IRS is investigating Alice and demands that she produce her corporate records. Alice refuses, pleading the Fifth Amendment privilege against self-incrimination. May the IRS force Alice to turn over her corporate records? Why?

SELF CHECK QUESTIONS

1. In comparing partnerships with corporations, the major factor favoring the corporate form is
 1. ease of formation
 2. flexible financing
 3. limited liability
 4. control of the business by investors
2. A corporation with no part of its income distributable to its members, directors, or officers is called
 1. a publicly held corporation
 2. a closely held corporation
 3. a professional corporation
 4. a nonprofit corporation
3. A corporation in which stock is widely held or available through a national or regional stock exchange is called
 1. a publicly held corporation
 2. a closely held corporation
 3. a public corporation
 4. none of the above
4. Essential to the formation of a de facto corporation is
 1. a statute under which the corporation could have been validly incorporated
 2. promoters who make a bona fide attempt to comply with the corporation statute
 3. the use or exercise of corporate powers
 4. each of the above
5. Even when incorporators miss important steps, it is possible to create
 1. a corporation by estoppel
 2. a de jure corporation
 3. an S corporation
 4. none of the above

Answers

1. c
2. d
3. a
4. d
5. a

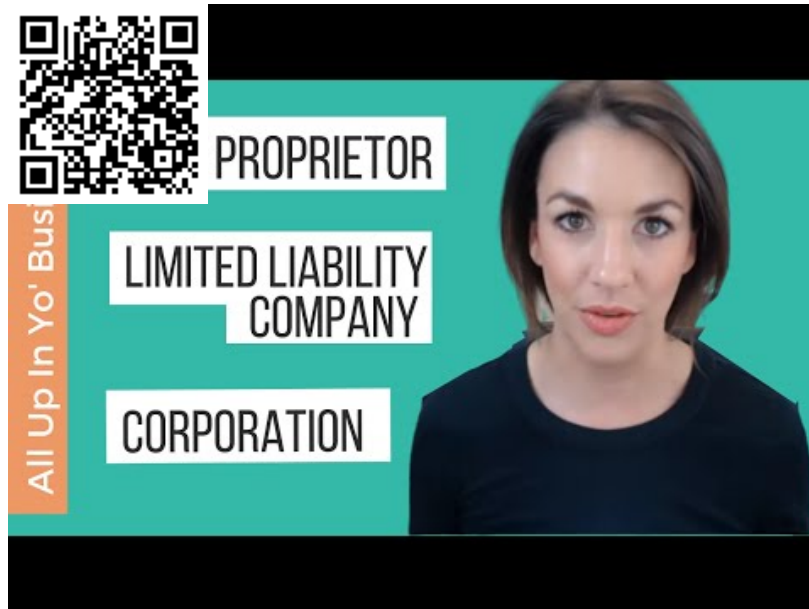
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2.3: WATCH - Types of Business Organizations (embedded quiz)

Notes:

Sole Proprietorship vs LLC vs Corporation | DBA or LLC? Watch this 8:43 video to learn more about the difference between types of organizations. How did you do on the quiz during the video?



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2.4: READ- What's the Difference Between Public and Private Administration

[READ: What's the Difference Between Public and Private Administration](#)

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2.5: WATCH- Legal Basics and Business Entity Formation

Notes:

It can be daunting to move from the abstract idea stage to the realm of bank accounts, taxes, and liability. Watch this 14:55 video to learn more.

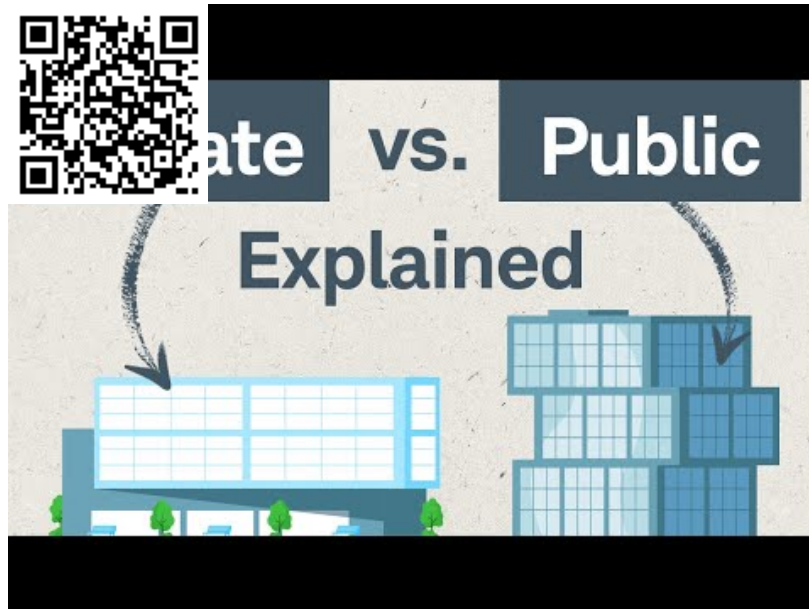


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2.6: WATCH- Private vs. Public Explained

Notes:

Publicly traded and privately held companies operate in different ways. Watch this 2:38 video to learn the key differences and why a public company may choose to return to private.



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CHAPTER OVERVIEW

3: Module 3 - Criminal Liability and the Tort System

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3.2: Criminal Liability

3.2.1: Introduction

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3.3: The Tort System

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3.4: READ- Tort vs. Criminal Law

3.5: WATCH- Tort vs. Crime

3.6: DISCUSSION - Tort or Crime?

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3.1: Key Ideas

Module 3: Key Ideas

White collar crimes	Fraud	Ponzi schemes	Larceny
Embezzlement	Environmental crimes	Anti-trust laws	Monopolies
Racketeering	Bribery	Money laundering	Spam
Criminal law	Civil law	Malpractice	

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SECTION OVERVIEW

3.2: Criminal Liability

3.2.1: Introduction

3.2.2: Common Business Crimes

3.2.3: Civil vs. Criminal Liability

3.2.4: End Notes

3.2.E: Assessment Questions

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3.2.1: Introduction

Learning Objectives

- Analyze sources of criminal exposure in business.



Figure 3.2.1.1: Introduction Lady Justice by Arend Ode(Image Credit: AJEL/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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3.2.2: Common Business Crimes

People rarely think about their conduct at work as being potentially illegal, or that jail time could result from poor workplace decisions. However, this fact is the reality. Organizations are fined, and executives are sentenced to jail, when business laws are broken. Many of the workplace violations are nonviolent crimes, such as fraud, property crimes, or drug- or alcohol-related infractions. Regardless of the level of violence or the employee's motivation for committing the crime, breaking the law can lead to negative consequences for the business, its employees, and its customers.

Constitutional Authority to Regulate Business

Congress is given the power to “regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” Our forefathers wanted to facilitate easier trade among the states by allowing Congress to adopt rules that could be uniformly applied. The theory was that if commercial enterprises knew that they would be dealing with essentially the same rules across the nation, it would be much easier to run their businesses and keep commerce flowing more efficiently.

While federal courts initially interpreted the commerce power narrowly, over time, the federal courts have decided that the commerce clause gives the federal government broad powers to regulate commerce, not only on an **interstate** (between the states) level, but also on an **intrastate** (within each state) level, as long as some economic transaction is involved. The federal government does not usually exceed its regulatory powers.

White Collar Crime

White collar crimes are characterized by deceit, concealment, or violation of trust. They are committed by business professionals. They generally involve fraud, and the employees committing the crimes are motivated by the desire for financial gains or fear of losing business standing, money, or property. **Fraud** is the intentional misrepresentation of material facts for monetary gain. This type of crime is not dependent on threats or violence.



Figure 3.2.2.1: White collar crimes are committed by business professionals within businesses with the intent of gaining or maintaining status. (Credit: Rawpixel/ pexels/ License: CC0)

White collar crimes tend to violate state laws, and sometimes federal laws. The violation depends on what is involved in the crime. For instance, criminal acts involving the United States postal system or interstate commerce violate federal law.

Although white collar crimes do not need to include physical violence, these types of crimes can destroy companies, the environment, and the financial stability of clients, employees, and communities. In 2018, Jeremiah Hand and his brothers, Jehu Hand and Adam Hand, were convicted and sentenced to between 9 and 30 months in prison for their respective roles in a **pump-and-dump** scheme. In this scheme, they were dishonest about control over their company's stock, and even went as far as filing false forms in an effort to raise the value of the stock. Once the value of the stock was raised, they released their shares into the market.

Types of Business Crimes

Business crimes or white collar crimes are not limited to pump-and-dump schemes; they come in many different forms. Business crimes come in many different forms. As previously stated, these crimes often involve deceit, fraud, or misinformation. The types

of high-profile crimes include Ponzi schemes, embezzlement, and crimes that intentionally violate environmental laws and regulations. This section will explore these three types of crimes and provide examples from the 2000s.

Ponzi Schemes

Ponzi schemes (also known as pyramid schemes) are investing scams that promise investors low-risk investment opportunities with a high rate of return. The high rates are paid to old investors with money acquired from the acquisition of new investors. The performance of the market is not a factor in the investors' rate of return.

Bernie Madoff operated a 20-year Ponzi scheme through his company. He paid high returns (above average) using the investments of new clients (investors). In 2008, investors attempted to withdraw funds, but the Madoff organization was not able to provide the reimbursement. Madoff is currently serving a more than 100-year sentence in prison.

Larceny and Embezzlement

Larceny and embezzlement are two forms of theft that can occur within a business. **Larceny** occurs when a person unlawfully takes the personal property of another person or a business. For example, if an employee takes another employee's computer with the intent of stealing it, he or she may be guilty of larceny. In contrast, **embezzlement** occurs when a person has been entrusted with an item of value and then refuses to return it or does not return the item. For example, if an employee is entrusted with the petty cash at his or her office and that person purposefully takes some of the money for himself or herself, this would be embezzlement.

One high-profile example of embezzlement occurred at Koss Corporation in Milwaukee, Wisconsin. Sujata "Sue" Sachdeva was a Vice President of Finance and Principal Accounting Officer at Koss Corporation. Sachdeva was convicted of embezzling \$34 million over a 5-year period and sentenced to 11 years in federal prison, as well as restitution to Koss Corporation. Sachdeva was entrusted with the company's funds and did not utilize the funds as intended.

Environmental Crimes

Many federal statutes regulate the environment. Many of these laws carry both civil and criminal penalties for violations.

The following federal laws can carry criminal penalties:

- Clean Air Act
- Clean Water Act
- Resource Conservation and Recovery Act
- Comprehensive Environmental Response, Compensation and Liability Act
- Endangered Species Act

The International Petroleum Corporation of Delaware (IPC) is paying restitution for environmental crimes, which included a scheme to violate the Clean Water Act. From 1992 to 2012, IPC processed oil and wastewater. The company admitted to altering required water test samples so they met the limits set by their permit before releasing the waste into the city's sewer system. The company also admitted to transporting waste that contained benzene, barium, chromium, cadmium, lead, PCE, and trichloroethene for disposal in South Carolina without the required reporting of the information, which also violated environmental laws.



Figure 3.2.2.2: White collar crimes are generally motivated by the desire to maintain or gain financial status. (Credit: TheDigitalWay/ pixabay/ License: CC0)

Other Types of Business Crime

The business environment is complex, and some crimes are less common or receive less media attention. These types of crimes include those that violate antitrust laws, racketeering, bribery, money laundering, and spamming.

Violations of Antitrust Laws

Antitrust laws do not allow activities that restrain trade or promote market domination. These laws are in place to provide guidance and supervision of mergers and acquisitions of companies to prevent market abuse. The goal is to avoid **monopolies**, or the control of one organization over a specific market. Monopolies reduce competition and, as a result, can have a detrimental impact on consumer prices. Since the United States is founded on capitalist principles, anti-competitive business conduct is prohibited by law, and some of those laws, such as the Sherman Antitrust Act, do include provisions about criminal punishment.

Racketeering

Racketeering activities include loan-sharking, money laundering, and blackmailing. In the past, the term has been used to describe organized crime. The term is now applied to other entities, as well. RICO, or the Racketeer Influenced and Corrupt Organizations Act, is a federal law aimed at preventing and prosecuting by both businesses and organized crime syndicates. “RICO is now used against insurance companies, stock brokerages, tobacco companies, banks, and other large commercial enterprises.” (Schodolski, 2018). Racketeering is no longer limited to organized crime. Health insurance companies and other legitimate businesses are being accused of pressure tactics similar to those used in organized crime racketeering. These claims involve allegations of lying about the actual cost of care, damaging the business for physicians, bullying patients, and attempting to control the doctor-patient relationship through lies and pressure tactics.

Bribery

Bribery occurs when monetary payments, goods, services, information, or anything of value is exchanged for favorable or desired actions. You can be charged with bribery for offering a bribe, or taking a bribe. Bribery is illegal within the United States and outside of it. The Foreign Corrupt Practices Act prohibits bribery payments by U.S. companies to foreign government officials with an intent to influence foreign business results. One example of bribery would be a situation in which a pharmaceutical company offers special benefits to individuals who agree to prescribe their medications.

Money Laundering

Money laundering refers to taking “dirty” money, or money obtained through criminal activities, and passing it through otherwise legitimate businesses so that it appears “clean.” The money cannot be tied back to the illegal acts. Clean money is money that was

obtained through legitimate business functions.

Spamming

Sending unsolicited commercial email, or spam, is illegal. While the onus is on consumers to avail themselves of whatever programs they can to block spam, laws are in place to discourage the sending of spam. The following points are outlined in the anti-spam legislation in Washington state and are similar to other legislation:

1. Individuals may not initiate the sending or plan the sending of an email that misrepresents the sender as someone he or she is not, represents the sender as being associated with an organization that he or she has no association, or otherwise hides the identity of the sender or origin of the email. Email messages may not have false or misleading information in the subject line of the message.
2. Commercial emails must include the contact information of the sender and the receiver must be aware that the message is from a commercial source.

States like Washington are putting legislation in place to reduce spam and asking consumers to take an active role in addressing spam. In general, legislators realize that spam is a nuisance and are finding ways to hold companies liable for sending spam messages.

Conclusion

It is important to know that not all people charged with business crimes or white collar crimes are necessarily guilty. A person must be found guilty of the crime before he or she is convicted. Regardless, business crimes and white collar crimes negatively impact the individual, the organization he or she worked for, the community, and customers.

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3.2.3: Civil vs. Criminal Liability

A legal case can be civil or criminal. Each case has different components and requirements. Before one can understand the civil and criminal systems, it is important to understand the aspects of both civil and criminal laws. The scope, consequences, and treatments of each vary.

Constitutional Rights

It is important to understand the Constitution, which is the basis of all law. States are allowed to create and categorize crimes and punishment, as long as they do not violate rights protected by the U.S. Constitution. For example, in a fairly recent United States Supreme Court case, *Lawrence v. Texas*, the defendants asserted the unconstitutionality of a Texas law (enacted by the Texas legislature) regarding a particular act. When the United States Supreme Court ruled it unconstitutional, Texas could no longer enforce it.

Frequent issues litigated in the courts are:

- Whether evidence must be suppressed (not allowed to be introduced at trial) because it was obtained pursuant to an unreasonable search and seizure (violating the Fourth Amendment). This category might involve a sub-issue about whether officers had sufficient probable cause to conduct a warrantless search. Without a warrant, and without the suspect's consent, officers generally may only conduct searches if they have "probable cause" to do so; any evidence obtained without consent or probable cause can be objected to, and ultimately ruled inadmissible by the court in trial, if illegally obtained.
- Whether evidence must be suppressed because it was obtained while the suspect was "in custody" without advising a suspect of his rights to remain silent, to speak to an attorney, and to the appointment of an attorney if he cannot afford one (Fifth Amendment privilege against self-incrimination and Sixth Amendment right to counsel), as required by the Supreme Court in the famous *Miranda v. Arizona* case. The term often used to describe these rights is "Mirandizing," which is named after the case.
- Whether a state law or constitutional provision provides more protection than the U.S. Constitution.



Figure 3.2.3.1: Both civil and criminal convictions are based on precedent. (Credit: PactoVisual/ pixabay/ License: CC0)

Components of Crime

There are usually two components to criminal conduct that must be proven by the prosecutor. The prosecutor prosecutes the case against the accused: ***mens rea*** (the criminal, or guilty, or "wrongful" mind) and ***actus reus*** (the criminal, or guilty, or "wrongful" act).

Each statute creating a crime is supposed to include a description of:

- a. the mental state (***mens rea***) required to establish that the suspect committed the crime, coupled with
- b. a description of the conduct (***actus reus***) that the suspect must have done.

The statute generally also indicates the category of crime (felony/misdemeanor/gross misdemeanor).

Criminal Procedures

Generally, the first pleading filed by the prosecutor is called the **information**. (This step could be described as the criminal counterpart to a civil “complaint.”)

The next stage is called the **arraignment**, where the defendant appears in court so that the court can determine or confirm his or her identity, inform the defendant of the charge the prosecutor has filed against him or her, and hear the defendant’s plea.

Then, there will be discovery and trial. In criminal cases, the jury will convict only if convinced “beyond a reasonable doubt” that the defendant committed the crime, and the verdict must be unanimous. This type of case involves a higher burden of proof than in civil cases.

Criminal and Civil Law

Criminal law addresses behaviors that are offenses against the public, society, or state. Examples of criminal law offenses include assault, drunk driving, and theft. In contrast, **civil laws** address behavior that causes an injury to the private rights of individuals in areas such as child support, divorce, contracts, property, and the person. Examples of civil law offenses include libel, slander, or contract breaches.

Criminal and civil cases differ in who initiates the case, how the case is decided, what punishments or penalties are issued, requirements of proof, and legal protections provided.



Figure 3.2.3.2: Civil and criminal cases involve the court system. (Credit: Brett Sayles/ pexels/ License: CC0)

Initiation and Roles

Criminal and civil cases are initiated differently, and the titles of the individuals involved differ slightly. Criminal cases are only initiated by the federal or state government in response to a law being broken. The federal or state governments are known as the prosecution. The prosecution is an attorney, or group of attorneys, hired by the government to present a case against the accused. Criminal cases are usually titled something like “State v. [last name of the defendant accused of a crime].” In criminal prosecutions, the victim is not a party to the lawsuit, but might be a witness for the state at the trial.

In contrast, private parties initiate civil cases when they feel that someone has injured them. Again, civil cases stem from breach of contract, custody cases, and attacks on one’s character. Private parties can include an individual, a group, or a business. The person, group, or business who initiates the case is referred to as the plaintiff or complainant. The accused is referred to as the defendant, in both criminal and civil proceedings.

Typically, there is a difference in the burden of proof for the two types of cases. In a criminal case, the defendant must be proven guilty “beyond a reasonable doubt.” In a civil case, the defendant must be proven liable through a “preponderance of the evidence.” In other words, the prosecution in a civil case must prove that it is more probable than not that the defendant is liable.

In criminal cases, the defendant is entitled to an attorney and may be appointed an attorney if he or she is not able to afford one. The state appoints the attorney. In contrast, all parties involved in a civil case are required to secure their own legal representation.

Typically, civil and criminal laws use different terminology, and being found guilty or accountable in each type of case results in different consequences.

In a civil action (lawsuit), the plaintiff is the person who is alleging that he or she has actually been harmed (physically, financially, or in another manner), and the defendant is the one who is asked to pay damages or otherwise compensate the plaintiff. Outside of financial compensation, the plaintiff may be ordered to do something or refrain from doing something, which is referred to as injunctive relief.

In the *Liebeck v. McDonald's* case, a woman sued McDonald's for serving hot coffee. The woman spilled hot coffee on her lap while trying to add cream and sugar. The woman sued McDonald's for negligence in a civil suit. The issue centered on whether or not the coffee's specific temperature was unreasonably hot. McDonald's lost the lawsuit. The compensatory verdict was \$160,000. McDonald's was found liable.

Conversely, if a defendant is convicted of committing a crime, the consequences are usually incarceration (jail/prison) and/or a fine (payment of money to the state).

The word used to describe the legal responsibility for harm in a civil case is liability, not guilt. Guilty is the word used to describe a person found guilty of committing a crime in a criminal case.

Businesses can be charged with criminal acts as well. In 2017, Oliver Schmidt, former manager of a Volkswagen engineering office near Detroit, was arrested. He faced years in prison for attempts to defraud the United States, wire fraud, violation of the Clean Air Act, and a charge of giving an untrue statement under the Clean Air Act. Schmidt's actions directly violated a business law and, since his actions violated an established law, he was held criminally liable. In December of 2017, Schmidt was sentenced to seven years in prison.

Professional Negligence

Professional negligence is often called **malpractice**. A professional's duty of care is usually a duty to exercise the degree of care, skill, diligence, and knowledge commonly possessed and exercised by a reasonable, careful, and prudent professional of the same type in the state (or sometimes in the community). Along with attorneys and health care providers, the following professionals might be sued for malpractice: accountants, architects, engineers, surveyors, insurance brokers, real estate agents and brokers, and clergy.

For negligence, the usual kind of damages recoverable are **compensatory**, or money to compensate for the injuries/damages incurred to make the person **whole** (e.g., money for medical bills, lost wages, loss of future earning capacity, pain and suffering, emotional distress, property damage, etc.).

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3.2.E: Assessment Questions

1. Explain White Collar Crime.

Answer

White collar crimes are characterized by deceit, concealment, or violation of trust. They are committed by business professionals. They generally involve fraud, and the employees committing the crimes are motivated by the desire for financial gains or fear of losing business standing, money, or property. Fraud is the intentional misrepresentation of material facts for monetary gain. This type of crime is not dependent on threats or violence.

2. What is a pump-and-dump scheme?
3. The crime of larceny includes:
 - a. The nontresspassory taking and controlling of personal property.
 - b. The trespassory taking and carrying away of real or personal property.
 - c. Joyriding.
 - d. The trespassory taking and control of personal property.

Answer

d

4. Distinguish between larceny and embezzlement.
5. What is the Foreign Corrupt Practices Act?

Answer

The Foreign Corrupt Practices Act prohibits bribery payments by U.S. companies to foreign government officials with an intent to influence foreign business results. One example of bribery would be a situation in which a pharmaceutical company offers special benefits to individuals who agree to prescribe their medications.

6. Businesses can be charged with crimes.
 - a. True.
 - b. False.
7. The burden of proof in a criminal case is:
 - a. Reasonable suspicion.
 - b. Beyond a reasonable doubt.
 - c. Preponderance of evidence.
 - d. Clear and convincing evidence.

Answer

b

8. Which of the following is a goal of an arraignment?
 - a. The defendant is informed of the charge and enters a plea.
 - b. Requires the defendant to bear the burden of proof
 - c. Begins the inquisitorial system of adjudication.
 - d. All of these are correct.
9. The criminal act necessary to commit a crime is known as:
 - a. Malice aforethought.
 - b. Mens rea.
 - c. Subjective fault.
 - d. Actus reus.

Answer

d

10. Distinguish between civil and criminal law.

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SECTION OVERVIEW

3.3: The Tort System

3.3.1: Introduction

3.3.2: Intentional Torts and Negligence

3.3.3: Product and Strict Liability

3.3.4: End Notes

3.3.E: Assessment Questions

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3.3.1: Introduction

Learning Objectives

- Explain torts system application to business.



Figure 3.3.1.1: Introduction (Credit: Free-Photos/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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3.3.2: Intentional Torts and Negligence

Civil suits arise from damages suffered by one or more persons or entities at the hands of another person or entity. The damage can happen in a variety of circumstances, and may be intentional or unintentional. Unlike criminal cases, civil suits seek to provide some form of remedy for the loss suffered by an injured party. Civil suits are decided by judges and juries based on the specific situation, especially when violation of **statutes**, or laws, is not in question.

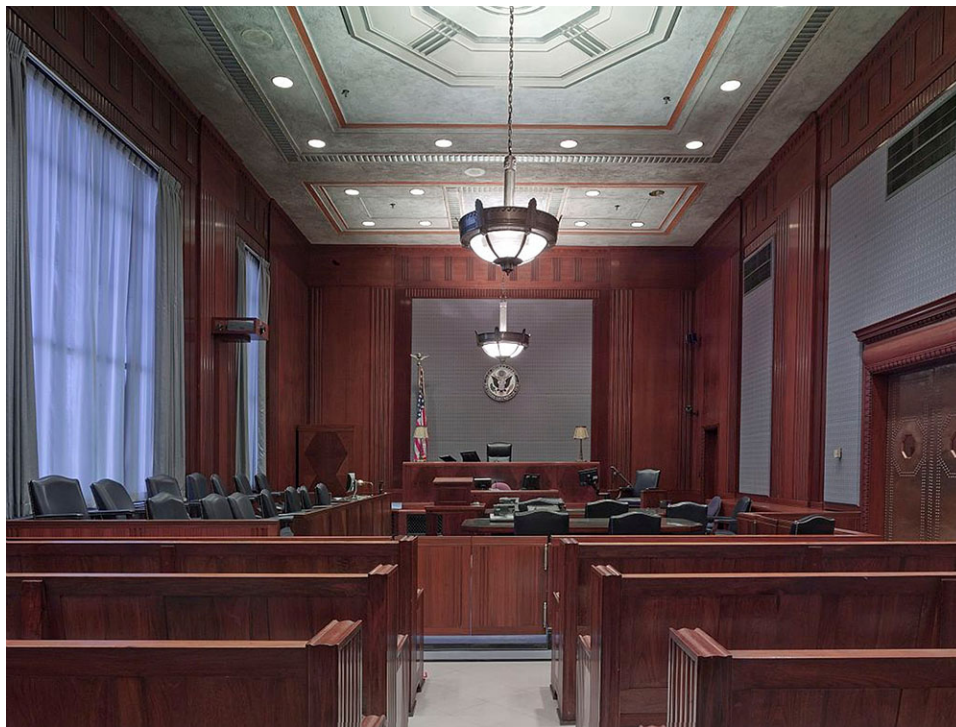


Figure 3.3.2.1: Civil suits are decided in court by judges and juries. (Credit: Coffee/ pixabay/ License: CC0)

Torts

Civil suits involve different causes of action, and they are included in one general classification: **torts**. The word “tort” means “wrong” in French. Thus, torts are wrongs committed against others who suffer some form of damage as a result. While these damages could also be the result of criminal action, the criminal element of the matter is not tried in a civil lawsuit. The standard of proof is lower for civil suits, and a finding of liability in a tort case does not necessarily translate to guilt in a criminal case.

The actor of the wrongs has historically been called a **tortfeasor**. When a wrong is committed by a tortfeasor, damage is done to another. **Tort law** seeks to address this damage based on the circumstances of the issue, which is based on **fault**. Civil lawsuits are used by the injured parties to seek redress for the loss associated with the tort. Unlike criminal proceedings, redress is often provided in the form of money as opposed to incarceration. As such, the burden of proof of fault is lower. The **offender**, or tortfeasor, who commits the act is the accused in a civil suit. The **plaintiff**, who is the injured party, files the lawsuit on which the civil court will make a decision. The offender ultimately becomes the **defendant**, who must respond to the accusations of the plaintiff in a civil suit.

During tort litigation, the judge and jury have certain separate functions (Kionka, 2013):

Table 3.3.2.1: Functions During a Tort Litigation

The Judge Decides Issues of Law	The Jury Decides Questions of Fact
The duty of the defendant to the plaintiff, if any	What happened
The elements of the defense	Legal consequences of what happened
Application of legal rules	The damages suffered by the plaintiff

Harm

Two types of torts are intentional torts and negligence. **Intentional torts** occur as the result of a conscious and purposeful act. **Negligence** occurs when an individual does not exercise duty of care. Torts are acts or omissions that result in injury or **harm** to an individual in such a way that it leads to a civil wrong that occurs as liability (WEX, n.d.). In tort law, harm can be defined as a loss or disadvantage suffered as a result of the actions or omissions of another (WEX, n.d.). This loss can be physical harm, such as slipping and falling on a wet floor, or personal property harm, such as allowing water to ruin furniture. The damage is the result of what someone else did, or did not do, either intentionally or based on a lack of reasonable care.

There are two basic elements to torts: damages and compensation (Laws, tort.laws.com). Tort law acts to compensate persons who have suffered damages at the hands of another (Baime, 2018). Tort law determines the legal responsibility of the defendant and the value of the harm. Different types of torts look at different types of circumstances.

Intentional Torts

Intentional torts are committed by an offender who understands that he or she is committing a tort. Intent does not always equate to directly causing an end result. In some cases, the intent may be something else, such as the possession of knowledge that some harm may occur. The harm may result from intentional action, or due to some circumstance that the offender feels will be excusable (Kionka, 2013).

Some circumstances that could allow the defendant to argue that the action is excusable would include: permission by the injured party, or defense of property, self, or another person (Kionka, 2013). If the injured party agrees to allow the defendant to juggle knives and one slips and causes harm, the action might be excusable to some extent. If a defendant caused harm to the plaintiff's car while trying to avoid being hit by the car, it would likely be excusable.

Different types of intentional torts are based on different circumstances and face different **remedies**, or means of recovering losses (Baime, 2018):

- **Assault** is an intentional tort that occurs when an individual has a reasonable apprehension of an intentional act that is designed to cause harm to himself or herself, or to another person.
- **Malicious prosecution** occurs when an individual files groundless complaints to initiate a criminal matter against another.
- **Defamation** occurs when an individual intentionally creates and promotes malicious falsehoods about another. Defamation can occur in two ways: slander and libel. **Slander** is, in effect, when falsehoods are spoken. **Libel** occurs when falsehoods are expressed in written or other recorded forums.
- **Invasion of privacy** involves unwanted production of negative public information. Different standards apply to invasion of privacy based on the status of the individual as a public figure.

Negligence

Negligence is another type of tort that has two meanings. It is the name of a **cause of action** in a tort, and it is a form of conduct that does not meet the **reasonable standard of care** (Kionka, 2013). The cause of action is the reason for the damage, and the standard of care is based on the care that a reasonable person would need in a given situation. Negligence is decided by determining the duty of the defendant, whether or not the defendant committed a breach of that duty, the cause of the injury, and the injury itself.

For an action to be deemed negligent, there must be a legal **duty of care**, or responsibility to act, based on the reasonable standard in a situation (Baime, 2018). An individual can be considered negligent if he agreed to watch a child, but did not do so, and then harm came to the child. An individual would not be considered negligent if he did not know that he was supposed to watch the child, or did not agree to watch the child.



Figure 3.3.2.2: If an individual agrees to watch a child and the child is injured while that person pays attention to her cell phone, it would be considered negligence. (Credit: JESHOOTScorn/ pixabay/ License: CC0)

A **reasonable person** is defined as someone who must exercise reasonable care based on what he or she knows about the situation, how much experience he or she has with the situation, and how he or she perceives the situation (Kionka, 2013). In some cases, this knowledge could be based on common knowledge of community matters, such as knowing that a bridge is closed for repairs.

In some cases, the duty of care is based on a **special relationship**, which is a relationship based on an implied duty of care. This implied duty of care often comes about as a **duty to aid**, or a duty to protect another, e.g., a nurse caring for patients in a hospital, or a lifeguard being responsible for swimmers in the guarded area (Baime, 2018). A passerby does not have a duty to aid, but if the individual tries to help, then he or she is responsible for acting responsibly.

The elements of a negligence cause of action are (Kionka, 2013):

- A duty by the defendant to either act or refrain from acting
- A breach of that duty, based on a failure to conform to the standard of care by the defendant
- A causal connection between the defendant's action or inaction, and the injury to the plaintiff
- Measurable harm that can be remedied in monetary damages

Foreseeability

Negligence case decisions are influenced by whether or not a defendant could have predicted that an action or inaction could have resulted in the tort, or **foreseeability** (Baime, 2018). Responsibility is often based on whether or not the harm caused by an action or inaction was **reasonably foreseeable**, which means that the result was fairly obvious before it occurred (Baime, 2018). A person assisting an inebriated individual into her car could be considered negligent due to the likelihood that harm would come to her while she is driving in an intoxicated state. This situation is an example of the **foreseeable probability of harm**.

Conclusion

Intentional torts and negligence arise based on intentional and unintentional acts committed by individuals. Damages are decided in civil courts by first determining fault and harm, and then by assigning a remedy. Sometimes, the damage can be excused if the circumstances indicate that the defendant acted with permission, or in his or her own defense. The main standard used to make a decision is the reasonable standard of care: what would a reasonable person do?

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3.3.3: Product and Strict Liability

Determination of fault and damages for intentional torts and negligence are based on the reasonable standard of care. Another form of torts looks at liability without fault, or **strict liability**. Strict liability determines liability, or harm, based on reasons other than fault (CCBC Legal Studies, n.d.). The mistakes leading to harm can be completely unintentional, and in some cases, unavoidable. Yet, damage is done, and a civil suit arises.

Strict Liability

Strict liability provides a remedy when harm is suffered through no intentional fault. The courts needed to create a standard that would cover this form of tort, or one without fault. The courts came up with the **abnormally dangerous activity standard**, which assigns responsibility when an individual engages in some form of dangerous activity, even if care is taken to avoid mishap (CCBC Legal Studies, n.d.). If a homeowner has horses in a pasture that is bounded by electric fencing, it can be determined that the homeowner exercised reasonable care. However, suppose that the electricity goes down, the horses get out onto the road, and an accident occurs as a result. In this case, the owner is responsible, even though he took reasonable care and the event was unforeseen.



Figure 3.3.3.1: If horses get out of a fenced-in area, the owner would be liable for any damage they cause while loose. (Credit: Slack/ pexels/ License: CC0)

For a court to assign strict liability based on abnormally dangerous activities, the activity must meet certain criteria. The court must establish that at least four of the following six factors are present (CCBC Legal Studies, n.d.):

- The activity poses a high degree of risk of harm to a person, the land of another, or the property owned by another.
- The harm resulting from this activity would likely be substantial.
- The use of reasonable care would not eliminate this risk.
- The activity is not something that would be considered a matter of common usage.
- The activity is not appropriate for the place where it occurs.
- The danger of the activity overshadows the benefit it poses to a given community.

In essence, the basis for determining strict liability is the extent of the risk involved in the activity. This basis could also apply to the ownership of dangerous pets. A dog that is known to be aggressive would qualify the owner for strict liability should it get out

and bite someone. The courts would find that the owner knew, or should have known, that the dog was dangerous and had a propensity to cause harm (Kionka, 2013).

Trespass

In some situations, the owner of the dangerous activity might not be held liable. One such situation is trespassing. Trespassing occurs as an individual enters or remains upon property owned by another without permission (Kionka, 2013). In the case of trespassing, the owner of the property does not have a duty to make the premises safe based on reasonable care for the trespasser (Kionka, 2013). Also, the owner does not have a responsibility to cancel or alter activities on the premises to avoid endangering the trespasser (Kionka, 2013).



Figure 3.3.3.2: Train tracks are a common area for trespassing. (Credit: Muscat_Coach/ pixabay/ License: CC0)

In some cases, however, the property owner could be held liable (Kionka, 2013):

- When the area in question is a common place for trespassing
- When the owner knows a trespasser is present
- When the trespasser needs aid, then the owner has a duty to rescue him or her
- When the trespasser is a child, and the dangerous activity is deemed as an **attractive nuisance**, or an attraction that a reasonable child would wish to view

Even though trespassing can present an exception to liability in the presence of a dangerous activity, it is not a given. There are numerous exceptions that allow for liability. In effect, strict liability can occur in a given situation even when the property owner has provided care that goes above and beyond what is reasonable. The court does not need to establish proof of lack of due care when applying strict liability to a case (Baime, 2018).

Product Liability

Individuals are not always the defendants involved in civil suits. Manufacturers, wholesalers, distributors, and retailers can also be named in torts that pertain to products and qualify as strict liability (CCBC Legal Studies, n.d.). Some products contain flaws that were not intentionally created; such flaws may not be discovered until an individual suffers harm as a result of using them.

It is not always possible to conclusively prove that an act or omission was responsible for the harm (Baime, 2018). As a result, the courts developed the doctrine of **res ipsa loquitur**, which means that whatever it is speaks for itself. The burden of proof shifts

from the plaintiff to the defendant, who must disprove negligence. However, the plaintiff must first establish three factors (Baime, 2018):

- The defendant had control over the product in question while it was being manufactured.
- Under normal use and circumstances, the product would not cause damage or harm, but damage or harm has occurred in the case in question.
- The behavior of the plaintiff did not significantly contribute to the harm caused.

The doctrine of *res ipsa loquitor* does not establish proof of negligence, but it does allow the jury to infer what is not explicitly available pertaining to negligent acts or omissions on the part of the defendant (Baime, 2018).

Negligence can occur when products are created because defects can harm consumers. Think about the potential harm that would occur if brake manufacturers were negligent. This negligence would cause brakes to have flaws, which would prevent them from doing their job of stopping cars. If a car does not stop, people will likely be injured. The manufacturing defect would result in a product liability lawsuit, based on legal responsibility for the harmful consequences proximately caused by the product defect (Baime, 2018). Since the courts would not be able to see the negligence occurring, the courts would base their decision on *res ipsa loquitor* and the fact that the brakes would not normally fail under normal use by the driver.



Figure 3.3.3.3: If brakes do not work like they are supposed to, it could be the result of a manufacturing defect that would result in product liability. (Credit: Valtercirillo/ pixabay/ License: CC0)

The Unreasonably Dangerous Product Standard

In the case of product liability, the court uses an unreasonably dangerous product standard to determine liability. The unreasonably dangerous product would be so dangerous that the danger would be beyond the expectation of the user, and a less dangerous option could have been produced instead (Kionka, 2013). This type of unreasonably dangerous product often falls into one of three categories (Kionka, 2013):

- A flaw in the manufacturing process that occurred because the manufacturer failed to exercise proper care during manufacturing
- A defect in the design of the product, which makes it dangerous, and safer alternatives are available and economically feasible
- The product includes insufficient warnings or instructions for the proper use of the product and its potential dangers

Defenses

There are defenses to product liability claims. In some cases, the plaintiff's own behaviors contribute to his or her injuries, based on his or her own negligence. This situation is known as **contributory negligence**. Contributory negligence, when determined by the court, prevents any recovery of damages by the plaintiff (Baime, 2018). So, if the court finds contributory negligence, the plaintiff is unable to recover any damages for the injury. Two forms of contributory negligence are assumption of risk and misuse.

Assumption of risk is one defense. In some cases, the defendant can argue that the user assumed the risk of using the product if he or she used the product while knowing that the defect in the product created a risk (CCBC Legal Studies, n.d.). An individual who purchases a saw and sees that the guard is too small to cover the teeth, but decides to use it anyway, is assuming the risk of using the product. If the saw cuts the individual, then the manufacturer could argue that the person assumed the risk because he saw the defect, understood the risk, and used the saw anyway.

Another defense is product **misuse**. In some cases, an individual will use a product in ways that it is not meant to be used (CCBC Legal Studies, n.d.). The user might not be aware of a defect, and he or she proceeds to use the product incorrectly. Misuse by the individual would be to blame for any resulting harm.



Figure 3.3.3.4: Using a chainsaw with bare feet could be dangerous and add to the risk of use without a guard. If the plaintiff suffered harm because his bare foot could not hold the wood down properly, he could be responsible for comparative negligence. (Credit: edman_eu/ pixabay/ License: CC0)

Plaintiffs might also be responsible for **comparative negligence**. With comparative negligence, the plaintiff's own actions in the use of the product contributed to the harm caused by the product, but the plaintiff might still receive damages (CCBC Legal Studies, n.d.). The amount of negligence on behalf of each part (plaintiff and defendant) is compared to determine the damages to which the plaintiff is entitled (Baime, 2018). If a plaintiff is found to be 30% responsible, and the defendant 70% responsible, then the plaintiff would be entitled to 70% of the damages suffered.

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3.3.4: End Notes

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3.3.E: Assessment Questions

1. Define Torts.

Answer

Torts are wrongs committed against others who suffer some form of damage as a result.

2. An example of an intentional tort is:

- a. Defamation.
- b. Assault.
- c. Malicious prosecution.
- d. All of the above.

3. When an individual creates and promotes malicious falsehoods about another that individual may be liable for:

- a. Libel.
- b. Slander.
- c. Defamation.
- d. All of the above.

Answer

d

4. Describe Negligence.

5. All of the following are elements of negligence except:

- a. A reasonable person.
- b. A duty by the defendant to either act or refrain from acting.
- c. A breach of a duty owed by defendant.
- d. Measurable harm.

Answer

a

6. Which of the following is a special relationship giving rise to a duty to act to aid or protect one in peril?

- a. Hotel and guest.
- b. Cousin to cousin.
- c. School principal and student.
- d. Hotel and guest, and school principal and student.

7. If an activity causes a foreseeable and highly significant risk of physical harm even when reasonable care is exercised by all actors, and the activity is not one of common usage, it is:

- a. Proximate cause.
- b. Abnormally dangerous.
- c. Negligence.
- d. None of these are correct.

Answer

b

8. What is an attractive nuisance?

9. The elements of res ipsa loquitur that a plaintiff must establish in a product liability lawsuit include all of the following except:

- a. The defendant breached his or her duty of care.
- b. The defendant had control over the product in question while it was being manufactured.
- c. Under normal circumstances, the product would not cause damage or harm, but damage or harm has occurred in the case in question.

d. The behavior of the plaintiff did not significantly contribute to the harm caused.

Answer

a

10. Describe the differences between contributory and comparative negligence.

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3.4: READ- Tort vs. Criminal Law

Tort or Crime?

Legal jargon can often be perplexing, leading to misconceptions and confusion, particularly when it comes to distinguishing between torts and crimes. These terms are frequently misunderstood and wrongly interchanged with one another. However, by delving into the basics of each field of law, we can gain clarity on the disparities between torts and crimes. In this article, we aim to set the record straight and provide you with a comprehensive understanding of both legal domains.

Read: [The Distinctions Between Tort and Criminal Law.pdf](#)

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3.5: WATCH- Tort vs. Crime



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3.6: DISCUSSION - Tort or Crime?

Notes:

Watch the video about Sam Bankman-Fried and answer the following questions.

1. What kind of crime did he commit? Is it criminal or tort? Can it be both? Was the sentence fair - why or why not?
2. Find another business crime in the news and share your article or video.



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CHAPTER OVERVIEW

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4.1: Key Ideas

Module 4: Key Ideas

Agreement	Consideration	Promissory Estoppel	Capacity
Voidable	Breach	Remedies	Restitution
Commutative	Principal	Uniform Commercial Code	Title
Warranty	Express Warranty	Onerous	

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SECTION OVERVIEW

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4.2.1: Introduction

Learning Objectives

- Analyze the principles of contract law and how they apply to businesses.



Figure 4.2.1.1: Introduction (Credit: edar/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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4.2.2: Consideration and Promissory Estoppel

A contract is defined as an agreement between two or more parties that is enforceable by law.

To be considered enforceable by law, a contract must contain several elements, including offer and acceptance, genuine agreement, consideration, capacity, and legality.



Figure 4.2.2.1: Before a contract can become legal and enforceable, several elements must first be in place. (Credit: rawpixel/pixabay/ License: CC0)

The key to a contract is that there must be an offer, and acceptance of the terms of that offer. An offer is a proposal made to demonstrate an intent to enter a contract. Acceptance is the agreement to be bound by the terms of the offer. Offers must be made with intent, must be definite and certain (i.e., the offer must be clearly expressed for it to be enforceable), and must be communicated to the offeree. An acceptance must demonstrate the willingness to consent to all of the terms of the offer.

Genuine agreement, i.e., “a meeting of the minds,” is also required. Agreement can be destroyed by fraud, misrepresentation, mistake, duress, or undue influence.

Consideration must be included in contracts. Consideration is a thing of value promised in exchange for something else of value. This mutual exchange binds the parties together.

Capacity to contract is the next element required for a valid agreement. The law presumes that anyone entering a contract has the legal capacity to do so. Minors are generally excused from contractual responsibility, as are mentally incompetent and drugged or drunk individuals.

Finally, legality is the last element considered. Parties entering into contracts that involve illegal conduct may not expect judicial relief to have that contract enforced. This theory has also been applied to conduct that would be considered in opposition to public policy.

Consideration and Promissory Estoppel

Contract law employs the principles of consideration and promissory estoppel.

Consideration

In most cases, consideration need not be pecuniary (monetary). Most contracts are enforceable only if each party gets consideration from the agreement. Consideration can be money, property, a promise, or some right. For instance, when a music company sells

studio equipment, the promised equipment is the consideration for the buyer. The seller's consideration is the money the buyer promises to pay for the equipment.

Promissory Estoppel

The promissory estoppel doctrine is an exception to the requirement of consideration for contracts. Promissory estoppel is triggered when one party acts on the other party's promise. In cases where it is triggered, there is harm or severe injustice to the party who acted because they relied on the other party's broken promise.

The doctrine of promissory estoppel allows aggrieved parties to pursue justice or fairness for the performance of a contract in court, or other equitable remedies, even in the absence of any consideration. Its legal application may vary from state to state, but the basic elements include:

- A legal relationship existed between the parties.
- A promise was made.
- There was reliance on the promise that caused one party to act before any real consideration was exchanged.
- A substantial and measurable detriment occurred as a result of the failure to perform on the contract.
- An unconscionable result, or gross injustice, resulted from the broken promise.

If it is found that these elements are satisfied and that the doctrine of estoppel is applicable, then the court will issue the appropriate damages in the form of reliance damages to restore the aggrieved party to the position they were in prior to the broken promise. Expectation damages are not usually available if promissory estoppel is being claimed.

An example of how this principle would apply is:

✓ Example 4.2.2.1: promissory estoppel

After a bidding war for his services, Bob turns down a job offer with We are the Best, LLC in Miami, Florida (where he lives), and accepts a dream job offer from MegaCorp Co. in San Francisco, California. The offer contains a specific start date, compensation terms, benefits outline, and more. However, it does not include relocation expenses or provisions. The company is aware of his plans to move across the country for the sole purpose of taking this dream role. Bob breaks his Miami lease with penalty and spends approximately \$13,000 in moving and travel costs. As the cost of living in San Francisco is much higher than in Miami, he puts down a much pricier first and last month's rent and security deposit payment than he is used to. Within two days of his planned start date, he receives a call from management at MegaCorp Co. stating that the company has changed its mind and decided to go in a different direction. If Bob brings a promissory estoppel suit, he will likely be entitled to all of the costs that he incurred while anticipating the start of the promised role (i.e., penalty for the broken lease, moving costs, difference in the rental costs, cost of breaking the new lease, if necessary, etc.) Following reimbursement of his costs, Bob will be returned to the same position he was in prior to the broken promise. However, the company will not likely be required to reopen the role for him or give him the job, as originally anticipated. Also, he will not likely be awarded any damages for the job that he turned down with We are the Best, LLC, as expectation damages are not usually available.

The doctrines of consideration and promissory estoppel are essential to an understanding of how contracts are formed and enforced in the United States.

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4.2.3: Capacity and Legality

For a contract to be legally binding, the parties entering into the contract must have the **capacity** to do so. As a legal matter, there are certain classes of people who are presumed to have no capacity to contract. These include legal minors, the mentally ill, and those who are intoxicated. If people meeting these criteria enter into a contract, the agreement is considered voidable. If a contract is **voidable**, then the person who lacked capacity has the choice to either end the contract or continue with it as agreed upon. This design is meant to protect the party lacking capacity.

Following are some examples of the application of these rules.

Minors Have No Capacity to Contract

In most states, minors under the age of 18 lack the capacity to make a contract and may therefore either honor an agreement or void the contract. However, there are a few exceptions to this rule. In most states, a contract for necessities (i.e. food and clothing) may not be voided. Also, in most states, the contract can no longer be voided when the minor turns 18.

✓ Example 4.2.3.1

Mary, 16, an athlete, signs a long-term endorsement deal with a well-known brand and is compensated for several years. At age 20, she decides she wants to take a better endorsement deal, so she tries to void the agreement on the grounds that it was made when she was a minor and that she lacked capacity at that time. Mary will not likely succeed in having her agreement voided, as she has passed the period of incapacity.

Mental Incapacity

If a person lacks the mental capacity to enter a contract, then either he or she, or his or her legal guardian, may void it, except in cases where the contract involved necessities. In most states, mental capacity is measured against the “cognitive standard” of whether the party understood its meaning and effect.

✓ Example 4.2.3.2

Mr. Williams contracted to sell a patent. Later, however, he claimed that he lacked capacity to enter the agreement. He, therefore, sought to have the contract voided. Williams based his claim on the fact that he had been diagnosed as manic-depressive and had received treatment from a variety of mental hospitals for this condition. His doctor stated that he was unable to properly evaluate business opportunities and contracts while in a “manic” state. A California Court of Appeals, evaluating a similar situation, refused to terminate the contract and stated that even in his manic state, the party was capable of contracting, as his condition may have impaired his judgment but not his understanding of the contract. With other mental conditions, a different legal conclusion could be reached.

Voluntary Intoxication – Drugs and Alcohol

Courts generally do not find lack of capacity to contract for people who are voluntarily intoxicated. The rationale for this decision is found in the reasoning that individuals should not be allowed to side-step their contractual obligations by virtue of their self-induced states. By another token, however, courts also seek to avoid the undesirable result of allowing the sober party to take advantage of the other person’s condition. Therefore, if a party is so inebriated that he or she is unable to understand the nature and consequences of the agreement, then the contract may be voided by the inebriated party.

✓ Example 4.2.3.3

In the late 1900s, the owner of a significant amount of stock went on a three-month drinking binge. A local bank that was aware of his consistent inebriation hired a third party to contract with him. The third party succeeded in getting him to sell his stock for about 1.5% of the worth of its total value. When the duped seller ended his binge a month later, he learned that the third party had sold the stock to the local bank behind the deal. He then sued the third party. Ultimately, the case was decided by the U.S. Supreme Court, which found that the agreement was void because both the bank and the third party knew that the plaintiff was unaware of what he was doing when he entered the contract. The bank was required to return the shares to the plaintiff, minus the 1.5% amount of real value that he had been paid for the shares.

Legality

Contracts must be created for the exchange of legal goods and services to be enforced. An agreement is void if it violates the law, or is formed for the purpose of violating the law. Contracts may also be found voidable if they are found violative of public policy, although this is rarer. Typically, this conclusion is only invoked in clear cases where the potential harm to the public is substantially incontestable, eluding the idiosyncrasies of particular judges.

For a contract to be binding, it must not have a criminal or immoral purpose or go against public policy. For example, a contract to commit murder in exchange for money will not be enforced by the courts. If performing the terms of the agreement, or if formation of the contract, will cause the parties to engage in activity that is illegal, then the contract will be deemed illegal and will be considered void or “unenforceable,” similar to a nonexistent contract. In this case, there will not be any relief available to either party if they breach the contract. Indeed, it is a defense to a breach of contract claim that the contract itself was illegal.

✓ Example 4.2.3.4

In a state where gambling is illegal, two parties enter into an employment contract for the hiring of a blackjack dealer. The contract would be void because the contract requires the employee to perform illegal gambling activities. If the blackjack dealer tries to recover any unpaid wages for work completed, his claim will not be recognized because the courts will treat the contract as if it never existed.

By contrast, parties enter a contract that involves the sale of dice to a known dealer in a state where gambling is unlawful. The contract would not be considered void because the act of selling dice, in and of itself, is not illegal.

Some examples of contracts that would be considered illegal are contracts for the sale or distribution of illegal drugs, contracts for illegal activities such as loansharking, and employment contracts for the hiring of undocumented workers.

An understanding of the several theories outlined herein for establishing (or challenging) capacity and legality in contract law is essential to this area of law.

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4.2.4: Breach of Contract and Remedies

Once a contract is legally formed, both parties are generally expected to perform according to the terms of the contract. A breach of contract claim arises when either (or both) parties claim that there was a failure, without legal excuse, to perform on any, or all, parts and promises of the contract.

Several inquiries are triggered when a breach of contract claims is initiated. The first step is to determine whether a contract existed in the first place. If it did, the following questions may be asked: What did the terms of the contract require of the parties? Were the contractual terms modified at any point? Did the breach actually occur? Was the claimed breach material to the contract? Does any legal excuse or defense to enforcement of the contract exist? What damages were caused by the breach?

Material vs. Minor Breach

The parties' obligations and remedies for a breach of contract depend on whether the breach is considered material or minor.

When something substantially different from what was expected under the terms of the contract is delivered, the breach will be considered material. For example, the breach will be considered material if the contract promises the delivery of Christmas ornaments, but the buyer receives a box of candies. In the case of a material breach, the non-breaching party has the right to all remedies for breach of the entire contract and is no longer expected to perform their obligations. In considering whether a breach is material, courts will determine whether the non-breaching party still received a benefit, and if so, how much was received, adequate compensation for the damages, the extent of the performance (if any) by the breaching party, any hardship to the breaching party, the negligence or intent behind the behavior of the breaching party, and finally, the possibility that the breaching party will perform the remainder of the contract.

There are times, however, that despite the breaching party's failure to perform some of the contract, the other party still receives a majority of the goods or services specified in the contract. In this case, the breach will be considered minor. For example, the breaching party may be late on delivering goods or services promised under a contract that does not specify a firm delivery date and that doesn't state that time is of the essence. In this case, a reasonably short delay would likely only be considered a minor breach of the contract. Consequently, the non-breaching party would still be required to perform as pursuant to the contract. However, damages may be available to them if they suffered some harm as a result of the delay.

Remedies

Typically, the remedies that will be available if a breach of contract is found are money damages, restitution, rescission, reformation, and specific performance.



Figure 4.2.4.1: When there is a breach of contract, the courts might get involved to help determine the remedy. (Credit: succo/pixabay/ License: CC0)

Money damages include compensation for financial losses caused by the breach.

Restitution restores the injured party to status quo or the position they had prior to the formation of the contract, by returning to the plaintiff any money or property given pursuant to the contract. This type of relief is typically sought when a contract is voided by courts due to a finding that the defendant is incompetent or lacks capacity.

Rescission or reformation may be available to parties who enter into contracts by mistake, fraud, undue influence, or duress. Rescission terminates the duties of both parties under the contract, while reformation allows courts to equitably change the contract's substance.

Specific performance compels one party to perform the promises stated in the contract as nearly as practicable. Specific performance is only mandated when money damages do not adequately compensate for the breach. Personal service, however, may not be used to compel specific performance, since doing so would constitute forced labor, i.e. slavery, which is in violation of the U.S. Constitution.

Inevitably, when valid contracts are created, the potential for breach exists. An understanding of what happens when a contract's terms are breached is fundamental to an understanding of contract law.

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4.2.E: Assessment Questions

1. What is the definition of a contract?

Answer

A contract is defined as an agreement between two or more parties that is enforceable by law.

2. The elements of a contract include all but the following element:

- a. Offer and acceptance.
- b. Consideration.
- c. Capacity.
- d. Promissory Estoppel.

3. What are the ways an agreement can be invalidated?

- a. Fraud.
- b. Misrepresentation.
- c. Undue influence.
- d. All of the above.

Answer

d

4. Describe the concept of Promissory Estoppel.

5. Consideration may include any of the following except:

- a. A promise.
- b. A gift.
- c. Property.
- d. Money.

Answer

b

6. What happens when a person lacks the legal capacity to enter into a contract?

7. Which of the following is most likely to be classified as a necessity for which a minor will be held liable on a contract?

- a. A television.
- b. School supplies.
- c. Education.
- d. Food.

Answer

d

8. A minor can avoid a contract to purchase a car if:

- a. The car has been destroyed.
- b. The car has been damaged.
- c. He or she grows tired of it.
- d. All of the above.

9. When can a mentally incompetent person void a contract?

Answer

If a person lacks the mental capacity to enter a contract, then either he or she, or his or her legal guardian, may void it, except in cases where the contract involved necessities. In most states, mental capacity is measured against the “cognitive standard” of whether the party understood its meaning and effect.

10. Examples of illegal contracts include all but the following:
- Contracts for the sale or distribution of heroin.
 - Contracts for loansharking.
 - Contracts in consideration of marriage.
 - Employment contracts for the hiring of undocumented workers.
11. Define a material breach.

Answer

A material breach is when something substantially different from what was expected under the terms of the contract is delivered, the breach is considered material.

12. Typical remedies available for a breach of contract include:
- Money damages.
 - Rescission.
 - Specific Performance.
 - All of the above.
13. Distinguish between rescission and reformation.

Answer

Rescission terminates the duties of both parties under the contract, while reformation allows courts to equitably change the contracts substance.

14. Courts of equity will not grant specific performance of contracts:
- For a personal service contract.
 - For the sale of real estate.
 - For the sale of the original manuscript of a rare edition book.
 - All of these are correct.
15. Define restitution.

Answer

Restitution restores the injured party to status quo or the position they had prior to the formation of the contract, by returning the plaintiff any money or property give pursuant to the contract.

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SECTION OVERVIEW

4.3: Sales Contracts

4.3.1: Introduction

4.3.2: The Nature and Origins of Sales Contracts

4.3.3: Warranties and Sales Contracts

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4.3.1: Introduction

Learning Objectives

- Recognize nuances of contracts pertaining to sales.



Figure 4.3.1.1: Introduction (Credit: JESHOOOTS-com/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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4.3.2: The Nature and Origins of Sales Contracts

Features of Sales Contracts

Commercial enterprises that engage in buying and selling practices need to be aware of the features and nature of **sales contracts**. A contract of sale is a specific type of contract in which one party is obligated to deliver and transfer ownership of a good to a second party, who in turn is obligated to pay for the good in money, or its equivalent. The party who is obligated to deliver the good is known as the **vendor** or seller. The party who is obligated to pay for the good is known as the **vendee** or buyer.

It has generally been established that there are six main features of sales contracts. Sales contracts are:

1. **Consensual**: they are perfected by mere consent without the need for any additional acts
2. **Bilateral**: both parties in the contract are bound to fulfill reciprocal obligations toward each other
3. **Onerous**: the good sold is conveyed in consideration of the price, and the price paid is conveyed in consideration of the good
4. **Commutative**: the good sold is considered to be the equivalent of the price, and vice versa
5. **Nominate**: this type of contract has a special designation (i.e., sale)
6. **Principal**: the validity does not depend upon the existence of other contracts

Sources of Law for Sales Contracts

Only in very limited circumstances (such as in the buying and selling of stocks) does federal law govern sales contracts. Until the 1950s, there were two main sources of law for sales contracts: state common law and state statutory law. Thus, the laws governing sales contracts differed from state to state. As interstate commercial activity grew in importance, there was a need for a uniform law for sales transactions that would harmonize rules across the states. Therefore, in 1952, the Uniform Commercial Code (UCC) was created to govern business transactions. All 50 states have adopted the Code, but each has the power to modify it, in line with the wishes of the state legislature.

The Uniform Commercial Code

The UCC categorizes items that can be bought or sold into three types:

1. **Goods** are defined in Section 2-105 of the UCC as tangible items “which are movable at the time of identification to the contract for sale.” Therefore, the primary features of goods are that they are movable and tangible. Refrigerators, paper, and furniture are all examples of goods.
2. **Services** are items that are movable but not tangible. Accounting is an example of a service.
3. **Realty** describes non-good items that are tangible but not movable. Under this definition, commercial and residential property are classed as realty.

These definitions have created some grey areas that have been clarified by the courts in their interpretation of the UCC. In the 2008 case *Crown Castle Inc. et al. v. Fred Nudd Corporation et al.*, a case in which the telecommunications company Crown Castle sued a cell phone tower installation firm for the construction of faulty towers, the courts had to determine whether cell phone towers (monopoles) should be classified as movable (and hence goods) or non-movable (and therefore realty). Ultimately, it was determined that monopoles are goods. Items that are attached to realty (e.g. a counter or a bar) and that are used for business activities are described as **trade fixtures** and treated as goods. Software licenses are not tangible, but they are also not movable, and have been treated in different ways: as goods, a **mixed sale** (a tangible item tied to an intangible item), and pure services. Items such as soil and clay may be treated as goods even if they are part of immovable land because they can be extracted and moved. Crops that are sold while they are still growing on the land are also considered to be goods even though they are technically immovable while growing.

Article 2 of the UCC specifically pertains to sales contracts of goods. It defines a sale as a transaction that involves “the passing of title from the seller to the buyer for a price.” However, **merchants** are classified as a separate entity under the terms of the UCC. This distinction is important because the Code contains provisions that specifically apply to merchants and place greater duties on merchants to protect private citizens. There are four ways in which an entity can be classified as a merchant:

Table 4.3.2.1

Classification	Examples

Classification	Examples
An agent who regularly sells goods as part of his or her business or trade	A seller on an online auction site
An individual who employs other people to sell goods	The owner of a clothing store
A person who works for a person who sells goods	An employee at a grocery retailer
Any entity who self-identifies as a merchant	An individual who describes himself or herself as a merchant in corporate documents

Formation of Sales Contracts under the UCC

Sales contracts require most of the same components as general contracts, but the UCC includes some provisions that specifically pertain to the creation of sales contracts. First, the UCC includes a new category of **offer**. Basic contract law states that for an offer to be valid, it has to have “definiteness of terms.” In the UCC, most of that particular rule is modified for greater flexibility. If the parties have “open” (in other words, “not definite”) terms, the UCC addresses the situation with an overlay of “reasonableness”—for example, if no time for performance is designated, the performance must occur within a “reasonable” time. As a result, the following terms are legally allowed to be “open,” and there is a “default” provision that will apply under the UCC:

Table 4.3.2.2

Open Term	Default	Applicable UCC Provision
Price	If price is not named, the default is “reasonable price.”	UCC 2-305(1)
Payment	If payment is not named, default is “due at the time and place at which the buyer is to receive the goods.”	UCC 2-310(a)
Delivery	If delivery is not named, the default is “buyer normally takes delivery at the seller’s place of business.”	UCC 2-308(a)
Duration of an Ongoing Contract	If duration of an ongoing contract is not named, the default is “buyer normally takes delivery at the seller’s place of business.”	UCC 2-308(a)

The only term that really cannot be left open is the **quantity** term. The court is not going to second-guess a quantity if the parties don’t set one in the contract—for example, why would the court arbitrarily want to force the parties to buy and sell 15,000 widgets if a quantity wasn’t specified? There are two exceptions to this rule: **requirements contracts** (“as much as I need”) and **output contracts** (“as much as you can produce”). Even though these ideas are **illusory**, they’re generally allowed in the commercial setting with good-faith limitations under UCC 2-306.

Sometimes, however, the courts will not allow purported “requirements” contracts. In one case, a court ruled that the contract was an unenforceable illusory contract instead of an enforceable requirements contract, even though it was a contract for the sale of goods (“as much as I need”). The reason for this ruling was that it did not appear that the buyer had any real intention of going through with any purchase.

Under Section 2-205 of the UCC, offers made by merchants are considered to be **firm offers** if the offers are made in writing and explicitly state that there is a three-month irrevocability period. A three-month irrevocability period is assumed if no mention is made with the offer. **Acceptance** of the offer can be made in any reasonable manner, but the **mirror-image rule** does not apply under the UCC. This means that if the terms of the acceptance do not mirror those of the offer, the acceptance is treated as a counteroffer and no legal contract is formed. Sale of goods contracts must be in writing if the value of the goods is \$500 or more. Modifications to the contract must be made in good faith, and new consideration is not required. A contract provision, or the entire

contract itself, can be considered to be **unconscionable** if its terms are unfair or unreasonable. If a court deems this to be the case, the contract, or certain provisions of it, may be unenforceable.

Title

Title means ownership of a good. When the sale is completed, an agent must pass the title for the good to the buyer. There are three types of titles:

1. **Good title** describes a title that is obtained from an individual who owns the goods free and clear.
2. **Void title** occurs when the title is passed to the buyer from a person who does not legitimately own the title. An important point is that good faith is irrelevant when a void title is acquired. For example, a person who unknowingly purchased stolen goods has a void title. An exception occurs when an owner **entrusts** goods to a merchant who ordinarily deals in those goods, and then that merchant sells the goods to a good-faith buyer. In this case, the buyer acquires a good title. For example, if a motorcycle owner takes the motorcycle to a vehicle repair shop and the motorcycle is accidentally sold, the buyer acquires the title.
3. **Voidable title** occurs when the contract would have been good, but certain circumstances make it voidable. For example, if the buyer was deceitful about his or her true identity, the buyer is a minor, or the buyer wrote a bad check in the sale, then the title is deemed voidable.



Figure 4.3.2.1: A sale is defined as a transaction that involves the passing of a title from the seller to the buyer for a price. (Credit: Negative Space/ pexels/ License: CC0)

Issues Associated with Title

Imagine the following scenario: A café purchases a new coffee machine from a supplier. However, when the supplier tries to deliver the equipment to the café, it is involved in an accident and the coffee machine is destroyed. A question emerging from this scenario is this: Is the supplier legally obligated to replace the machine? Asked differently: Who holds the good title in this scenario?

Prior to the introduction of the Uniform Common Code, the loss would have fallen on the owner of the café, since he or she paid for the coffee machine prior to taking possession of it. Under the UCC, however, as long as the supplier is considered a merchant, the risk of loss remains with the merchant until the buyer takes possession of the good.

Given problems like the one described above, the UCC separately considers four specific issues relating to titles:

- **Ownership.** Under consideration is the question of when the title transfers from vendor to vendee, and hence when ownership is said to occur.
- The concept of **encumbrance** considers when the vendee is granted an interest in the good such that the good can be used as collateral for a debt.
- The UCC considers when the risk of **loss** attaches and what the responsibilities of the buyer and seller are to each other, should a loss occur.
- **Insurable interest** is the right to insure the goods against exposure to risk of loss or damage

The UCC allows four scenarios for sales contracts: simple delivery contracts, common-carrier delivery contracts, goods-in-bailment contracts, and conditional sales contracts.

Each type involves the title, risk of loss, and insurable interest passing at different times.

A **simple delivery contract** occurs when the goods are transferred from the buyer to the seller at the time of the sale or later, e.g., if the goods are delivered. Title transfers when the contract is executed, insurable interest passes at the same time, and risk of loss transfers when the buyer takes possession, unless the seller is not a merchant. In the latter case, under the rule of **tender of delivery**, risk remains with the buyer.

A **common-carrier delivery contract** occurs when a common carrier, who is an independent contractor rather than an agent of the seller (e.g., a trucking line), delivers the goods. The UCC further categorizes these types of contracts into shipment contracts and destination contracts:

1. A **shipment contract** occurs when it is the responsibility of the seller to make the shipping arrangements and to transfer the goods to the common carrier. Under this contract, title passes to the buyer at the time of shipment, so the buyer bears the risk of loss, even when he or she has not taken possession of the goods.
2. A **destination contract** occurs when the seller is required to deliver the goods to a location that is stipulated in the contract. Under this contract, title transfers when the goods are delivered, but the seller bears the risk of loss until that time.

A **goods-in-bailment contract** occurs when the goods are stored under the control of a third party, such as in a warehouse or on a ship. Transfer of title and risk of loss depends on whether the seller has a document indicating ownership of the goods and whether that document is negotiable or non-negotiable. A **negotiable** document contains the words, “deliver to the order of [seller].” As soon as that document is endorsed to the buyer, both title and risk pass to the buyer. A **non-negotiable** document lacks those words. Under these circumstances, title passes with the endorsement of the document, but risk of loss does not pass until the custodian of the goods is notified of the title. If a document of title is completely absent, title passes at the same time as the execution of the contract, but risk does not pass until the custodian is notified of, and acknowledges, the transaction. Insurable interest is created when either the buyer or seller has the title, risk of loss, or an economic interest in the goods.

Finally, a **conditional sales contract** is a contract that occurs when the sale is dependent on approval. For example, a sale-or-return agreement occurs when both parties agree that the buyer can return the goods at a later date. Insurable interest is created once the goods are identified in the contract. Title and risk of loss depend on whether the goods are delivered by the common carrier, the seller, or in bailment, as described above.

The International Sale of Goods

With globalization, there has been a significant expansion of commercial transactions undertaken across international borders. The **United Nations Convention on Contracts for the International Sale of Goods**, or the CISG, is the main legal structure offered for the governance of international commercial transactions. The CISG broadly covers the same topics as the UCC, but it preempts the UCC if there is a problem with an international sale.

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4.3.3: Warranties and Sales Contracts

Warranties

A **warranty** is a guarantee on the good that comes as part of the sales contract, but contract law treats warranties as an additional form of contract that binds the selling party to undertake a certain action. Typically, the selling party has an obligation to provide a product that achieves a specified task, or to deliver a service that meets certain minimal standards. Warranties are offered for a range of different goods and services, from manufactured goods to real estate to plumbing services. The warranty assures the buyer that the good or service is free from defects, and it is a legally binding commitment. In the event that the product or service fails to meet the standards set out in the warranty, then the contract provides a specific remedy, such as a replacement or repair.



Figure 4.3.3.1: The law provides remedies for breach of sales contracts. (Credit: rawpixel/ pexels/ License: CC0)

According to UCC 1-203, the performance and execution of all contracts must be undertaken in good faith. **Good faith** means honesty in fact and the observance of reasonable commercial standards of fair dealing. If the parties in the contract are merchants, the UCC also requires that the contract be undertaken in accordance with **commercial reasonableness**. This requirement means that the transaction should be undertaken in a sensible and prudent way.

Express and Implied Warranties

Warranties can be express, implied, or both. Both express and implied warranties provide legal relief for the purchaser in the event of a breach of contract.

An **express warranty** is one in which the seller explicitly guarantees the quality of the good or service sold. Typically, the vendor provides a statement, or other binding document, as part of the sales contract. What this means in practice is that the buyer has engaged in the contract on the reasonable assumption that the quality, nature, character, purpose, performance, state, use, or capacity of the goods or services are the same as those stated by the seller. Therefore, the sales contract is based, in part, on the understanding that the goods or services being supplied by the seller will conform to the description, or any sample, that has been provided.

There are myriad ways in which the seller can make statements as to the characteristics of the goods.

Here are a few examples of express warranties:

“Wrinkle-free shirt”

“Lifetime guarantee”

“Made in the USA”

“This orange juice is not from concentrate”

“24k gold”

There is not a specific way that words must be formed to make an express warranty valid. Importantly, the sales contract does not need to explicitly state that a warranty is being intended. It is enough that the seller asserts facts about the goods that then become part of the contract between the parties. However, the courts do apply a **reasonableness test of reliance** upon warranties. Puffery,

or language used to bolster sales, is lawful, and the consumer is required to apply reason when evaluating such statements. For example, buyers are expected to use reason when judging seller claims such as “this sandwich is the best in the world.” Obvious sales talk cannot ordinarily be treated as a legally binding warranty.

A **breach** of the warranty occurs when the express warranty has been found to be false. In such circumstances, the warrantor is legally liable just as though the truth of the warranty had been guaranteed. The courts do not accept as a defense:

- Seller claims the warranty was true.
- Seller claims due care was exercised in the production or handling of the product.
- Seller claims there is not any reason to believe that the warranty was false.

Implied Warranties

In certain circumstances where no express warranty was made, the law **implies** a warranty. This statement means that the warranty automatically arises from the fact that a sale was made. With regard to implied warranties, the law distinguishes between casual sellers and merchant sellers, with the latter held to a higher standard, given that they are in the business of buying or selling the good or service rendered. For example, unless otherwise agreed, goods sold by merchants carry an implied warranty against claims by any third party by way of trademark infringement, patent infringement, or any other intellectual property law infringement. This type of warranty is known as the **warranty against infringement**. Another implied warranty provided by merchant sellers is the **warranty of fitness for normal use**, which means that the goods must be fit for the ordinary purposes for which they are sold.

It is important to note that if express warranties are made, this does not preclude implied warranties. If an express warranty is made, it should be consistent with implied warranties, and can be treated as cumulative, if such a construction is reasonable. If the express and implied warranties cannot be construed as consistent and cumulative, the express warranty generally prevails over the implied warranty, except in the case of the implied warranty of merchantability, or fitness for purpose.

Breaches of Warranty

If the buyer believes that there has been a breach of the implied warranty of merchantability, it is their responsibility to demonstrate that the good was defective, that this defect made the good not fit for purpose, and that this defect caused the plaintiff harm. Typical examples of defects are:

- Design defects
- Manufacturing defects
- Inadequate instructions on the use of the good
- Inadequate warning against the dangers involved in using the good.

Specific Examples of Goods Under the Warranty of Merchantability

Table 4.3.3.1

Type	Description
Second-hand goods	The UCC treats warranties arising for used goods in the same way as warranties arising for new goods, but second-hand products tend to be held to a lower standard on the warranty of merchantability.
Buyer-designed goods	The same warranties arise for mass manufactured goods as for goods that have been specified or made to order for the buyer. However, in this case, no warranty of fitness for purpose can arise since the buyer is using his or her own decisions, skill, and judgment when making the purchase.
Food and drink	The sale of food or drink carries the implied warranty of being fit for human consumption.

The buyer might intend to use the goods purchased for a different purpose than that for which it was sold. In this case, the implied warranty holds only if the buyer relies on the seller’s skill or judgment to select the product, the buyer informs the seller at the time of purchase of his or her intention for the use of the good, and the buyer relies on the seller’s judgment and skill in making the final

choice. If the seller is not made aware of the buyer's true intention, or does not offer his or her skill and judgment in aiding the sale, then warranty of fitness for a particular purpose does not arise. For this reason, it is common for vendors to include provisions in the average terms and conditions of sale with regard to the true and intended purpose of use.

Warranty of Title

By the mere act of selling, the vendor implies a warranty that the title is good and that the transfer of title is lawful. In addition, the act of the sale creates a warranty that the goods shall be delivered free from any lien of which the buyer was unaware. In some circumstances, the warranty of title can be excluded from the contract documents. For instance, when the seller makes the sale in a representative capacity (e.g. as an executor of an estate), then a warranty of title will not arise.

Remedies to Buyers under the UCC

Table 4.3.3.2

Remedy	Description
Cancel the contract	The UCC allows buyers to cancel the contract for nonconforming goods and to seek remedies that give them the benefit of the bargain.
Obtain cover	Buyers are allowed to substitute goods for those due under the sales contract. However, substitutes must be reasonable, acquired without delay, and obtained in good faith.
Obtain specific performance	If the goods are unique or a legal remedy is inadequate, the seller may be required to deliver the goods as identified in the contract.
Sue	Buyers are entitled to consequential and incidental damages if there is a breach of contract. They may also be able to obtain liquidated damages (damages before the breach occurs) or punitive damages.

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4.3.E: Assessment Questions

1. What is a sales contract?

Answer

A sales contract is a specific type of contract in which one party is obligated to deliver and transfer ownership of a good to a second party, who in turn is obligated to pay for the good in money, or its equivalent.

2. All of the following are features of sales contracts except:

- a. Consensual.
- b. Bilateral.
- c. Cumulative.
- d. Principal.

3. What source of law governs sales contracts?

- a. Common Law.
- b. The Uniform Commercial Code.
- c. Statutory Law.
- d. Federal Law.

Answer

b

4. What is the definition of a good?

5. Distinguish a shipment contract from a destination contract.

Answer

A shipment contract occurs when it is the responsibility of the seller to make the shipping arrangements and to transfer the goods to the common carrier. Under this contract, title passes to the buyer at the time of shipment, so the buyer bears the risk of loss, even when he or she has not taken possession of the goods. A destination contract occurs when the seller is required to deliver the goods to a location that is stipulated in the contract. Under this contract, title transfers when the goods are delivered, but the seller bears the risk of loss until that time.

6. What is a warranty in a sales contract?

7. Describe the difference between an express and implied warranty.

Answer

An express warranty is one in which the seller explicitly guarantees the quality of the good or service sold. Typically, the vendor provides a statement, or other binding document, as part of the sales contract. In certain circumstances where no express warranty was made, the law implies a warranty. This statement means that the warranty automatically arises from the fact that a sale was made.

8. Examples of a defect in a breach of the implied warranty of merchantability, include all of the following except:

- a. Design defect.
- b. Manufacturing defect.
- c. Inadequate instructions.
- d. Product defect.

9. The following are possible remedies to buyers under the UCC:

- a. Cancel the contract.
- b. Obtain Cover.
- c. Sue.
- d. All of the above.

Answer

d

10. What is a breach of warranty?

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4.4: WATCH- Contracts - The Uniform Commercial Code



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4.5: REVIEW- UCC - Wisconsin vs. Other States

Review:

The Uniform Commercial Code (UCC) is a **comprehensive set of laws governing all commercial transactions in the United States**. It is not a federal law, but a uniformly adopted state law. Uniformity of law is essential in this area for the interstate transaction of business.

Uniform Commercial Code (UCC) filings allow creditors to notify other creditors about a debtor's assets used as collateral for a secured transaction. UCC liens filed with Secretary of State offices act as a public notice by the "creditor" of the creditor's interest in the property.

Since the Uniform Commercial Code is managed by each state, ALWAYS be sure you're using the correct information when dealing with the UCC.

<https://www.nass.org/business-services/ucc-filings>

https://www.law.cornell.edu/wex/table_ucc

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4.6: Breach of Contract Example

Breach of Contract

Read this article to learn more about an actual breach of contract.

A funeral home buried a stranger instead of their dad. Now, they're suing.

Byline: Jonathan Edwards

Stacy Holzman wanted to inspect her father's body an hour before his March 2 funeral on Long Island, just to confirm he was wearing the clothes he'd specified -- his favorite Led Zeppelin T-shirt, black jeans and no shoes.

Holzman had a funeral employee drive the hearse into the parking lot, pull out the casket and open it. Inside, she saw the Led Zeppelin shirt and the black jeans. She looked and saw bare feet, just like her father wanted.

But the man wearing the clothes wasn't her father but a stranger. The funeral home employee, however, allegedly insisted that the body belonged to Holzman's father. And so they buried another man in her father's grave.

On Wednesday, Holzman and her sister, Megan Zaner, sued the Star of David Memorial Chapels and Fletcher Funeral & Cremation Service, accusing the companies of gross negligence and breach of contract. In the 19-page suit filed in the New York Supreme Court of Suffolk County, Holzman and Zaner allege that Fletcher Funeral & Cremation Service transported the wrong body from South Carolina, where their father died, to Long Island, where Star of David Memorial Chapels was supposed to bury him in a Zaner family plot.

Fletcher Funeral & Cremation Service did not respond Thursday to a request for comment. In a statement to The Washington Post, Star of David said Zaner's family had confirmed his identity in New York, allowing the burial to proceed.

Holzman denied that. She said she was stunned by the strange-looking man in her father's clothes and assumed the funeral home employees knew what they were doing, especially after the one who opened the casket allegedly explained that some of the changes in appearance were normal and proceeded with the burial at Mount Ararat Cemetery in Lindenhurst, N.Y.

In the statement, Star of David described what happened as "the mistake made by the funeral home in South Carolina." Still, Star of David said that it's reviewing its procedures and "will make any recommended changes to ensure the correct identification of family members."

"We are committed to continuing to provide the highest level of compassion and care to families who have entrusted us with their loved ones," according to the statement.

Clifford Zaner died on Feb. 25 of respiratory and congestive heart failure, Holzman said. His death was not a shock. He'd had multiple heart attacks and lived with Holzman and her son for a year. At the end of January or early February, he got pneumonia and "his heart just couldn't keep up." He was 72.

Holzman hired Star of David to prepare her father's body and bury it in accordance with Jewish custom, she said. The company then contracted with Fletcher, a funeral home with a location in Fountain Inn, S.C., to transport the body to Long Island, the lawsuit states.

On March 1, Holzman and her 12-year-old son flew from Greenville, S.C., to New York. The next day, they drove to the cemetery, where Holzman said she signed some paperwork and paid Star of David some \$12,000 for its services. Then, she asked to see her father's body.

"As the oldest child, it was my responsibility just to peek in and make sure that everything was in order," she told The Post.

When the funeral home employee opened the casket, Holzman saw a man who was clean shaven and had stitches across his forehead, indicating that an autopsy had been performed. Holzman was confused. Her father had always had a mustache and she'd been clear that, in keeping with Jewish custom, her father's body wasn't to be touched.

The employee told her that Star of David routinely shaved facial hair of the bodies that came to them and that an autopsy was also standard when someone died at a hospital, Holzman said.

The employee went inside, saying she had to make some phone calls, Holzman said. About 15 minutes later, the employee re-emerged and allegedly said something like "let's go" before driving to the gravesite, which Holzman took as confirmation that

everything was copacetic.

Reluctantly, Holzman was convinced that the man was their father, and they buried him.

About a week-and-a-half later, an employee from Star of David called Holzman while she was out at dinner, she told The Post. He allegedly told Holzman that Fletcher had called to tell them that the man they'd buried wasn't Zaner. His body was still in South Carolina, according to the lawsuit. It had never moved. The next day, Fletcher called Holzman directly to deliver the news "and was very apologetic and said that they made a mistake," she said.

Holzman went to Fletcher to see her father's body. This time, it looked like him -- the facial hair, no mark across his forehead, which was "a bit comforting."

But the gravity of the situation soon occurred to Holzman. A stranger was in the Zaner family plot, in the grave reserved for her father so that he could be buried next to his parents and grandparents, she said. Holzman learned it was not an easy fix, that exhuming the body of the stranger would be "a big deal" and require a court order.

Holzman's lawsuit doesn't provide any information about the man who was buried in her father's plot or what might happen to his body.

After consulting with relatives and myriad rabbis from across the country, they decided to start a new family plot in Jacksonville, Fla., where some of Holzman's relatives live, she said. She arranged to have his body moved on March 22 and two days later "had to endure a second funeral with the proper corpse of their father," her lawsuit states.

Three rabbis were there to oversee the burial, she said. Her son, who'd become close with his grandfather over the year they'd lived together, once again picked up a shovel and, as is Jewish custom, helped fill the grave "until every trace of dirt that was there was taken care of," Holzman told The Post.

"It was gut-wrenching," she added.

Holzman still has family members at Mount Ararat Cemetery. Her great-grandmother died about a month before her dad and was buried in the Zaner family plot. In the coming months, Holzman is supposed to go to her gravesite for an unveiling, a custom in Judaism in which family gathers around a loved one's grave six months to a year after their death to unveil their headstone or, in this case, her footstone.

Holzman said she's dreading it.

"We don't know how we're going to go to New York and go to the cemetery and stand there -- the grave where my dad's supposed to be and isn't."

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4.7: DISCUSSION - Read and Watch

Notes for Discussion:

After learning more about the Breach of Contract suit in the courts between Elon Musk and OpenAI, answer the following questions:

1. What is the issue being contested?
2. Do you feel a contract was breached?
3. What could have been done to avoid this lawsuit?



[Future_wars_Musk_sues_OpenAI.pdf](#)

[OpenAI_fires_back_at_Elon_Musk.pdf](#)

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5.1: Key Ideas

Module 5: Key Ideas

Premium	Policy	Term life insurance	Whole-life insurance
Deductible	Workers' Compensation	Malpractice Insurance	Business Interruption Insurance
Liability Insurance	Insurable Interest	Subrogation	Assignment
Coinsurance	Concealment	Warranty	Incontestable clause

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SECTION OVERVIEW

5.2: Bankruptcy

Learning Objectives

After reading this chapter, you should understand the following:

- A short history of US bankruptcy law
- An overview of key provisions of the 2005 bankruptcy act
- The basic operation of Chapter 7 bankruptcy
- The basic operation of Chapter 11 bankruptcy
- The basic operation of Chapter 13 bankruptcy
- What debtor's relief is available outside of bankruptcy

Bankruptcy is understood as an aspect of financing, a system that permits creditors to receive an equitable distribution of the bankrupt person's assets and promises new hope to debtors facing impossible financial burdens. Without such a law, we may reasonably suppose that the level of economic activity would be far less than it is, for few would be willing to risk being personally burdened forever by crushing debt. Bankruptcy gives the honest debtor a fresh start and resolves disputes among creditors.

5.2.1: Introduction to Bankruptcy and Overview of the 2005 Bankruptcy Act

5.2.2: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

5.2.3: Chapter 7 Liquidation

5.2.4: Chapter 11 and Chapter 13 Bankruptcies

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5.2.1: Introduction to Bankruptcy and Overview of the 2005 Bankruptcy Act

Learning Objectives

By the end of this section, you will be able to:

- Understand what law governs bankruptcy in the United States.
- Know the key provisions of the law.

The Purpose of Bankruptcy Law

Bankruptcy law governs the rights of creditors and insolvent debtors who cannot pay their debts. In broadest terms, bankruptcy deals with the seizure of the debtor's assets and their distribution to the debtor's various creditors. The term derives from the Renaissance custom of Italian traders, who did their trading from benches in town marketplaces. Creditors literally "broke the bench" of a merchant who failed to pay his debts. The term *banco rotta* (broken bench) thus came to apply to business failures.

In the Victorian era, many people in both England and the United States viewed someone who became bankrupt as a wicked person. In part, this attitude was prompted by the law itself, which to a greater degree in England and to a lesser degree in the United States treated the insolvent debtor as a sort of felon. Until the second half of the nineteenth century, British insolvents could be imprisoned; jail for insolvent debtors was abolished earlier in the United States. And the entire administration of bankruptcy law favored the creditor, who could with a mere filing throw the financial affairs of the alleged insolvent into complete disarray.

Today a different attitude prevails. Bankruptcy is understood as an aspect of financing, a system that permits creditors to receive an equitable distribution of the bankrupt person's assets and promises new hope to debtors facing impossible financial burdens. Without such a law, we may reasonably suppose that the level of economic activity would be far less than it is, for few would be willing to risk being personally burdened forever by crushing debt. Bankruptcy gives the honest debtor a fresh start and resolves disputes among creditors.

History of the Bankruptcy System; Bankruptcy Courts and Judges

Constitutional Basis

The US Constitution prohibits the states from impairing the "obligation of a contract." This means that no state can directly provide a means for discharging a debtor unless the debt has been entirely paid. But the Constitution in Article I, Section 8, does give the federal government such a power by providing that Congress may enact a uniform bankruptcy law.

Bankruptcy Statutes

Congress passed bankruptcy laws in 1800, 1841, and 1867. These lasted only a few years each. In 1898, Congress enacted the Bankruptcy Act, which together with the Chandler Act amendments in 1938, lasted until 1978. In 1978, Congress passed the Bankruptcy Reform Act, and in 2005, it adopted the current law, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This law is the subject of our chapter.

At the beginning of the twentieth century, bankruptcies averaged fewer than 20,000 per year. Even in 1935, at the height of the Great Depression, bankruptcy filings in federal court climbed only to 69,000. At the end of World War II, in 1945, they stood at 13,000. From 1950 on, the statistics show a steep increase. During the decade before the 1978 changes, bankruptcy filings in court averaged 181,000 a year—reaching a high of 254,000 in 1975. They soared to over 450,000 filings per year in the 1980s and mostly maintained that pace until just before the 2005 law took effect (see Figure 13.1). The 2005 act—preceded by "massive lobbying largely by banks and credit card companies" CCH Bankruptcy Reform Act Briefing, "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," April 2005, http://www.cch.com/bankruptcy/bankruptcy_04-21.pdf.—was intended by its promoters to restore personal responsibility and integrity in the bankruptcy system. The law's critics said it was simply a way for the credit card industry to extract more money from consumers before their debts were wiped away.

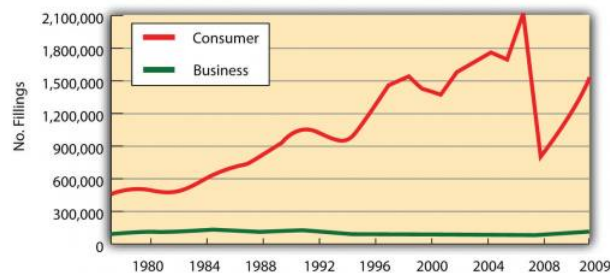


Figure 13.1 US Bankruptcies, 1980–2009

Bankruptcy Action.com, www.bankruptcyaction.com/USbankstats.htm, statistics from Administrative Office of the Courts.

Bankruptcy Courts, Judges, and Costs

Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. They have administrative responsibilities in overseeing the proceedings.

The filing fee for a bankruptcy is about \$200, depending upon the type of bankruptcy, and the typical lawyer's fee for uncomplicated cases is about \$1,200–\$1,400.

Overview of Bankruptcy Provisions

The BAPCPA provides for six different kinds of bankruptcy proceedings. Each is covered by its own chapter in the act and is usually referred to by its chapter number (see Figure 13.2).

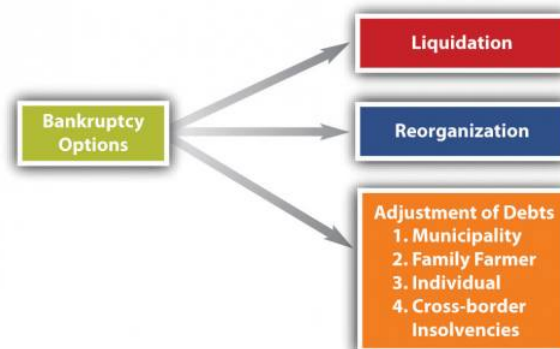


Figure 13.2 Bankruptcy Options

The bankruptcy statute (as opposed to case law interpreting it) is usually referred to as the bankruptcy *code*. The types of bankruptcies are as follows:

- Chapter 7, Liquidation: applies to all debtors except railroads, insurance companies, most banks and credit unions, and homestead associations.¹¹ United States Code, Section 109(b). A liquidation is a “straight” bankruptcy proceeding. It entails selling the debtor’s nonexempt assets for cash and distributing the cash to the creditors, thereby discharging the insolvent person or business from any further liability for the debt. About 70 percent of all bankruptcy filings are Chapter 7.
- Chapter 9, Adjustment of debts of a municipality: applies to municipalities that are insolvent and want to adjust their debts.¹¹ United States Code, Section 109(c). (The law does not suppose that a town, city, or county will go out of existence in the wake of insolvency.)
- Chapter 11, Reorganization: applies to anybody who could file Chapter 7, plus railroads. It is the means by which a financially troubled company can continue to operate while its financial affairs are put on a sounder basis. A business might liquidate following reorganization but will probably take on new life after negotiations with creditors on how the old debt is to be paid off. A company may voluntarily decide to seek Chapter 11 protection in court, or it may be forced involuntarily into a Chapter 11 proceeding.
- Chapter 12, Adjustment of debts of a family farmer or fisherman with regular annual income.¹¹ United States Code, Section 109(f). Many family farmers cannot qualify for reorganization under Chapter 13 because of the low debt ceiling, and under

Chapter 11, the proceeding is often complicated and expensive. As a result, Congress created Chapter 12, which applies only to farmers whose total debts do not exceed \$1.5 million.

- Chapter 13, Adjustment of debts of an individual with regular income: applies only to individuals (no corporations or partnerships) with debt not exceeding about \$1.3 million.¹¹ United States Code, Section 109(e). This chapter permits an individual with regular income to establish a repayment plan, usually either a composition (an agreement among creditors, discussed in Section 13.5, “Alternatives to Bankruptcy”) or an extension (a stretch-out of the time for paying the entire debt).
- Chapter 15, Ancillary and other cross-border cases: incorporates the United Nations’ Model Law on Cross-Border Insolvency to promote cooperation among nations involved in cross-border cases and is intended to create legal certainty for trade and investment. “Ancillary” refers to the possibility that a US debtor might have assets or obligations in a foreign country; those non-US aspects of the case are “ancillary” to the US bankruptcy case.

The BAPCPA includes three chapters that set forth the procedures to be applied to the various proceedings. Chapter 1, “General Provisions,” establishes who is eligible for relief under the act. Chapter 3, “Case Administration,” spells out the powers of the various officials involved in the bankruptcy proceedings and establishes the methods for instituting bankruptcy cases. Chapter 5, “Creditors, the Debtor, and the Estate,” deals with the debtor’s “estate”—his or her assets. It lays down ground rules for determining which property is to be included in the estate, sets out the powers of the bankruptcy trustee to “avoid” (invalidate) transactions by which the debtor sought to remove property from the estate, orders the distribution of property to creditors, and sets forth the duties and benefits that accrue to the debtor under the act.

To illustrate how these procedural chapters (especially Chapter 3 and Chapter 5) apply, we focus on the most common proceeding: liquidation (Chapter 7). Most of the principles of bankruptcy law discussed in connection with liquidation apply to the other types of proceedings as well. However, some principles vary, and we conclude the chapter by noting special features of two other important proceedings—Chapter 13 and Chapter 11.

Key Takeaway

Bankruptcy law’s purpose is to give the honest debtor a fresh start and to resolve disputes among creditors. The most recent amendments to the law were effective in 2005. Bankruptcy law provides relief to six kinds of debtors: (1) Chapter 7, straight bankruptcy—liquidation—applies to most debtors (except banks and railroads); (2) Chapter 9 applies to municipalities; (3) Chapter 11 is business reorganization; (4) Chapter 12 applies to farmers; (5) Chapter 13 is for wage earners; and (6) Chapter 15 applies to cross-border bankruptcies. The bankruptcy statutes also have several chapters that cover procedures of bankruptcy proceedings.

Exercises

1. Why is bankruptcy law required in a modern capitalistic society?
2. Who does the bankruptcy trustee represent?
3. The three most commonly filed bankruptcies are Chapter 7, 11, and 13. Who gets relief under those chapters?

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5.2.2: Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

Learning Objectives

By the end of this section, you will be able to:

- Understand the basic procedures involved in administering a bankruptcy case.
- Recognize the basic elements of creditors' rights under the bankruptcy code.
- Understand the fundamentals of what property is included in the debtor's estate.
- Identify some of the debtor's exemptions—what property can be kept by the debtor.
- Know some of the debts that cannot be discharged in bankruptcy.
- Know how an estate is liquidated under Chapter 7.

Case Administration (Chapter 3 of the Bankruptcy Code)

Recall that the purpose of liquidation is to convert the debtor's assets—except those exempt under the law—into cash for distribution to the creditors and thereafter to discharge the debtor from further liability. With certain exceptions, any person may voluntarily file a petition to liquidate under Chapter 7. A “person” is defined as any individual, partnership, or corporation. The exceptions are railroads and insurance companies, banks, savings and loan associations, credit unions, and the like.

For a Chapter 7 liquidation proceeding, as for bankruptcy proceedings in general, the various aspects of case administration are covered by the bankruptcy code's Chapter 3. These include the rules governing commencement of the proceedings, the effect of the petition in bankruptcy, the first meeting of the creditors, and the duties and powers of trustees.

Commencement

The bankruptcy begins with the filing of a petition in bankruptcy with the bankruptcy court.

Voluntary and Involuntary Petitions

The individual, partnership, or corporation may file a voluntary petition in bankruptcy; 99 percent of bankruptcies are voluntary petitions filed by the debtor. But involuntary bankruptcy is possible, too, under Chapter 7 or Chapter 11. To put anyone into bankruptcy involuntarily, the petitioning creditors must meet three conditions: (1) they must have claims for unsecured debt amounting to at least \$13,475; (2) three creditors must join in the petition whenever twelve or more creditors have claims against the particular debtor—otherwise, one creditor may file an involuntary petition, as long as his claim is for at least \$13,475; (3) there must be no bona fide dispute about the debt owing. If there is a dispute, the debtor can resist the involuntary filing, and if she wins the dispute, the creditors who pushed for the involuntary petition have to pay the associated costs. Persons owing less than \$13,475, farmers, and charitable organizations cannot be forced into bankruptcy.

The Automatic Stay

The petition—voluntary or otherwise—operates as a stay against suits or other actions against the debtor to recover claims, enforce judgments, or create liens (but not alimony collection). In other words, once the petition is filed, the debtor is freed from worry over other proceedings affecting her finances or property. No more debt collection calls! Anyone with a claim, secured or unsecured, must seek relief in the bankruptcy court. This provision in the act can have dramatic consequences. Beset by tens of thousands of products-liability suits for damages caused by asbestos, UNR Industries and Manville Corporation, the nation's largest asbestos producers, filed (separate) voluntary bankruptcy petitions in 1982; those filings automatically stayed all pending lawsuits.

First Meeting of Creditors

Once a petition in bankruptcy is filed, the court issues an order of relief, which determines that the debtor's property is subject to bankruptcy court control and creates the stay. The Chapter 7 case may be dismissed by the court if, after a notice and hearing, it finds that among other things (e.g., delay, nonpayment of required bankruptcy fees), the debts are primarily consumer debts and the debtor could pay them off—that's the 2005 act's famous “means test,” discussed in Section 13.3.

Assuming that the order of relief has been properly issued, the creditors must meet within a reasonable time. The debtor is obligated to appear at the meeting and submit to examination under oath. The judge does not preside and, indeed, is not even

entitled to attend the meeting.

When the judge issues an order for relief, an interim trustee is appointed who is authorized initially to take control of the debtor's assets. The trustee is required to collect the property, liquidate the debtor's estate, and distribute the proceeds to the creditors. The trustee may sue and be sued in the name of the estate. Under every chapter except Chapter 7, the court has sole discretion to name the trustee. Under Chapter 7, the creditors may select their own trustee as long as they do it at the first meeting of creditors and follow the procedures laid down in the act.

Trustee's Powers and Duties

The act empowers the trustee to use, sell, or lease the debtor's property in the ordinary course of business or, after notice and a hearing, even if not in the ordinary course of business. In all cases, the trustee must protect any security interests in the property. As long as the court has authorized the debtor's business to continue, the trustee may also obtain credit in the ordinary course of business. She may invest money in the estate to yield the maximum, but reasonably safe, return. Subject to the court's approval, she may employ various professionals, such as attorneys, accountants, and appraisers, and may, with some exceptions, assume or reject executory contracts and unexpired leases that the debtor has made. The trustee also has the power to avoid many prebankruptcy transactions in order to recover property of the debtor to be included in the liquidation.

Creditors' Claims, the Debtor, and the Estate (Chapter 5 of the Bankruptcy Code)

We now turn to the major matters covered in Chapter 5 of the bankruptcy act: creditors' claims, debtors' exemptions and discharge, and the property to be included in the estate. We begin with the rules governing proof of claims by creditors and the priority of their claims.

Claims and Creditors

A claim is defined as a right to payment, whether or not it is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. A creditor is defined as a person or entity with a claim that arose no later than when the court issues the order for relief. These are very broad definitions, intended to give the debtor the broadest possible relief when finally discharged.

Proof of Claims

Before the trustee can distribute proceeds of the estate, unsecured creditors must file a proof of claim, prima facie evidence that they are owed some amount of money. They must do so within six months after the first date set for the first meeting of creditors. A creditor's claim is disallowed, even though it is valid, if it is not filed in a timely manner. A party in interest, such as the trustee or creditor, may object to a proof of claim, in which case the court must determine whether to allow it. In the absence of objection, the claim is "deemed allowed." The court will not allow some claims. These include unenforceable claims, claims for unmatured interest, claims that may be offset by debts the creditor owes the debtor, and unreasonable charges by an insider or an attorney. If it's a "no asset" bankruptcy—most are—creditors are in effect told by the court not to waste their time filing proof of claim.

Claims with Priority

The bankruptcy act sets out categories of claimants and establishes priorities among them. The law is complex because it sets up different orders of priorities.

First, *secured creditors* get their security interests before anyone else is satisfied, because the security interest is not part of the property that the trustee is entitled to bring into the estate. This is why being a secured creditor is important (as discussed in Chapter 11 and Chapter 12). To the extent that secured creditors have claims in excess of their collateral, they are considered unsecured or general creditors and are lumped in with general creditors of the appropriate class.

Second, of the six classes of claimants (see Figure 13.3), the first is known as that of "*priority claims*." It is subdivided into ten categories ranked in order of priority. The highest-priority class within the general class of priority claims must be paid off in full before the next class can share in a distribution from the estate, and so on. Within each class, members will share pro rata if there are not enough assets to satisfy everyone fully. The priority classes, from highest to lowest, are set out in the bankruptcy code (11 USC Section 507) as follows:

(1) *Domestic support obligations* ("DSO"), which are claims for support due to the spouse, former spouse, child, or child's representative, and at a lower priority within this class are any claims by a governmental unit that has rendered support assistance to the debtor's family obligations.

(2) *Administrative expenses* that are required to administer the bankruptcy case itself. Under former law, administrative expenses had the highest priority, but Congress elevated domestic support obligations above administrative expenses with the passage of the BAPCPA. Actually, though, administrative expenses have a de facto priority over domestic support obligations, because such expenses are deducted before they are paid to DSO recipients. Since trustees are paid from the bankruptcy estate, the courts have allowed de facto top priority for administrative expenses because no trustee is going to administer a bankruptcy case for nothing (and no lawyer will work for long without getting paid, either).

(3) *Gap creditors*. Claims made by gap creditors in an involuntary bankruptcy petition under Chapter 7 or Chapter 11 are those that arise between the filing of an involuntary bankruptcy petition and the order for relief issued by the court. These claims are given priority because otherwise creditors would not deal with the debtor, usually a business, when the business has declared bankruptcy but no trustee has been appointed and no order of relief issued.

(4) *Employee wages* up to \$10,950 for each worker, for the 180 days previous to either the bankruptcy filing or when the business ceased operations, whichever is earlier (180-day period).

(5) *Unpaid contributions to employee benefit plans* during the 180-day period, but limited by what was already paid by the employer under subsection (4) above plus what was paid on behalf of the employees by the bankruptcy estate for any employment benefit plan.

(6) *Any claims for grain from a grain producer or fish from a fisherman* for up to \$5,400 each against a storage or processing facility.

(7) *Consumer layaway deposits* of up to \$2,425 each.

(8) *Taxes owing to federal, state, and local governments* for income, property, employment and excise taxes. Outside of bankruptcy, taxes usually have a higher priority than this, which is why many times creditors—not tax creditors—file an involuntary bankruptcy petition against the debtor so that they have a higher priority in bankruptcy than they would outside it.

(9) *Allowed claims based on any commitment by the debtor to a federal depository institution* to maintain the capital of an insured depository institution.

(10) *Claims for death or personal injury from a motor vehicle or vessel that occurred while the debtor was legally intoxicated*.

Third through sixth (after secured creditors and priority claimants), other claimants are attended to, but not immediately. The bankruptcy code (perhaps somewhat awkwardly) deals with who gets paid when in more than one place. Chapter 5 sets out priority *claims* as just noted; that order applies to *all* bankruptcies. Chapter 7, dealing with liquidation (as opposed to Chapter 11 and Chapter 13, wherein the debtor pays most of her debt), then lists the order of *distribution*. Section 726 of 11 United States Code provides: “Distribution of property of the estate. (1) First, in payment of claims of the kind specified in, and in the order specified in section 507...” (again, the priority of claims just set out). Following the order specified in the bankruptcy code, our discussion of the order of distribution is taken up in Section 13.3.

Debtor's Duties and Exemptions

The act imposes certain duties on the debtor, and it exempts some property that the trustee can accumulate and distribute from the estate.

Debtor's Duties

The debtor, reasonably enough, is supposed to file a list of creditors, assets, liabilities, and current income, and a statement of financial affairs. The debtor must cooperate with the trustee and be an “honest debtor” in general; the failure to abide by these duties is grounds for a denial of discharge.

The individual debtor (not including partnerships or corporations) also must show evidence that he or she attended an approved nonprofit budget and counseling agency within 180 days before the filing. The counseling may be “an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outline[s] the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.”¹¹ United States Code, Section 109(h). In Section 111, the 2005 act describes who can perform this counseling, and a host of regulations and enforcement mechanisms are instituted, generally applying to persons who provide goods or services related to bankruptcy work for consumer debtors whose nonexempt assets are less than \$150,000, in order to improve the professionalism of attorneys and others who work with debtors in, or contemplating, bankruptcy. A debtor who is incapacitated, disabled, or on active duty in a military zone doesn't have to go through the counseling.

Debtor's Exemptions

The bankruptcy act exempts certain property of the estate of an individual debtor so that he or she will not be impoverished upon discharge. Exactly what is exempt depends on state law.

Notwithstanding the Constitution's mandate that Congress establish "uniform laws on the subject of bankruptcies," bankruptcy law is in fact not uniform because the states persuaded Congress to allow nonuniform exemptions. The concept makes sense: what is necessary for a debtor in Maine to live a nonimpoverished postbankruptcy life might not be the same as what is necessary in southern California. The bankruptcy code describes how a person's residence is determined for claiming state exemptions: basically, where the debtor lived for 730 days immediately before filing or where she lived for 180 days immediately preceding the 730-day period. For example, if the debtor resided in the same state, without interruption, in the two years leading up to the bankruptcy, he can use that state's exemptions. If not, the location where he resided for a majority of the half-year preceding the initial two years will be used. The point here is to reduce "exemption shopping"—to reduce the incidences in which a person moves to a generous exemption state only to declare bankruptcy there.

Unless the state has opted out of the federal exemptions (a majority have), a debtor can choose which exemptions to claim. These are the states that allow residents to choose either federal or state exemptions (the other states mandate the use of state exemptions only): Arkansas, Connecticut, District of Columbia, Hawaii, Kentucky, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, Pennsylvania, Rhode Island, Texas, Vermont, Washington, and Wisconsin. There are also some exemptions not included in the bankruptcy code: veteran's, Social Security, unemployment, and disability benefits are outside the code, and alimony payments are also exempt under federal law. The federal exemptions can be doubled by a married couple filing together.

Here are the federal exemptions: 11 United States Code, Section 522.

Homestead:

- Real property, including mobile homes and co-ops, or burial plots up to \$20,200. Unused portion of homestead, up to \$10,125, may be used for other property.

Personal Property:

- Motor vehicle up to \$3,225.
- Animals, crops, clothing, appliances and furnishings, books, household goods, and musical instruments up to \$525 per item, and up to \$10,775 total.
- Jewelry up to \$1,350.
- \$1,075 of any property, and unused portion of homestead up to \$10,125.
- Health aids.
- Wrongful death recovery for person you depended upon.
- Personal injury recovery up to \$20,200 except for pain and suffering or for pecuniary loss.
- Lost earnings payments.

Pensions:

- Tax exempt retirement accounts; IRAs and Roth IRAs up to \$1,095,000 per person.

Public Benefits:

- Public assistance, Social Security, Veteran's benefits, Unemployment Compensation.
- Crime victim's compensation.

Tools of Trade:

- Implements, books, and tools of trade, up to \$2,025.

Alimony and Child Support:

- Alimony and child support needed for support.

Insurance:

- Unmatured life insurance policy except credit insurance.
- Life insurance policy with loan value up to \$10,775.
- Disability, unemployment, or illness benefits.

- Life insurance payments for a person you depended on, which you need for support.

In the run-up to the 2005 changes in the bankruptcy law, there was concern that some states—especially FloridaThe Florida homestead exemption is “[r]eal or personal property, including mobile or modular home and condominium, to unlimited value. Property cannot exceed: 1/2 acre in a municipality, or 160 acres elsewhere.” The 2005 act limits the state homestead exemptions, as noted.—had gone too far in giving debtors’ exemptions. The BAPCPA amended Section 522 to limit the amount of equity a debtor can exempt, even in a state with unlimited homestead exemptions, in certain circumstances. (Section 522(o) and (p) set out the law’s changes.)

Secured Property

As already noted, secured creditors generally have priority, even above the priority claims. That’s why banks and lending institutions almost always secure the debtor’s obligations. But despite the general rule, the debtor can avoid certain types of security interests. Liens that attach to assets that the debtor is entitled to claim as exempt can be avoided to the extent the lien impairs the value of the exemption in both Chapter 13 and Chapter 7. To be avoidable, the lien must be a judicial lien (like a judgment or a garnishment), or a nonpossessory, non-purchase-money security interest in household goods or tools of the trade.

Tax liens (which are statutory liens, not judicial liens) aren’t avoidable in Chapter 7 even if they impair exemptions; tax liens can be avoided in Chapter 13 to the extent the lien is greater than the asset’s value.

Dischargeable and Nondischargeable Debts

The whole point of bankruptcy, of course, is for debtors to get relief from the press of debt that they cannot reasonably pay.

Dischargeable Debts

Once discharged, the debtor is no longer legally liable to pay any remaining unpaid debts (except nondischargeable debts) that arose before the court issued the order of relief. The discharge operates to void any money judgments already rendered against the debtor and to bar the judgment creditor from seeking to recover the judgment.

Nondischargeable Debts

Some debts are not dischargeable in bankruptcy. A bankruptcy discharge varies, depending on the type of bankruptcy the debtor files (Chapter 7, 11, 12, or 13). The most common nondischargeable debts listed in Section 523 include the following:

- All debts not listed in the bankruptcy petition
- Student loans—unless it would be an undue hardship to repay them (see Section 13.6, *In re Zygarewicz*)
- Taxes—federal, state, and municipal
- Fines for violating the law, including criminal fines and traffic tickets
- Alimony and child support, divorce, and other property settlements
- Debts for personal injury caused by driving, boating, or operating an aircraft while intoxicated
- Consumer debts owed to a single creditor and aggregating more than \$550 for luxury goods or services incurred within ninety days before the order of relief
- Cash advances aggregating more than \$825 obtained by an individual debtor within ninety days before the order for relief
- Debts incurred because of fraud or securities law violations
- Debts for willful injury to another’s person or his or her property
- Debts from embezzlement

This is not an exhaustive list, and as noted in Section 13.3, there are some circumstances in which it is not just certain debts that aren’t dischargeable: sometimes a discharge is denied entirely.

Reaffirmation

A debtor may reaffirm a debt that was discharged. Section 524 of the bankruptcy code provides important protection to the debtor intent on doing so. No reaffirmation is binding unless the reaffirmation was made *prior* to the granting of the discharge; the reaffirmation agreement must contain a clear and conspicuous statement that advises the debtor that the agreement is not required by bankruptcy or nonbankruptcy law and that the agreement may be rescinded by giving notice of rescission to the holder of such claim at any time prior to discharge or within sixty days after the agreement is filed with the court, whichever is later.

A written agreement to reaffirm a debt must be filed with the bankruptcy court. The attorney for the debtor must file an affidavit certifying that the agreement represents a fully informed and voluntary agreement, that the agreement does not impose an undue hardship on the debtor or a dependent of the debtor, and that the attorney has fully advised the debtor of the legal consequences of the agreement and of a default under the agreement. Where the debtor is an individual who was not represented by an attorney during the course of negotiating the agreement, the reaffirmation agreement must be approved by the court, after disclosures to the debtor, and after the court finds that it is in the best interest of the debtor and does not cause an undue hardship on the debtor or a dependent.

Property Included in the Estate

When a bankruptcy petition is filed, a debtor's estate is created consisting of all the debtor's then-existing property interests, whether legal or equitable. In addition, the estate includes any bequests, inheritances, and certain other distributions of property that the debtor receives within the next 180 days. It also includes property recovered by the trustee under certain powers granted by the law. What is not exempt property will be distributed to the creditors.

The bankruptcy code confers on the trustee certain powers to recover property for the estate that the debtor transferred before bankruptcy.

One such power (in Section 544) is to act as a hypothetical lien creditor. This power is best explained by an example. Suppose Dennis Debtor purchases equipment on credit from Acme Supply Company. Acme fails to perfect its security interest, and a few weeks later Debtor files a bankruptcy petition. By virtue of the section conferring on the trustee the status of a hypothetical lien creditor, the trustee can act as though she had a lien on the equipment, with priority over Acme's unperfected security interest. Thus the trustee can avoid Acme's security interest, with the result that Acme would be treated as an unsecured creditor.

Another power is to avoid transactions known as voidable preferences—transactions highly favorable to particular creditors.¹¹ United States Code, Section 547. A transfer of property is voidable if it was made (1) to a creditor or for his benefit, (2) on account of a debt owed before the transfer was made, (3) while the debtor was insolvent, (4) on or within ninety days before the filing of the petition, and (5) to enable a creditor to receive more than he would have under Chapter 7. If the creditor was an “insider”—one who had a special relationship with the debtor, such as a relative or general partner of the debtor or a corporation that the debtor controls or serves in as director or officer—then the trustee may void the transaction if it was made within one year of the filing of the petition, assuming that the debtor was insolvent at the time the transaction was made.

Some prebankruptcy transfers that seem to fall within these provisions do not. The most important exceptions are (1) transfers made for new value (the debtor buys a refrigerator for cash one week before filing a petition; this is an exchange for new value and the trustee may not void it); (2) a transfer that creates a purchase-money security interest securing new value if the secured party perfects within ten days after the debtor receives the goods; (3) payment of a debt incurred in the ordinary course of business, on ordinary business terms; (4) transfers totaling less than \$600 by an individual whose debts are primarily consumer debts; (5) transfers totaling less than \$5,475 by a debtor whose debts are not primarily consumer debts; and (6) transfers to the extent the transfer was a bona fide domestic support obligation.

A third power of the trustee is to avoid fraudulent transfers made within two years before the date that the bankruptcy petition was filed.¹¹ United States Code, Section 548. This provision contemplates various types of fraud. For example, while insolvent, the debtor might transfer property to a relative for less than it was worth, intending to recover it after discharge. This situation should be distinguished from the voidable preference just discussed, in which the debtor pays a favored creditor what he actually owes but in so doing cannot then pay other creditors.

Key Takeaway

A bankruptcy commences with the filing of a petition of bankruptcy. Creditors file proofs of claim and are entitled to certain priorities: domestic support obligations and the costs of administration are first. The debtor has an obligation to file full and truthful schedules and to attend a credit counseling session, if applicable. The debtor has a right to claim exemptions, federal or state, that leave her with assets sufficient to make a fresh start: some home equity, an automobile, and clothing and personal effects, among others. The honest debtor is discharged of many debts, but some are nondischargeable, among them taxes, debt from illegal behavior (embezzlement, drunk driving), fines, student loans, and certain consumer debt. A debtor may, after proper counseling, reaffirm debt, but only before filing. The bankruptcy trustee takes over the nonexempt property of the debtor; he may act as a hypothetical lien creditor (avoiding unperfected security interests) and avoid preferential and fraudulent transfers that unfairly diminish the property of the estate.

Exercises

1. What is the automatic stay, and when does it arise?
2. Why are the expenses of claimants administering the bankruptcy given top priority (notwithstanding the nominal top priority of domestic support obligations)?
3. Why are debtor's exemptions not uniform? What sorts of things are exempt from being taken by the bankruptcy trustee, and why are such exemptions allowed?
4. Some debts are nondischargeable; give three examples. What is the rationale for disallowing some debts from discharge?
5. How does the law take care that the debtor is fully informed of the right *not* to reaffirm debts, and why is such care taken?
6. What is a hypothetical lien creditor? What is the difference between a preferential transfer and a fraudulent one? Why is it relevant to discuss these three things in the same paragraph?

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5.2.3: Chapter 7 Liquidation

Learning Objectives

By the end of this section, you will be able to:

- Recognize the grounds for a Chapter 7 case to be dismissed.
- Be familiar with the BAPCPA's means-testing requirements before Chapter 7 discharge is granted.
- Know under what circumstances a debtor will be denied discharge.
- Understand the order of distribution of the debtor's estate under Chapter 7.

Trustee's Duties under Chapter 7; Grounds for Dismissal: The Means Test

Except as noted, the provisions discussed up until now apply to each type of bankruptcy proceeding. The following discussion is limited to certain provisions under Chapter 7.

Trustee's Duties

In addition to the duties already noted, the trustee has other duties under Chapter 7. He must sell the property for money, close up the estate “as expeditiously as is compatible with the best interests of parties in interest,” investigate the debtor's financial affairs, examine proofs of claims, reject improper ones, oppose the discharge of the debtor where doing so is advisable in the trustee's opinion, furnish a creditor with information about the estate and his administration (unless the court orders otherwise), file tax reports if the business continues to be operated, and make a final report and file it with the court.

Conversion

Under Section 706 of the bankruptcy code, the debtor may convert a Chapter 7 case to Chapter 11, 12, or 13 at any time. The court may order a conversion to Chapter 11 at any time upon request of a party in interest and after notice and hearing. And, as discussed next, a case may be converted from Chapter 7 to Chapter 13 if the debtor agrees, or be dismissed if he does not, in those cases where the debtor makes too much money to be discharged without it being an “abuse” under the 2005 act.

Dismissal

The court may dismiss a case for three general reasons.

The first reason is “for cause,” after notice and a hearing for cause, including (1) unreasonable delay by the debtor that prejudices creditors, (2) nonpayment of any fees required, (3) failure to file required documents and schedules.

The second reason for dismissal (or, with the debtor's permission, conversion to Chapter 11 or 13) applies to debtors whose debt is primarily consumer debt: the court may—after notice and a hearing—dismiss a case if granting relief would be “an abuse of the provisions” of the bankruptcy code.

The third reason for dismissal is really the crux of the 2005 law: under it, the court will find that granting relief under Chapter 7 to a debtor whose debt is primarily consumer debt is “an abuse” if the debtor makes too much money. The debtor must pass a means test: If he's poor enough, he can go Chapter 7. If he is not poor enough (or if they are not, in case of a married couple), Chapter 13—making payments to creditors—is the way to go. Here is one practitioner's explanation of the means test:

To apply the means test, the courts will look at the debtor's average income for the 6 months prior to filing [not the debtor's income at the time of filing, when—say—she just lost her job] and compare it to the median income for that state. For example, the median annual income for a single wage-earner in California is \$42,012. If the income is below the median, then Chapter 7 remains open as an option. If the income exceeds the median, the remaining parts of the means test will be applied.

The next step in the calculation takes monthly income less reasonable living expenses [“reasonable living expenses” are strictly calculated based on IRS standards; the figure excludes payments on the debts included in the bankruptcy], and multiplies that figure times 60. This represents the amount of income available over a 5-year period for repayment of the debt obligations.

If the income available for debt repayment over that 5-year period is \$10,000 or more, then Chapter 13 will be required. In other words, anyone earning above the state median, and with at least \$166.67 per month (\$10,000 divided by 60) of available income, will automatically be denied Chapter 7. So for example, if the court determines that you have \$200 per month income above living expenses, \$200 times 60 is \$12,000. Since \$12,000 is above \$10,000, you're stuck with Chapter 13.

What happens if you are above the median income but do NOT have at least \$166.67 per month to pay toward your debts? Then the final part of the means test is applied. If the available income is less than \$100 per month, then Chapter 7 again becomes an option. If the available income is between \$100 and \$166.66, then it is measured against the debt as a percentage, with 25% being the benchmark.

In other words, let's say your income is above the median, your debt is \$50,000, and you only have \$125 of available monthly income. We take \$125 times 60 months (5 years), which equals \$7,500 total. Since \$7,500 is less than 25% of your \$50,000 debt, Chapter 7 is still a possible option for you. If your debt was only \$25,000, then your \$7,500 of available income would exceed 25% of your debt and you would be required to file under Chapter 13.

To sum up, first figure out whether you are above or below the median income for your state—median income figures are available at www.new-bankruptcy-law-info.com. Be sure to account for your spouse's income if you are a two-income family. Next, deduct your average monthly living expenses from your monthly income and multiply by 60. If the result is above \$10,000, you're stuck with Chapter 13. If the result is below \$6,000, you may still be able to file Chapter 7. If the result is between \$6,000 and \$10,000, compare it to 25% of your debt. Above 25%, you're looking at Chapter 13 for sure. Charles Phelan, "The New Bankruptcy Means Test Explained in Plain English," *Buzzle.com*, www.buzzle.com/editorials/1-10-2006-85999.asp.

The law also requires that attorneys sign the petition (as well as the debtor); the attorney's signature certifies that the petition is well-grounded in fact and that the attorney has no knowledge after reasonable inquiry that the schedules and calculations are incorrect. Attorneys thus have an incentive to err in favor of filing Chapter 13 instead of Chapter 7 (perhaps that was part of Congress's purpose in this section of the law).

If there's been a dismissal, the debtor and creditors have the same rights and remedies as they had prior to the case being commenced—as if the case had never been filed (almost). The debtor can refile immediately, unless the court orders a 120-day penalty (for failure to appear). In most cases, a debtor can file instantly for a Chapter 13 following a Chapter 7 dismissal.

Distribution of the Estate and Discharge; Denying Discharge

Distribution of the Estate

The estate includes all his or her assets or all their assets (in the case of a married couple) broadly defined. From the estate, the debtor removes property claimed exempt; the trustee may recapture some assets improperly removed from the estate (preferential and fraudulent transfers), and what's left is the distributable estate. It is important to note that the vast majority of Chapter 7 bankruptcies are no-asset cases—90–95 percent of them, according to one longtime bankruptcy trustee. Eugene Crane, Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary, House of Representatives, One Hundred Tenth Congress, Second Session, *Statement to the House Judiciary Sub-Committee*, September 16, 2008; judiciary.house.gov/hearings/printers/110th/44493.PDF. That means creditors get nothing. But in those cases where there are assets, the trustee must distribute the estate to the remaining classes of claimants in this order:

1. Secured creditors, paid on their security interests
2. Claims with priority
3. Unsecured creditors who filed their claims on time
4. Unsecured creditors who were tardy in filing, if they had no notice of the bankruptcy
5. Unsecured creditors who were tardy and had notice, real or constructive
6. Claims by creditors for fines, penalties, and exemplary or punitive damages
7. Interest for all creditors at the legal rate
8. The debtor

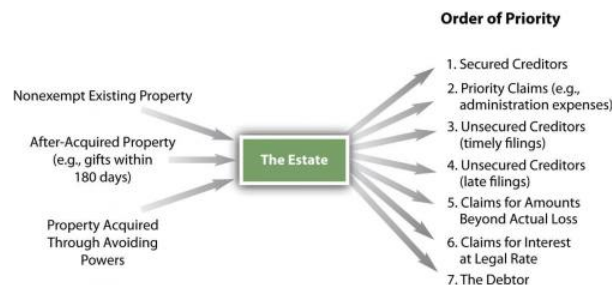


Figure 13.3 Distribution of the Estate

Discharge

Once the estate is distributed, the court will order the debtor discharged (except for nondischargeable debts) unless one of the following overall exceptions applies for denying discharge (i.e., relief from the debt). This list is not exhaustive:

1. The debtor is not an individual. In a Chapter 7 case, a corporation or partnership does not receive a bankruptcy discharge; instead, the entity is dissolved and its assets liquidated. The debts remain theoretically valid but uncollectible until the statute of limitations on them has run. Only an individual can receive a Chapter 7 discharge.¹¹ United States Code, Section 727(a)(1).
2. The debtor has concealed or destroyed property with intent to defraud, hinder, or delay within twelve months preceding filing of the petition.
3. The debtor has concealed, destroyed, or falsified books and records
4. The debtor has lied under oath, knowingly given a false account, presented or used a false claim, given or received bribes, refused to obey court orders.
5. The debtor has failed to explain satisfactorily any loss of assets.
6. The debtor has declared Chapter 7 or Chapter 11 bankruptcy within eight years, or Chapter 13 within six years (with some exceptions).
7. The debtor failed to participate in “an instructional course concerning personal financial management” (unless that’s excused).
8. An individual debtor has “abused” the bankruptcy process. A preferential transfer is not an “abuse,” but it will be set aside. Making too much money to file Chapter 7 is “an abuse” that will deny discharge.

A discharge may be revoked if the debtor committed fraud during the bankruptcy proceedings, but the trustee or a creditor must apply for revocation within one year of the discharge.

Having the discharge denied does not affect the administration of the bankruptcy case. The trustee can (and will) continue to liquidate any nonexempt assets of the debtor and pay the creditors, but the debtor still has to pay the debts left over.

As to any consequence of discharge, bankruptcy law prohibits governmental units from discriminating against a person who has gone through bankruptcy. Debtors are also protected from discrimination by private employers; for example, a private employer may not fire a debtor because of the bankruptcy. Certainly, however, the debtor’s credit rating will be affected by the bankruptcy.

Key Takeaway

A Chapter 7 bankruptcy case may be dismissed for cause or because the debtor has abused the system. The debtor is automatically considered to have abused the system if he makes too much money. With the debtor’s permission, the Chapter 7 may be converted to Chapter 11, 12, or 13. The law requires that the debtor pass a means test to qualify for Chapter 7. Assuming the debtor does qualify for Chapter 7, her nonexempt assets (if there are any) are sold by the trustee and distributed to creditors according to a priority set out in the law. A discharge may be denied, in general because the debtor has behaved dishonestly or—again—has abused the system.

Exercises

1. What is the difference between denial of a discharge for cause and denial for abuse?
2. What is the difference between a dismissal and a denial of discharge?
3. Which creditors get satisfied first in a Chapter 7 bankruptcy?

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5.2.4: Chapter 11 and Chapter 13 Bankruptcies

Learning Objectives

By the end of this section, you will be able to:

- Understand the basic concepts of Chapter 11 bankruptcies.
- Understand the basic concepts of Chapter 13 bankruptcies.

Reorganization: Chapter 11 Bankruptcy

Overview

Chapter 11 provides a means by which corporations, partnerships, and other businesses, including sole proprietorships, can rehabilitate themselves and continue to operate free from the burden of debts that they cannot pay.

It is simple enough to apply for the protection of the court in Chapter 11 proceeding, and for many years, large financially ailing companies have sought shelter in Chapter 11. Well-known examples include General Motors, Texaco, K-Mart, Delta Airlines, and Northwest Airlines. An increasing number of corporations have turned to Chapter 11 even though, by conventional terms, they were solvent. Doing so enables them to negotiate with creditors to reduce debt. It also may even permit courts to snuff out lawsuits that have not yet been filed. Chapters 3 and 5, discussed in Section 13.2, apply to Chapter 11 proceedings also. Our discussion, therefore, is limited to special features of Chapter 11.

How It Works

Eligibility

Any person eligible for discharge in Chapter 7 proceeding (plus railroads) is eligible for a Chapter 11 proceeding, except stockbrokers and commodity brokers. Individuals filing Chapter 11 must take credit counseling; businesses do not. A company may voluntarily enter Chapter 11 or may be put there involuntarily by creditors. Individuals can file Chapter 11 particularly if they have too much debt to qualify for Chapter 13 and make too much money to qualify for Chapter 7; under the 2005 act, individuals must commit future wages to creditors, just as in Chapter 13.¹¹ United States Code, Sections 1115, 1123(a)(8), and 1129(a)(15).

Operation of Business

Unless a trustee is appointed, the debtor will retain possession of the business and may continue to operate with its own management. The court may appoint a trustee on request of any party in interest after notice and a hearing. The appointment may be made for cause—such as dishonesty, incompetence, or gross mismanagement—or if it is otherwise in the best interests of the creditors. Frequently, the same incompetent management that got the business into bankruptcy is left running it—that's a criticism of Chapter 11.

Creditors' Committee

The court must appoint a committee of unsecured creditors as soon as practicable after issuing the order for relief. The committee must consist of creditors willing to serve who have the seven largest claims, unless the court decides to continue a committee formed before the filing, if the committee was fairly chosen and adequately represents the various claims. The committee has several duties, including these: (1) to investigate the debtor's financial affairs, (2) to determine whether to seek appointment of a trustee or to let the business continue to operate, and (3) to consult with the debtor or trustee throughout the case.

The Reorganization Plan

The debtor may always file its own plan, whether in a voluntary or involuntary case. If the court leaves the debtor in possession without appointing a trustee, the debtor has the exclusive right to file a reorganization plan during the first 120 days. If it does file, it will then have another 60 days to obtain the creditors' acceptances. Although its exclusivity expires at the end of 180 days, the court may lengthen or shorten the period for good cause. At the end of the exclusive period, the creditors' committee, a single creditor, or a holder of equity in the debtor's property may file a plan. If the court does appoint a trustee, any party in interest may file a plan at any time.

The Bankruptcy Reform Act specifies certain features of the plan and permits others to be included. Among other things, the plan must (1) designate classes of claims and ownership interests; (2) specify which classes or interests are impaired—a claim or

ownership interest is impaired if the creditor's legal, equitable, contractual rights are altered under the plan; (3) specify the treatment of any class of claims or interests that is impaired under the plan; (4) provide the same treatment of each claim or interests of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment; and (5) provide adequate means for carrying out the plan. Basically, what the plan does is provide a process for rehabilitating the company's faltering business by relieving it from repaying part of its debt and initiating reforms so that the company can try to get back on its feet.

Acceptance of the Plan

The act requires the plan to be accepted by certain proportions of each impaired class of claims and interests. A class of claims accepts the plan if creditors representing at least two-thirds of the dollar amount of claims and more than one-half the number of allowed claims vote in favor. A class of property interests accepts the plan if creditors representing two-thirds of the dollar amount of the allowed ownership interests vote in favor. Unimpaired classes of claims and interest are deemed to have accepted the plan; it is unnecessary to solicit their acceptance.

Confirmation of the Plan

The final act necessary under Chapter 11 is confirmation by the court. Once the court confirms the plan, the plan is binding on all creditors. The rules governing confirmation are complex, but in essence, they include the following requirements:

1. The plan must have been proposed in good faith. Companies must also make a good-faith attempt to negotiate modifications in their collective bargaining agreements (labor union contracts).
2. All provisions of the act must have been complied with.
3. The court must have determined that the reorganized business will be likely to succeed and be unlikely to require further financial reorganization in the foreseeable future.
4. Impaired classes of claims and interests must have accepted the plan, unless the plan treats them in a "fair and equitable" manner, in which case consent is not required. This is sometimes referred to as the cram-down provision.
5. All members of every class must have received no less value than they would have in Chapter 7 liquidation.

Discharge, Conversion

The debtor gets discharged when all payments under the plan are completed. A Chapter 11 bankruptcy may be converted to Chapter 7, with some restrictions, if it turns out the debtor cannot make the plan work.

Adjustment of Debts of an Individual with Regular Income: Chapter 13 Bankruptcy

In General

Anyone with a steady income who is having difficulty paying off accumulated debts may seek the protection of a bankruptcy court in Chapter 13 proceeding (often called the wage earner's plan). Under this chapter, the individual debtor presents a payment plan to creditors, and the court appoints a trustee. If the creditors wind up with more under the plan presented than they would receive in Chapter 7 proceeding, then the court is likely to approve it. In general, a Chapter 13 repayment plan extends the time to pay the debt and may reduce it so that the debtor need not pay it all. Typically, the debtor will pay a fixed sum monthly to the trustee, who will distribute it to the creditors. The previously discussed provisions of Chapters 3 and 5 apply also to this chapter; therefore, the discussion that follows focuses on some unique features of Chapter 13.

People seek Chapter 13 discharges instead of Chapter 7 for various reasons: they make too much money to pass the Chapter 7 means test; they are behind on their mortgage or car payments and want to make them up over time and reinstate the original agreement; they have debts that can't be discharged in Chapter 7; they have nonexempt property they want to keep; they have codebtors on a personal debt who would be liable if the debtor went Chapter 7; they have a real desire to pay their debts but cannot do so without getting the creditors to give them some breathing room. Chapter 7 cases may always be converted to Chapter 13.

How It Works

Eligibility

Chapter 13 is voluntary only. Anyone—sole proprietorships included—who has a regular income, unsecured debts of less than \$336,000, and secured debts of less than \$1,010,650 is eligible to seek its protection. The debts must be unpaid and owing at the time the debtor applies for relief. If the person has more debt than that, she will have to file Chapter 11. The debtor must attend a credit-counseling class, as in Chapter 7.

The Plan

Plans are typically extensions or compositions—that is, they extend the time to pay what is owing, or they are agreements among creditors each to accept something less than the full amount owed (so that all get something). Under Chapter 13, the stretch-out period is three to five years. The plan must provide for payments of all future income or a sufficient portion of it to the trustee. Priority creditors are entitled to be paid in full, although they may be paid later than required under the original indebtedness. As long as the plan is being carried out, the debtor may enjoin any creditors from suing to collect the original debt.

Confirmation

Under Section 1325 of the bankruptcy code, the court must approve the plan if it meets certain requirements. These include (1) distribution of property to unsecured creditors whose claims are allowed in an amount no less than that which they would have received had the estate been liquidated under Chapter 7; (2) acceptance by secured creditors, with some exceptions, such as when the debtor surrenders the secured property to the creditor; and (3) proposal of the plan “in good faith.” If the trustee or an unsecured creditor objects to confirmation, the plan must meet additional tests. For example, a plan will be approved if all of the debtor’s disposable income (as defined in Section 1325) over the commitment period (three to five years) will be used to make payments under the plan.

Discharge

Once a debtor has made all payments called for in the plan, the court will discharge him from all remaining debts except certain long-term debts and obligations to pay alimony, maintenance, and support. Under former law, Chapter 13 was so broad that it permitted the court to discharge the debtor from many debts considered nondischargeable under Chapter 7, but 1994 amendments and the 2005 act made Chapter 13 less expansive. Debts dischargeable in Chapter 13, but not in Chapter 7, include debts for willful and malicious injury to property, debts incurred to pay nondischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings. (See Section 13.6, *In re Ryan*, for a discussion of what debts are dischargeable under Chapter 13 as compared with Chapter 7.)

Although a Chapter 13 debtor generally receives a discharge only after completing all payments required by the court-approved (i.e., “confirmed”) repayment plan, there are some limited circumstances under which the debtor may request the court to grant a “hardship discharge” even though the debtor has failed to complete plan payments. Such a discharge is available only to a debtor whose failure to complete plan payments is due to circumstances beyond the debtor’s control. A Chapter 13 discharge stays on the credit record for up to ten years.

A discharge may be denied if the debtor previously went through a bankruptcy too soon before filing Chapter 13, failed to act in good faith, or—with some exceptions—failed to complete a personal financial management course.

Key Takeaway

Chapter 11—frequently referred to as “corporate reorganization”—is most often used by businesses whose value as a going concern is greater than it would be if liquidated, but, with some exceptions, anyone eligible to file Chapter 7 can file Chapter 11. The business owners, or in some cases the trustee or creditors, develop a plan to pay the firm’s debts over a three- to five-year period; the plan must be approved by creditors and the court. Chapter 13—frequently called the wage-earner’s plan—is a similar mechanism by which a person can discharge some debt and have longer to pay debts off than originally scheduled. Under Chapter 13, people can get certain relief from creditors that they cannot get in Chapter 7.

Exercises

1. David Debtor is a freelance artist with significant debt that he feels a moral obligation to pay. Why is Chapter 11 his best choice of bankruptcy chapters to file under?
2. What is the practical difference between debts arising from property settlements in divorce or separation proceedings—which can be discharged under Chapter 13—and debts owing for alimony (maintenance) and child support—which cannot be discharged under Chapter 13?
3. Why would a person want to go through the long grind of Chapter 13 instead of just declaring straight bankruptcy (Chapter 7) and being done with it?

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5.2.5: Alternatives to Bankruptcy

Learning Objectives

By the end of this section, you will be able to:

- Understand that there are nonbankruptcy alternatives for debtors who cannot pay their bills in a timely way: assignment for benefit of creditors, compositions, and receiverships.
- Recognize the reasons why these alternatives might not work.

Alternatives to Bankruptcy: Overview

Bankruptcy is a necessary thing in a capitalist economic system. As already noted, without it, few people would be willing to take business risks, and the economy would necessarily operate at a lower level (something some people might not think so bad overall). But bankruptcy, however “enlightened” society may have become about it since Victorian days, still carries a stigma. Bankruptcy filings are public information; the lists of people and businesses who declare bankruptcy are regularly published in monthly business journals. Bankruptcy is expensive, too, and both debtors and creditors become enmeshed in significantly complex federal law. For these reasons, among others, both parties frequently determine it is in their best interest to find an alternative to bankruptcy. Here we take up briefly three common alternatives.

In other parts of this book, other nonbankruptcy creditors’ rights are discussed: under the Uniform Commercial Code (UCC), creditors have rights to reclaim goods sold and delivered but not paid for; under the UCC, too, creditors have a right to repossess personal property that has been put up as collateral for the debtor’s loan or extension of credit; and mortgagees have the right to repossess real estate without judicial assistance in many circumstances. These nonbankruptcy remedies are governed mostly by state law.

The nonbankruptcy alternatives discussed here are governed by state law also.

Assignment for Benefit of Creditors; Compositions; Receivership

Benefit of Creditors

Under a common-law assignment for the benefit of creditors, the debtor transfers some or all of his assets to a trustee—usually someone appointed by the adjustment bureau of a local credit managers’ association—who sells the assets and apportions the proceeds in some agreed manner, usually pro rata, to the creditors. Of course, not every creditor need agree with such a distribution. Strictly speaking, the common-law assignment does not discharge the balance of the debt. Many state statutes attempt to address this problem either by prohibiting creditors who accept a partial payment of debt under an assignment from claiming the balance or by permitting debtors to demand a release from creditors who accept partial payment.

Composition

A composition is simply an agreement by creditors to accept less than the full amount of the debt and to discharge the debtor from further liability. As a contract, composition requires consideration; the mutual agreement among creditors to accept a pro rata share of the proceeds is held to be sufficient consideration to support the discharge. The essential difference between assignment and composition lies in the creditors’ agreement: an assignment implies no agreement among the creditors, whereas a composition does. Not all creditors of the particular debtor need agree to the composition for it to be valid. A creditor who does not agree to the composition remains free to attempt to collect the full sum owed; in particular, a creditor not inclined to compose the debt could attach the debtor’s assets while other creditors are bargaining over the details of the composition agreement.

One advantage of the assignment over the composition is that in the former the debtor’s assets—having been assigned—are protected from attachment by hungry creditors. Also, the assignment does not require creditors’ consent. However, an advantage to the debtor of the assignment (compared with the composition) is that in the composition creditors cannot go after the debtor for any deficiency (because they agreed not to).

Receivership

A creditor may petition the court to appoint a receiver; receivership is a long-established procedure in equity whereby the receiver takes over the debtor’s property under instructions from the court. The receiver may liquidate the property, continue to operate the

business, or preserve the assets without operating the business until the court finally determines how to dispose of the debtor's property.

The difficulty with most of the alternatives to bankruptcy lies in their voluntary character: a creditor who refuses to go along with an agreement to discharge the debtor can usually manage to thwart the debtor and her fellow creditors because, at the end of the day, the US Constitution forbids the states from impairing private citizens' contractual obligations. The only final protection, therefore, is to be found in the federal bankruptcy law.

Key Takeaway

Bankruptcy is expensive and frequently convoluted. Nonbankruptcy alternatives include assignment for the benefit of creditors (the debtor's assets are assigned to a trustee who manages or disposes of them for creditors), compositions (agreements by creditors to accept less than they are owed and to discharge the debtor from further liability), and receivership (a type of court-supervised assignment).

Exercises

1. What is an assignment for benefit of creditors?
2. What is a composition?
3. What is a receivership?
4. Why are these alternatives to bankruptcy often unsatisfactory?

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5.2.6: Cases

Dischargeability of Student Loans under Chapter 7

In re Zygarewicz

423 B.R. 909 (Bkrtcy.E.D.Cal. 2010)

MCMANUS, BANKRUPTCY JUDGE.

Angela Zygarewicz, a chapter 7 debtor and the plaintiff in this adversary proceeding, borrowed 16 government-guaranteed student [sic] loans totaling \$81,429. The loans have been assigned to Educational Credit Management Corporation (“ECMC”). By September 2009, the accrual of interest on these student loans had caused the debt to balloon to more than \$146,000. The debtor asks the court to declare that these student loans were discharged in bankruptcy.

The Bankruptcy Code provides financially distressed debtors with a fresh start by discharging most of their pre-petition debts.... However, under 11 U.S.C. § 523(a)(8), there is a presumption that educational loans extended by or with the aid of a governmental unit or nonprofit institution are nondischargeable unless the debtor can demonstrate that their repayment would be an undue hardship. See [Citation]. This exception to a bankruptcy discharge ensures that student loans, which are typically extended solely on the basis of the student’s future earnings potential, cannot be discharged by recent graduates who then pocket all of the future benefits derived from their education. See [Citation].

The debtor bears the burden of proving by a preponderance of the evidence that she is entitled to a discharge of the student loan. See [Citation]. That is, the debtor must prove that repayment of student loans will cause an undue hardship.

The Bankruptcy Code does not define “the undue hardship.” Courts interpreting section 523(a)(8), however, have concluded that undue hardship [and] is something more than “garden-variety hardship.” [Citation.] Only cases involving “real and substantial” hardship merit discharges. See [Citation.]

The Ninth Circuit has adopted a three-part test to guide courts in their attempts to determine whether a debtor will suffer an undue hardship is required to repay a student loan:

- First, the debtor must establish “that she cannot maintain, based on current income and expenses, a ‘minimal’ standard of living for herself and her dependents if forced to repay the loans.”...
- Second, the debtor must show “that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans.”...
- The third prong requires “that the debtor has made good faith efforts to repay the loans....”

(*Pena*, citing *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, [Citation]).

Debtor must satisfy all three parts of the *Brunner* test before her student loans can be discharged. Failure to prove any of the three prongs will defeat a debtor’s case.

When this bankruptcy case was filed in September 2005, the debtor was a single woman and had no dependents. She is 39 years old.

Schedule I reported that the debtor was unemployed. The debtor’s responses to the Statement of Financial Affairs revealed that she had received \$5,500 in income during 2005 prior to the filing of the petition. Evidence at trial indicated that after the petition was filed, the debtor found work and earned a total of \$9,424 in 2005. In 2004 and 2003, she earned \$13,994 and \$17,339, respectively.

Despite this modest income, the debtor did not immediately file an adversary proceeding to determine the dischargeability of her student loans. It was almost three years after the entry of her chapter 7 discharge ‘on January 3, 2006 that the debtor reopened her chapter 7 case in order to pursue this adversary proceeding.’

In her complaint, the debtor admits that after she received a discharge, she found part-time work with a church and later took a full-time job as a speech therapist. During 2006, the debtor earned \$20,009 and in 2007 she earned \$37,314. Hence, while it is clear the debtor’s income was very modest in the time period immediately prior to her bankruptcy petition, her financial situation improved during her bankruptcy case.

The court cannot conclude based on the evidence of the debtor’s financial circumstances up to the date of the discharge, that she was unable to maintain a minimal standard of living if she was required to repay her students [sic] loans.

However, in January 2007, the debtor was injured in an automobile accident. Her injuries eventually halted the financial progress she had been making and eventually prevented her from working. She now subsists on social security disability payments.

The circumstance creating the debtor's hardship, the automobile accident, occurred after her chapter 7 petition was filed, indeed, approximately one year after her discharge was entered. The debtor is maintaining that this post-petition, post-discharge circumstance warrants a declaration that her student loans were discharged effective from the petition date.

When must the circumstances creating a debtor's hardship arise: before the bankruptcy case is filed; after the case is filed but prior to the entry of a discharge; or at anytime, including after the entry of a discharge?

The court concludes that the circumstances causing a chapter 7 debtor's financial hardship must arise prior to the entry of the discharge. If the circumstances causing a debtor's hardship arise after the entry of a discharge, those circumstances cannot form the basis of a determination that repayment of a student loan will be an undue hardship....

[T]here is nothing in the Bankruptcy Code requiring that a complaint under section 523(a)(8) [to discharge student loans] be filed at any particular point in a bankruptcy case, whether it is filed under chapter 7 or 13. [Relevant Federal Rules of Bankruptcy Procedure] permits such dischargeability complaints to be brought at any time, including after the entry of a discharge and the closing of the bankruptcy case....

While a debtor's decision to file an action to determine the dischargeability of a student loan is not temporally constrained, this does not mean that a debtor's financial hardship may arise after a discharge has been entered.

[The] *Coleman* [case, cited by debtor] deals with the ripeness of a dispute concerning the dischargeability of a student loan. [The Ninth Circuit held that it] is ripe for adjudication at any point during the case. The Ninth Circuit did not conclude, however, that a debtor could rely upon post-discharge circumstances to establish undue hardship. In fact, the court in *Coleman* made clear that the debtor could take a snapshot of the hardship warranting a discharge of a student loan any time *prior* to discharge. [*Coleman* was a Chapter 13 case.]

Here, the debtor was injured in an automobile accident on January 17, 2007, almost exactly one year after her January 3, 2006 chapter 7 discharge. Because the accident had no causal link to the misfortune prompting the debtor to seek bankruptcy relief in the first instance, the accident cannot be relied on to justify the discharge of the student loans because repayment would be an undue hardship.

To hold otherwise would mean that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted. If a discharged debtor suffers later financial misfortune, that debtor must consider seeking another discharge subject to the limitations imposed by [the sections of the code stipulating how often a person can petition for bankruptcy]. In the context of a second case, the debtor could then ask that the student loan be declared dischargeable under section 523(a)(8).

In this instance, the debtor is now eligible for a discharge in a chapter 13 case. Her chapter 7 petition was filed on September 19, 2005. Section 1328(f)(1) bars a chapter 13 discharge when the debtor has received a chapter 7 discharge in a case commenced in the prior four years. She would not be eligible for a chapter 7 discharge until September 19, 2013.

This is not to say that post-discharge events are irrelevant. The second and third prongs of the *Pena* test require the court to consider whether the circumstances preventing a debtor from repaying a student loan are likely to persist, and whether the debtor has made good faith efforts to repay the student loan. Post-discharge events are relevant to these determinations because they require the court to look into the debtor's financial future.

Unfortunately for the debtor, it is unnecessary to consider the second and third prongs because she cannot satisfy the first prong.

Case Questions

1. What is the rationale for making the bankruptcy discharge of student loans very difficult?
2. Petitioner argued that she should be able to use a postdischarge event (the auto accident) as a basis for establishing that she could not maintain a "minimal" standard of living, and thus she should get a retroactive discharge of her student loans. What benefit is there to her if she could successfully make the argument, given that she could—as the court noted—file for Chapter 13?
3. The court cites the *Coleman* case. That was a Chapter 13 proceeding. Here were the facts: Debtor had not yet completed her payments under her five-year repayment plan, and no discharge order had yet been entered; one year into the plan, she was laid off work. She had been trying to repay her student loans for several years, and she claimed she would suffer hardship in

committing to the five-year repayment plan without any guarantee that her student loan obligations would be discharged, since she was required to commit all of her disposable income to payments under the plan and would likely be forced to pursue undue hardship issue pro se upon completion of the plan.” In *Coleman*, the court held that Debtor could, postfiling but predischARGE—one year into the five-year plan—bring up the hardship issue. Now, in the case here, after the auto accident, the petitioner “subsists” on Social Security disability payments, and she has almost \$150,000 in debt, yet the court prohibited her from claiming a hardship discharge of student loans. Does this result really make sense? Is the court’s concern that allowing this postdischarge relief would mean “that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted” well founded? Suppose it is scheduled to take thirty years to pay off student loans; in year 4, the student-borrower, now Debtor, declares Chapter 7 bankruptcy, student loans not being discharged; in year 6, the person is rendered disabled. What public policy is offended if the person is allowed to “reopen” the bankruptcy and use the postbankruptcy event as a basis for claiming a hardship discharge of student loans?

4. The court suggests she file for Chapter 13. What if—because of timing—the petitioner was not eligible for Chapter 13? What would happen then?

Chapter 11 Bankruptcy

In re Johns-Manville Corp.

36 B.R. 727 (Bkrtcy. N.Y. 1984)

Lifland, Bankruptcy Judge.

Whether an industrial enterprise in the United States is highly successful is often gauged by its “membership” in what has come to be known as the “Fortune 500”. Having attained this measure of financial achievement, Johns-Manville Corp. and its affiliated companies (collectively referred to as “Manville”) were deemed a paradigm of success in corporate America by the financial community. Thus, Manville’s filing for protection under Chapter 11 of Title 11 of the United States Code (“the Code or the Bankruptcy Code”) on August 26, 1982 (“the filing date”) was greeted with great surprise and consternation on the part of some of its creditors and other corporations that were being sued along with Manville for injuries caused by asbestos exposure. As discussed at length herein, Manville submits that the sole factor necessitating its filing is the mammoth problem of uncontrolled proliferation of asbestos health suits brought against it because of its substantial use for many years of products containing asbestos which injured those who came into contact with the dust of this lethal substance. According to Manville, this current problem of approximately 16,000 lawsuits pending as of the filing date is compounded by the crushing economic burden to be suffered by Manville over the next 20–30 years by the filing of an even more staggering number of suits by those who had been exposed but who will not manifest the asbestos-related diseases until some time during this future period (“the future asbestos claimants”). Indeed, approximately 6,000 asbestos health claims are estimated to have arisen in only the first 16 months since the filing date. This burden is further compounded by the insurance industry’s general disavowal of liability to Manville on policies written for this very purpose.

It is the propriety of the filing by Manville which is the subject of the instant decision. Four separate motions to dismiss the petition pursuant to Section 1112(b) of the Code have been lodged before this Court...

Preliminarily, it must be stated that there is no question that Manville is eligible to be a debtor under the Code’s statutory requirements. Moreover, it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains any insolvency requirement....Accordingly, it is abundantly clear that Manville has met all of the threshold eligibility requirements for filing a voluntary petition under the Code....

A “principal goal” of the Bankruptcy Code is to provide “open access” to the “bankruptcy process.” [Citation.] The rationale behind this “open access” policy is to provide access to bankruptcy relief which is as “open” as “access to the credit economy.” Thus, Congress intended that “there should be no legal barrier to voluntary petitions.” Another major goal of the Code, that of “rehabilitation of debtors,” requires that relief for debtors must be “timely.” Congress declared that it is essential to both the “open access” and “rehabilitation” goals that

[i]nitiating relief should not be a death knell. The process should encourage resort to it, by debtors and creditors, that cuts short the dissipation of assets and the accumulation of debts. Belated commencement of a case may kill an opportunity for reorganization or arrangement.

Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition. The “Congressional

purpose” in enacting the Code was to encourage resort to the bankruptcy process. This philosophy not only comports with the elimination of an insolvency requirement, but also is a corollary of the key aim of Chapter 11 of the Code, that of avoidance of liquidation. The drafters of the Code announced this goal, declaring that reorganization is more efficient than liquidation because “assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.” [Citation.] Moreover, reorganization also fosters the goals of preservation of jobs in the threatened entity. [Citation.]

In the instant case, not only would liquidation be wasteful and inefficient in destroying the utility of valuable assets of the companies as well as jobs, but, more importantly, liquidation would preclude just compensation of some present asbestos victims and all future asbestos claimants. This unassailable reality represents all the more reason for this Court to adhere to this basic potential liquidation avoidance aim of Chapter 11 and deny the motions to dismiss. Manville must not be required to wait until its economic picture has deteriorated beyond salvation to file for reorganization.

Clearly, none of the justifications for declaring an abuse of the jurisdiction of the bankruptcy court announced by these courts [in various cases cited] are present in the *Manville* case. In *Manville*, it is undeniable that there has been no sham or hoax perpetrated on the Court in that Manville is a real business with real creditors in pressing need of economic reorganization. Indeed, the Asbestos Committee has belied its own contention that Manville has no debt and no real creditors by quantifying a benchmark settlement demand approaching one billion dollars for compensation of approximately 15,500 pre-petition asbestos claimants, during the course of negotiations pitched toward achieving a consensual plan. This huge asserted liability does not even take into account the estimated 6,000 new asbestos health claims which have arisen in only the first 16 months since the filing date. The number of post-filing claims increases each day as “future claims back into the present.” ...

In short, Manville’s filing did not in the appropriate sense abuse the jurisdiction of this Court and it is indeed, like the debtor in [Citation], a “once viable business supporting employees and unsecured creditors [that] has more recently been burdened with judgments [and suits] that threaten to put it out of existence.” Thus, its petition must be sustained....

In sum, Manville is a financially besieged enterprise in desperate need of reorganization of its crushing real debt, both present and future. The reorganization provisions of the Code were drafted with the aim of liquidation avoidance by great access to Chapter 11. Accordingly, Manville’s filing does not abuse the jurisdictional integrity of this Court, but rather presents the same kinds of reasons that were present in [Citation], for awaiting the determination of Manville’s good faith until it is considered...as a prerequisite to confirmation or as a part of the cadre of motions before me which are scheduled to be heard subsequently.

[A]ll four of the motions to dismiss the Manville petition are denied in their entirety.

Case Questions

1. What did Manville want to do here, and why?
2. How does this case demonstrate the fundamental purpose of Chapter 11 as opposed to Chapter 7 filings?
3. The historical background here is that Manville knew from at least 1930 that asbestos—used in many industrial applications—was a deadly carcinogen, and it worked diligently for decades to conceal and obfuscate the fact. What “good faith” argument was raised by the movants in this case?

Chapter 13: What Debts Are Dischargeable?

In re Ryan

389 B.R. 710 9th Cir. BAP, (Idaho, 2008)

On July 13, 1995, Ryan was convicted of possession of an unregistered firearm under 26 U.S.C. § 5861(d) in the United States District Court for the District of Alaska. Ryan was sentenced to fifty-seven months in prison followed by three years of supervised release. In addition, Ryan was ordered to pay a fine of \$7,500..., costs of prosecution in the amount of \$83,420, and a special assessment of \$50.00. Ryan served his sentence. He also paid the \$7,500 fine. The district court, following an appellate mandate, ultimately eliminated the restitution obligation.

On April 25, 2003, Ryan filed a petition for bankruptcy relief under chapter 7 in the District of Idaho. He received his chapter 7 discharge on August 11, 2003. Shortly thereafter, Ryan filed a case under chapter 13, listing as his only obligation the amount of unpaid costs of prosecution owed to the United States (“Government”)....

Ryan completed payments under the plan, and an “Order of Discharge” was entered on October 5, 2006. The chapter 13 trustee’s final report reflected that the Government received \$2,774.89 from payments made by Ryan under his plan, but a balance of \$77,088.34 on the Government’s costs of prosecution claim remained unpaid. Ryan then renewed his request for determination of

dischargeability. The bankruptcy court held that the unpaid portion of the Government's claim for costs of prosecution was excepted from discharge by § 1328(a)(3). Ryan appealed.

Section 1328(a)(3) provides an exception to discharge in chapter 13 for "restitution, or a criminal fine." It states, in pertinent part:

[A]s soon as practicable after the completion by the debtor of all payments under the plan, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title except any debt...

(3) for restitution, or a *criminal fine*, included in a sentence on the debtor's conviction of a crime [...] [emphasis added].

The essential question, then, is whether these costs of prosecution constitute a "criminal fine."

Statutory interpretation begins with a review of the particular language used by Congress in the relevant version of the law. [Citation.]

The term "criminal fine" is not defined in [Chapter 13] or anywhere else in the Bankruptcy Code. However, its use in § 1328(a)(3) implicates two important policies embedded in the Bankruptcy Code. First, in light of the objective to provide a fresh start for debtors overburdened by debts that they cannot pay, exceptions to discharge are interpreted strictly against objecting creditors and in favor of debtors. See, e.g. [Citations]. In chapter 13, this principle is particularly important because Congress adopted the liberal "superdischarge" provisions of § 1328 as an incentive to debtors to commit to a plan to pay their creditors all of their disposable income over a period of years rather than simply discharging their debts in a chapter 7 liquidation.

"[T]he dischargeability of debts in chapter 13 that are not dischargeable in chapter 7 represents a policy judgment that [it] is preferable for debtors to attempt to pay such debts to the best of their abilities over three years rather than for those debtors to have those debts hanging over their heads indefinitely, perhaps for the rest of their lives." [Citations.]

A second, countervailing policy consideration is a historic deference, both in the Bankruptcy Code and in the administration of prior bankruptcy law, to excepting criminal sanctions from discharge in bankruptcy. Application of this policy is consistent with a general recognition that, "[t]he principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the 'honest but unfortunate debtor.'" [Citation] (emphasis added [in original]).

The legislative history is clear that [in its 1994 amendments to the bankruptcy law] Congress intended to overrule the result in [of a 1990 Supreme Court case so that]:... "[N]o debtor with criminal restitution obligations will be able to discharge them through any bankruptcy proceeding..."

The imposition on a defendant of the costs of a special prosecutor is different from ordering a defendant to pay criminal fines. Costs are paid to the entity incurring the costs; criminal fines are generally paid to a special fund for victims' compensation and assistance in the U.S. Treasury....

To honor the principle that exceptions to discharge are to be construed narrowly in favor of debtors, particularly in chapter 13, where a broad discharge was provided by Congress as an incentive for debtors to opt for relief under that chapter rather than under chapter 7, it is not appropriate to expand the scope of the [Chapter 13] exception beyond the terms of the statute. Congress could have adopted an exception to discharge in chapter 13 that mirrored [the one in Chapter 7]. It did not do so. In contrast, under [the 2005] BAPCPA, when Congress wanted to limit the chapter 13 "superdischarge," it incorporated exceptions to discharge from [Chapter 7] wholesale....

As a bottom line matter, Ryan served his time and paid in full the criminal fine that was imposed as part of his sentence for conviction of possession of an unregistered firearm. The restitution obligation that was included as part of his sentence was voided. Ryan paid the Government a total of \$6,331.66 to be applied to the costs of prosecution awarded as part of his criminal judgment, including \$2,774.89 paid under his chapter 13 plan, leaving a balance of \$77,088.34. We determine that the unpaid balance of the costs of prosecution award was covered by Ryan's chapter 13 discharge.

Based on the foregoing analysis, we conclude that the exception to discharge included in [Chapter 13] for "restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" does not cover costs of prosecution included in such a sentence, and we REVERSE.

Case Questions

1. What is the rationale for making some things dischargeable under Chapter 13 that are not dischargeable under Chapter 7?
2. What is the difference between "criminal restitution" (which in 1994 Congress said could not get discharged at all) and "the costs of prosecution"?

3. Why did the court decide that Ryan’s obligation to pay “costs of prosecution” was not precluded by the limits on Chapter 13 bankruptcies imposed by Congress?

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5.2.7: Summary and Exercises

Summary

The Constitution gives Congress the power to legislate on bankruptcy. The current law is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides for six types of proceedings: (1) liquidation, Chapter 7; (2) adjustment of debts of a municipality, Chapter 9; (3) reorganization, Chapter 11; (4) family farmers with regular income, Chapter 12; (5) individuals with regular income, Chapter 13; and (6) cross-border bankruptcies, Chapter 15.

With some exceptions, any individual, partnership, or corporation seeking liquidation may file a voluntary petition in bankruptcy. An involuntary petition is also possible; creditors petitioning for that must meet certain criteria.

A petition operates as a stay against the debtor for lawsuits to recover claims or enforce judgments or liens. A judge will issue an order of relief and appoint a trustee, who takes over the debtor's property and preserves security interests. To recover monies owed, creditors must file proof of claims. The trustee has certain powers to recover property for the estate that the debtor transferred before bankruptcy. These include the power to act as a hypothetical lien creditor, to avoid fraudulent transfers and voidable preferences.

The bankruptcy act sets out categories of claimants and establishes priority among them. After secured parties take their security, the priorities are (1) domestic support obligations, (2) administrative expenses, (3) gap creditor claims, (4) employees' wages, salaries, commissions, (5) contributions to employee benefit plans, (6) grain or fish producers' claims against a storage facility, (7) consumer deposits, (8) taxes owed to governments, (9) allowed claims for personal injury or death resulting from debtor's driving or operating a vessel while intoxicated. After these priority claims are paid, the trustee must distribute the estate in this order: (a) unsecured creditors who filed timely, (b) unsecured creditors who filed late, (c) persons claiming fines and the like, (d) all other creditors, (e) the debtor. Most bankruptcies are no-asset, so creditors get nothing.

Under Chapter 7's 2005 amendments, debtors must pass a means test to be eligible for relief; if they make too much money, they must file Chapter 13.

Certain property is exempt from the estate of an individual debtor. States may opt out of the federal list of exemptions and substitute their own; most have.

Once discharged, the debtor is no longer legally liable for most debts. However, some debts are not dischargeable, and bad faith by the debtor may preclude discharge. Under some circumstances, a debtor may reaffirm a discharged debt. A Chapter 7 case may be converted to Chapter 11 or 13 voluntarily, or to Chapter 11 involuntarily.

Chapter 11 provides for reorganization. Any person eligible for discharge in Chapter 7 is eligible for Chapter 11, except stockbrokers and commodity brokers; those who have too much debt to file Chapter 13 and surpass the means test for Chapter 7 file Chapter 11. Under Chapter 11, the debtor retains possession of the business and may continue to operate it with its own management unless the court appoints a trustee. The court may do so either for cause or if it is in the best interests of the creditors. The court must appoint a committee of unsecured creditors, who remain active throughout the proceeding. The debtor may file its own reorganization plan and has the exclusive right to do so within 120 days if it remains in possession. The plan must be accepted by certain proportions of each impaired class of claims and interests. It is binding on all creditors, and the debtor is discharged from all debts once the court confirms the plan.

Chapter 13 is for any individual with regular income who has difficulty paying debts; it is voluntary only; the debtor must get credit counseling. The debtor presents a payment plan to creditors, and the court appoints a trustee. The plan extends the time to pay and may reduce the size of the debt. If the creditors wind up with more in this proceeding than they would have in Chapter 7, the court is likely to approve the plan. The court may approve a stretch-out of five years. Some debts not dischargeable under Chapter 7 may be under Chapter 13.

Alternatives to bankruptcy are (1) composition (agreement by creditors to accept less than the face amount of the debt), (2) assignment for benefit of creditors (transfer of debtor's property to a trustee, who uses it to pay debts), and (3) receivership (a disinterested person is appointed by the court to preserve assets and distribute them at the court's direction). Because these are voluntary procedures, they are ineffective if all parties do not agree to them.

Exercises

1. David has debts of \$18,000 and few assets. Because his debts are less than \$25,000, he decides to file for bankruptcy using the state court system rather than the federal system. Briefly describe the procedure he should follow to file for bankruptcy at the state level.
2. Assume that David in Exercise 1 is irregularly employed and has developed a plan for paying off his creditors. What type of bankruptcy should he use, Chapter 7, 11, or 13? Why?
3. Assume that David owns the following unsecured property: a \$3,000 oboe, a \$1,000 piano, a \$2,000 car, and a life insurance policy with a cash surrender value of \$8,000. How much of this property is available for distribution to his creditors in a bankruptcy? Explain.
4. If David owes his ex-wife alimony (maintenance) payments and is obligated to pay \$12,000 for an educational loan, what effect will his discharge have on these obligations?
5. Assume that David owns a corporation that he wants to liquidate under Chapter 7. After the corporate assets are distributed to creditors, there is still money owing to many of them. What obstacle does David face in obtaining a discharge for the corporation?
6. The famous retired professional football player—with a pension from the NFL—Orenthal James “O.J.” Simpson was convicted of wrongful death in a celebrated Santa Monica, California, trial in 1997 and ordered to pay \$33.5 million in damages to the families of the deceased. Mr. Simpson sold his California house, moved to Florida, and, from occasional appearances in the press, seemed to be living a high-style life with a big house, nice cars, and sharp clothing. He has never declared bankruptcy. Why hasn’t he been forced into an involuntary Chapter 7 bankruptcy by his creditors?
7.
 1. A debtor has an automobile worth \$5,000. The federal exemption applicable to her is \$3,225. The trustee sells the car and gives the debtor the amount of the exemption. The debtor, exhausted by the bankruptcy proceedings, takes the \$3,225 and spends it on a six-week vacation in Baja California. Is this an “abuse” of the bankruptcy system?
 2. A debtor has \$500 in cash beyond what is exempt in bankruptcy. She takes the cash and buys new tires for her car, which is worth about \$2,000. Is this an “abuse” of the bankruptcy system?

SELF CHECK QUESTIONS

1. Alternatives to bankruptcy include
 1. an assignment
 2. a composition
 3. receivership
 4. all of the above
2. A composition is
 1. a procedure where a receiver takes over the debtor’s property
 2. an agreement by creditors to take less than the face value of their debt
 3. basically the same as an assignment
 4. none of these
3. The highest-priority class set out by the 2005 act is for
 1. employees’ wages
 2. administrative expenses
 3. property settlements arising from divorce
 4. domestic support obligations
4. Darlene Debtor did the following within ninety days of filing for bankruptcy. Which could be set aside as a preferential payment?
 1. paid water and electricity bills
 2. made a gift to the Humane Society
 3. prepaid an installment loan on inventory
 4. borrowed money from a bank secured by a mortgage on business property
5. Donald Debtor sold his 1957 Chevrolet to his brother for one-fifth its value sixty days before filing for bankruptcy. The trustee wishes to avoid the transaction on the basis that it was
 1. a hypothetical lien

2. a lease disguised as a sale
 3. a preferential payment
 4. a voidable preference
6. Acme Co. filed for bankruptcy with the following debts; which is their correct priority from highest to lowest?i. wages of \$15,000 owed to employeesii. unpaid federal taxesiii. balance owed to a creditor who claimed its security with a \$5,000 deficiency owing
1. i, ii, iii
 2. ii, iii, i
 3. iii, ii, i
 4. i, iii, ii

Answers

1. d
2. b
3. d
4. c
5. d
6. a

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SECTION OVERVIEW

5.3: Insurance

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5.3.3: Property Insurance, Liability Insurance, and Life Insurance

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5.3.1: Chapter Introduction

Learning Objectives

After reading this chapter, you should understand the following:

1. The basic terms and distinctions in the law of insurance
2. The basic types of insurance for property, liability, and life
3. The basic defenses to claims against insurance companies by the insured: representation, concealment, and warranties

We conclude our discussions about property with a focus on insurance law, not only because insurance is a means of compensating an owner for property losses but also because the insurance contract itself represents a property right. In this chapter, we begin by examining regulation of the insurance industry. We then look at legal issues relating to specific types of insurance. Finally, we examine defenses that insurance companies might raise to avoid making payments under insurance policies.

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5.3.2: Definitions and Types of Insurance

Learning Objectives

1. Know the basic types of insurance for individuals.
2. Name and describe the various kinds of business insurance.

Certain terms are usefully defined at the outset. **Insurance** is a contract of reimbursement. For example, it reimburses for losses from specified perils, such as fire, hurricane, and earthquake. An **insurer** is the company or person who promises to reimburse. The **insured** (sometimes called the assured) is the one who receives the payment, except in the case of life insurance, where payment goes to the beneficiary named in the life insurance contract. The **premium** is the consideration paid by the insured—usually annually or semiannually—for the insurer’s promise to reimburse. The contract itself is called the **policy**. The events insured against are known as **risks** or **perils**.

Regulation of insurance is left mainly in the hands of state, rather than federal, authorities. Under the McCarran-Ferguson Act, Congress exempted state-regulated insurance companies from the federal antitrust laws. Every state now has an insurance department that oversees insurance rates, policy standards, reserves, and other aspects of the industry. Over the years, these departments have come under fire in many states for being ineffective and “captives” of the industry. Moreover, large insurers operate in all states, and both they and consumers must contend with fifty different state regulatory schemes that provide very different degrees of protection. From time to time, attempts have been made to bring insurance under federal regulation, but none have been successful.

We begin with an overview of the types of insurance, from both a consumer and a business perspective. Then we examine in greater detail the three most important types of insurance: property, liability, and life.

Public and Private Insurance

Sometimes a distinction is made between public and private insurance. Public (or social) insurance includes Social Security, Medicare, temporary disability insurance, and the like, funded through government plans. Private insurance plans, by contrast, are all types of coverage offered by private corporations or organizations. The focus of this chapter is private insurance.

Types of Insurance for the Individual

Life Insurance

Life insurance provides for your family or some other named beneficiaries on your death. Two general types are available: **term insurance** provides coverage only during the term of the policy and pays off only on the insured’s death; **whole-life insurance** provides savings as well as insurance and can let the insured collect before death.

Health Insurance

Health insurance covers the cost of hospitalization, visits to the doctor’s office, and prescription medicines. The most useful policies, provided by many employers, are those that cover 100 percent of the costs of being hospitalized and 80 percent of the charges for medicine and a doctor’s services. Usually, the policy will contain a deductible amount; the insurer will not make payments until after the deductible amount has been reached. Twenty years ago, the deductible might have been the first \$100 or \$250 of charges; today, it is often much higher.

Disability Insurance

A disability policy pays a certain percentage of an employee’s wages (or a fixed sum) weekly or monthly if the employee becomes unable to work through illness or an accident. Premiums are lower for policies with longer waiting periods before payments must be made: a policy that begins to pay a disabled worker within thirty days might cost twice as much as one that defers payment for six months.

Homeowner’s Insurance

A homeowner’s policy provides insurance for damages or losses due to fire, theft, and other named perils. No policy routinely covers all perils. The homeowner must assess his needs by looking to the likely risks in his area—earthquake, hailstorm, flooding, and so on. Homeowner’s policies provide for reduced coverage if the property is not insured for at least 80 percent of its

replacement costs. In inflationary times, this requirement means that the owner must adjust the policy limits upward each year or purchase a rider that automatically adjusts for inflation. Where property values have dropped substantially, the owner of a home (or a commercial building) might find savings in lowering the policy's insured amount.

Automobile Insurance

Automobile insurance is perhaps the most commonly held type of insurance. Automobile policies are required in at least minimum amounts in all states. The typical automobile policy covers liability for bodily injury and property damage, medical payments, damage to or loss of the car itself, and attorneys' fees in case of a lawsuit.

Other Liability Insurance

In this litigious society, a person can be sued for just about anything: a slip on the walk, a harsh and untrue word spoken in anger, an accident on the ball field. A personal liability policy covers many types of these risks and can give coverage in excess of that provided by homeowner's and automobile insurance. Such umbrella coverage is usually fairly inexpensive, perhaps \$250 a year for \$1 million in liability.

Types of Business Insurance

Workers' Compensation

Almost every business in every state must insure against injury to workers on the job. Some may do this through self-insurance—that is, by setting aside certain reserves for this contingency. Most smaller businesses purchase workers' compensation policies, available through commercial insurers, trade associations, or state funds.

Automobile Insurance

Any business that uses motor vehicles should maintain at least a minimum automobile insurance policy on the vehicles, covering personal injury, property damage, and general liability.

Property Insurance

No business should take a chance of leaving unprotected its buildings, permanent fixtures, machinery, inventory, and the like. Various property policies cover damage or loss to a company's own property or to property of others stored on the premises.

Malpractice Insurance

Professionals such as doctors, lawyers, and accountants will often purchase malpractice insurance to protect against claims made by disgruntled patients or clients. For doctors, the cost of such insurance has been rising over the past thirty years, largely because of larger jury awards against physicians who are negligent in the practice of their profession.

Business Interruption Insurance

Depending on the size of the business and its vulnerability to losses resulting from damage to essential operating equipment or other property, a company may wish to purchase insurance that will cover loss of earnings if the business operations are interrupted in some way—by a strike, loss of power, loss of raw material supply, and so on.

Liability Insurance

Businesses face a host of risks that could result in substantial liabilities. Many types of policies are available, including policies for owners, landlords, and tenants (covering liability incurred on the premises); for manufacturers and contractors (for liability incurred on all premises); for a company's products and completed operations (for liability that results from warranties on products or injuries caused by products); for owners and contractors (protective liability for damages caused by independent contractors engaged by the insured); and for contractual liability (for failure to abide by performances required by specific contracts).

Some years ago, different types of individual and business coverage had to be purchased separately and often from different companies. Today, most insurance is available on a package basis, through single policies that cover the most important risks. These are often called multiperil policies.

Key Takeaway

Although insurance is a need for every US business, and many businesses operate in all fifty states, regulation of insurance has remained at the state level. There are several forms of public insurance (Social Security, disability, Medicare) and many forms of

private insurance. Both individuals and businesses have significant needs for various types of insurance, to provide protection for health care, for their property, and for legal claims made against them by others.

Exercises

1. Theresa Conley is joining the accounting firm of Hunter and Patton in Des Moines, Iowa. She is a certified public accountant. What kind of insurance will she (or the firm, on her behalf) need to buy because of her professional activities?
2. Nate Johnson has just signed a franchise agreement with Papa Luigi's Pizza and will be operating his own Papa Luigi's store in Lubbock, Texas. The franchise agreement requires that he personally contract for "all necessary insurance" for the successful operation of the franchise. He expects to have twelve employees, five full-time and seven part-time (the delivery people), at his location, which will be on a busy boulevard in Lubbock and will offer take-out only. Pizza delivery employees will be using their own automobiles to deliver orders. What kinds of insurance will be "necessary"?

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5.3.3: Property Insurance, Liability Insurance, and Life Insurance

Learning Objectives

1. Distinguish and define the basic types of insurance for property, liability, and life.
2. Explain the concepts of subrogation and assignment.

We turn now to a more detailed discussion of the law relating to the three most common types of insurance: property, liability, and life insurance.

Property Insurance

It is sometimes said that property is the foundation for a system of free market capitalism. If so, then protecting property is a necessary part of being part of that system, whether as an individual or as a business entity.

Coverage

As we have noted, property insurance provides coverage for real and personal property owned by a business or an individual. Property insurance is also part of automobile policies covering damage to the car caused by an accident (collision coverage) or by other events such as vandalism or fire (comprehensive coverage). Different levels of coverage are available. For example, many basic homeowners' policies cover damage resulting from the following types of perils only: fire and lightning, windstorm and hail, explosions, riots and civil commotions, aircraft and vehicular accidents, smoke, vandalism and malicious mischief, theft, and breakage of glass that is part of a building.

A broader policy, known as broad coverage, also includes these perils: falling objects; weight of ice, snow, and sleet; collapse of buildings; sudden and accidental damage to heating systems; accidental discharge from plumbing, heating, or air-conditioning systems; freezing of heating, plumbing, and air conditioning systems; and sudden and accidental injury from excess currents to electrical appliances and wiring. Even with the broadest form of coverage, known as comprehensive, which covers all perils except for certain named exclusions, the homeowner can be left without protection. For example, comprehensive policies do not usually cover damage resulting from flooding, earthquakes, war, or nuclear radiation. The homeowner can purchase separate coverage for these perils but usually at a steep premium.

Insurable Interest in Property

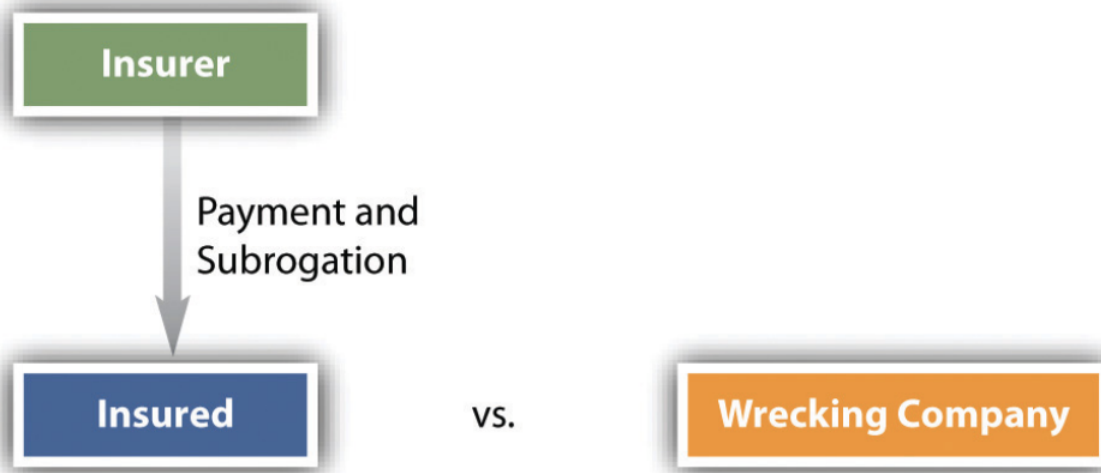
To purchase property insurance, the would-be insured must have an **insurable interest** in the property. Insurable interest is a real and substantial interest in specific property such that a loss to the insured would ensue if the property were damaged. You could not, for instance, take out an insurance policy on a motel down the block with which you have no connection. If a fire destroyed it, you would suffer no economic loss. But if you helped finance the motel and had an investment interest in it, you would be permitted to place an insurance policy on it. This requirement of an insurable interest stems from the public policy against wagering. If you could insure anything, you would in effect be betting on an accident.

To insure property, therefore, you must have a legal interest and run the risk of a pecuniary loss. Any legal interest is sufficient: a contractual right to purchase, for instance, or the right of possession (a bailee may insure). This insurable interest must exist both at the time you take out the policy and at the time the loss occurs. Moreover, coverage is limited to the extent of the interest. As a mortgagee, you could ensure only for the amount still due.

Prior to the financial meltdown of 2008, many investment banks took insurance against possible losses from collateralized debt obligations (CDOs) and other financial products based on subprime loans. The principal insurer was American International Group, Inc. (AIG), which needed a US government bailout when the risks covered by AIG turned out to be riskier than AIG's models had projected.

Subrogation

Figure 19.1 Subrogation



Subrogation is the substitution of one person for another in pursuit of a legal claim. When an insured is entitled to recover under a policy for property damage, the insurer is said to be subrogated to the insured's right to sue any third party who caused the damage. For example, a wrecking company negligently destroys an insured's home, mistaking it for the building it was hired to tear down. The insured has a cause of action against the wrecking company. If the insured chooses instead to collect against a homeowner's policy, the insurance company may sue the wrecking company in the insured's place to recover the sum it was obligated to pay out under the policy (see [Figure 19.1 "Subrogation"](#)).

Assignment

Assignment is the transfer of any property right to another. In property insurance, a distinction is made between assignment of the coverage and assignment of the proceeds. Ordinarily, the insured may not assign the policy itself without the insurer's permission—that is, he may not commit the insurer to insure someone else. But the insured may assign any claims against the insurer—for example, the proceeds not yet paid out on a claim for a house that has already burned down.

Intentional Losses

Insurance is a means of spreading risk. It is economically feasible because not every house burns down and not every car is stolen. The number that do burn down or that are stolen can be calculated and the premium set accordingly. Events that will certainly happen, like ordinary wear and tear and the destruction of property through deliberate acts such as arson, must be excluded from such calculations. The injury must result from accidental, not deliberate, causes.

Coinsurance Clause

Most commercial property policies contain a so-called **coinsurance clause**, which requires the insured to maintain insurance equal to a specified percentage of the property value. It is often 80 percent but may be higher or lower. If the property owner insures for less than that percentage, the recovery will be reduced. In effect, the owner becomes a coinsurer with the insurance company. The usual formula establishes the proportion that the insurer must pay by calculating the ratio of (1) the amount of insurance actually taken to (2) the coinsurance percentage multiplied by the total dollar value of the property. Suppose a fire causes \$160,000 damage to a plant worth \$1,000,000. The plant should have been insured for 80 percent (\$800,000), but the insured took out only a \$500,000 policy. He will recover only \$100,000. To see why, multiply the total damages of \$160,000 by the coinsurance proportion of five-eighths (\$500,000 of insurance on the required minimum of \$800,000). Five-eighths of \$160,000 equals \$100,000, which would be the insured's recovery where the policy has a coinsurance clause.

Liability Insurance

Liability insurance has taken on great importance for both individuals and businesses in contemporary society. Liability insurance covers specific types of legal liabilities that a homeowner, driver, professional, business executive, or business itself might incur in the round of daily activities. A business is always at risk in sending products into the marketplace. Doctors, accountants, real estate brokers, insurance agents, and lawyers should obtain liability insurance to cover the risk of being sued for malpractice. A prudent

homeowner will acquire liability insurance as part of homeowner's policy and a supplemental umbrella policy that insures for liability in excess of a limit of, say, \$100,000 in the regular homeowner's policy. And businesses, professionals, and individuals typically acquire liability insurance for driving-related activities as part of their automobile insurance. In all cases, liability policies cover not only any settlement or award that might ultimately have to be paid but also the cost of lawyers and related expenses in defending any claims.

Liability insurance is similar in several respects to property insurance and is often part of the same package policy. As with property insurance, subrogation is allowed with liability insurance, but assignment of the policy is not allowed (unless permission of the insurer is obtained), and intentional losses are not covered. For example, an accountant who willfully helps a client conceal fraud will not recover from his malpractice insurance policy if he is found guilty of participating in the fraud.

No-Fault Trends

The major legal development of the century relating to liability insurance has been the elimination of liability in the two areas of greatest exposure: in the workplace and on the highway. In the next unit on agency law, we discuss the no-fault system of workers' compensation, under which a worker receives automatic benefits for workplace injuries and gives up the right to sue the employer under common-law theories of liability. Here we will look briefly at the other major type of no-fault system: recovery for damages stemming from motor vehicle accidents.

"No-fault" means that recovery for damages in an accident no longer depends on who was at fault in causing it. A motorist will file a claim to recover his actual damages (medical expenses, income loss) directly from his own insurer. The no-fault system dispenses with the costly and uncertain tort system of having to prove negligence in court. Many states have adopted one form or another of no-fault automobile insurance, but even in these states the car owner must still carry other insurance. Some no-fault systems have a dollar "threshold" above which a victim may sue for medical expenses or other losses. Other states use a "verbal threshold," which permits suits for "serious" injury, defined variously as "disfigurement," "fracture," or "permanent disability." These thresholds have prevented no-fault from working as efficiently as theory predicts. Inflation has reduced the power of dollar thresholds (in some states as low as \$200) to deter lawsuits, and the verbal thresholds have standards that can only be defined in court, so much litigation continues.

No state has adopted a "pure" no-fault system. A pure no-fault system trades away entirely the right to sue in return for the prompt payment of "first-party" insurance benefits—that is, payment by the victim's own insurance company instead of traditional "third-party" coverage, in which the victim collects from the defendant's insurance company.

Among the criticisms of no-fault insurance is the argument that it fails to strengthen the central purpose of the tort system: to deter unsafe conduct that causes accidents. No-fault lessens, it is said, the incentive to avoid accidents. In any event, no-fault automobile insurance has been a major development in the insurance field since 1970 and seems destined to be a permanent fixture of insurance law.

Life Insurance

Insurable Interest

The two types of life insurance mentioned in [Section 19.1.2 "Types of Insurance for the Individual"](#), term and whole-life policies, are important both to individuals and to businesses (insurance for key employees). As with property insurance, whoever takes out a life insurance policy on a person's life must have an insurable interest. Everyone has an insurable interest in his own life and may name whomever he pleases as beneficiary; the beneficiary need not have an insurable interest. But the requirement of insurable interest restricts those who may take out insurance on someone else's life. A spouse or children have an insurable interest in a spouse or parent. Likewise, a parent has an insurable interest in any minor child. That means that a wife, for example, may take out a life insurance policy on her husband without his consent. But she could not take out a policy on a friend or neighbor. As long as the insurable interest existed when the policy was taken out, the owner may recover when the insured dies, even if the insurable interest no longer exists. Thus a divorced wife who was married when the policy was obtained may collect when her ex-husband dies as long as she maintained the payments. Likewise, an employer has an insurable interest in his key employees and partners; such insurance policies help to pay off claims of a partner's estate and thus prevent liquidation of the business.

Subrogation

Unlike property insurance, life insurance does not permit subrogation. The insurer must pay the claim when the insured dies and may not step into the shoes of anyone entitled to file a wrongful death claim against a person who caused the death. Of course, if

the insured died of natural causes, there would be no one to sue anyway.

Change of Beneficiary and Assignment

Unless the insured reserves the right to change beneficiaries, his or her initial designation is irrevocable. These days, however, most policies do reserve the right if certain formalities are observed, including written instructions to the insurer's home office to make the change and endorsement of the policy. The insured may assign the policy, but the beneficiary has priority to collect over the assignee if the right to change beneficiaries has not been reserved. If the policy permits beneficiaries to be changed, then the assignee will have priority over the original beneficiary.

Intentional Losses

Two types of intentional losses are especially important in life insurance: suicide and murder of the insured by the beneficiary.

Suicide

In a majority of states, in the absence of a suicide clause in the policy, when an insured commits suicide, the insurer need not pay out if the policy is payable to the insured's estate. However, if the policy is payable to a third person (e.g., the insured's company), payment will usually be allowed. And if an insured kills himself while insane, all states require payment, whether to the estate or a third party. Most life insurance policies today have a provision that explicitly excepts suicide from coverage for a limited period, such as two years, after the policy is issued. In other words, if the insured commits suicide within the first two years, the insurer will refund the premiums to his estate but will not pay the policy amount. After two years, suicide is treated as any other death would be.

Murder

Under the law in every state, a beneficiary who kills the insured in order to collect the life insurance is barred from receiving it. But the invocation of that rule does not absolve the insurer of liability to pay the policy amount. An alternate beneficiary must be found. Sometimes the policy will name contingent beneficiaries, and many, but not all, states require the insurer to pay the contingent beneficiaries. When there are no contingent beneficiaries or the state law prohibits paying them, the insurer will pay the insured's estate. Not every killing is murder; the critical question is whether the beneficiary intended his conduct to eliminate the insured in order to collect the insurance.

The willful, unlawful, and felonious killing of the insured by the person named as beneficiary in a life policy results in the forfeiture of all rights of such person therein. It is unnecessary that there should be an express exception in the contract of insurance forbidding a recovery in favor of such a person in such an event. On considerations of public policy, the death of the insured, willfully and intentionally caused by the beneficiary of the policy, is an excepted risk so far as the person thus causing the death is concerned.

Key Takeaway

Many kinds of insurance are available for individuals and businesses. For individuals, life insurance, homeowner's insurance, and automobile insurance are common, with health insurance considered essential but often expensive. Businesses with sufficient employees will obtain workers' compensation insurance, property insurance, and liability insurance, and auto insurance for any employees driving company vehicles. Insurance companies will often pay a claim for their insured and take over the insured's claim against a third party.

Liability insurance is important for individuals, companies, and licensed professionals. A trend toward no-fault in liability insurance is seen in claims for work-related injuries (workers' compensation) and in automobile insurance. Life insurance is common for most families and for businesses that want to protect against the loss of key employees.

Exercises

1. Helen Caldicott raises a family and then begins a career as a caterer. As her business grows, she hires several employees and rents space near downtown that has a retail space, parking, and a garage for the three vehicles that bear her business's name. What kinds of insurance does Helen need for her business?
2. One of Helen's employees, Bob Zeek, is driving to a catered event when another car fails to stop at a red light and severely injures Bob and nearly totals the van Bob was driving. The police issue a ticket for careless and reckless driving to the other driver, who pleads guilty to the offense. The other driver is insured, but Helen's automobile insurance carrier goes ahead and pays for the damages to the company vehicle. What will her insurance company likely do next?

3. The health insurance provider for Helen's employees pays over \$345,000 of Bob's medical and hospitalization bills. What will Helen's insurance company likely do next?
4. Many homeowners live on floodplains but have homeowner's insurance nonetheless. Must insurance companies write such policies? Do homeowners on floodplains pay more in premiums? If insurance companies are convinced that global climate change is happening, with rising sea levels and stronger storms, can they simply avoid writing policies for homes and commercial buildings in coastal areas?

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5.3.4: Insurer's Defenses

Learning Objectives

1. Understand the principal defenses available to insurers when claims are made.
2. Recognize that despite these defenses, insurance companies must act in good faith.

Types of Defenses

It is a common perception that because insurance contracts are so complex, many insureds who believe they are covered end up with uninsured losses. In other words, the large print giveth, and the small print taketh away. This perception is founded, to some extent, on the use by insurance companies of three common defenses, all of which relate to a duty of good faith on the part of the insured: (1) representation, (2) concealment, and (3) warranties.

Representation

A **representation** is a statement made by someone seeking an insurance policy—for example, a statement that the applicant did (or did not) consult a doctor for any illness during the previous five years. An insurer has grounds to avoid the contract if the applicant makes a false representation. The misrepresentation must have been material; that is, a false description of a person's hair coloring should not defeat a claim under an automobile accident policy. But a false statement, even if innocent, about a material fact—for instance, that no one in the family uses the car to go to work, when unbeknownst to the applicant, his wife uses the car to commute to a part-time job she hasn't told him about—will at the insurer's option defeat a claim by the insured to collect under the policy. The accident need not have arisen out of the misrepresentation to defeat the claim. In the example given, the insurance company could refuse to pay a claim for any accident in the car, even one occurring when the car was driven by the husband to go to the movies, if the insurer discovered that the car was used in a manner in which the insured had declared it was not used. This chapter's case, *Mutual Benefit Life Insurance Co. v. JMR Electronics Corp.*, (see [Section 19.4.1 "Misrepresentation to Insurer"](#)), illustrates what happens when an insured misrepresents his smoking habits.

Concealment

An insured is obligated to volunteer to the insurer all material facts that bear on insurability. The failure of an insured to set forth such information is a **concealment**, which is, in effect, the mirror image of a false representation. But the insured must have had a fraudulent intent to conceal the material facts. For example, if the insured did not know that gasoline was stored in his basement, the insurer may not refuse to pay out on a fire insurance policy.

Warranties

Many insurance policies covering commercial property will contain warranties. For example, a policy may have a warranty that the insured bank has installed or will install a particular type of burglar alarm system. Until recently, the rule was strictly enforced: any breach of a warranty voided the contract, even if the breach was not material. A nonmaterial breach might be, for example, that the bank obtained the alarm system from a manufacturer other than the one specified, even though the alarm systems are identical. In recent years, courts or legislatures have relaxed the application of this rule. But a material breach still remains absolute grounds for the insurer to avoid the contract and refuse to pay.

Incontestable Clause

In life insurance cases, the three common defenses often are unavailable to the insurer because of the so-called **incontestable clause**. This states that if the insured has not died during a specified period of time in which the life insurance policy has been in effect (usually two years), then the insurer may not refuse to pay even if it is later discovered that the insured committed fraud in applying for the policy. Few nonlife policies contain an incontestable clause; it is used in life insurance because the effect on many families would be catastrophic if the insurer claimed misrepresentation or concealment that would be difficult to disprove years later when the insured himself would no longer be available to give testimony about his intentions or knowledge.

Requirement of Insurer's Good Faith

Like the insured, the insurer must act in good faith. Thus defenses may be unavailable to an insurer who has waived them or acted in such a manner as to create an estoppel. Suppose that when an insured seeks to increase the amount on his life insurance policy,

the insurance company learns that he lied about his age on his original application. Nevertheless, the company accepts his application for an increase. The insured then dies, and the insurer refuses to pay his wife any sum. A court would hold that the insurer had waived its right to object, since it could have cancelled the policy when it learned of the misrepresentation. Finally, an insurer that acts in bad faith by denying a claim that it knows it should pay may find itself open to punitive damage liability.

Key Takeaway

Some claims by insured parties can be legally denied by insurance companies where the insured has made a material misrepresentation. Some claims can be legally denied if the insured has deliberately concealed important matters in applying for insurance coverage. Because insurance coverage is by contract, courts often strictly construe the contract language, and if the language does not cover the insured, the courts will typically not bend the language of the contract to help the insured.

Exercises

1. Amir Labib gets a reduced rate from his auto insurance company because he represents in his application that he commutes less than ten miles a day to work. Three years later, he and his wife buy a new residence, farther away from work, and he begins a fifteen-mile-a-day commute. The rate would be raised if he were to mention this to his insurance company. The insurance company sees that he has a different address, because they are mailing invoices to his new home. But the rate remains the same. Amir has a serious accident on a vacation to Yellowstone National Park, and his automobile is totaled. His insurance policy is a no-fault policy as it relates to coverage for vehicle damage. Is the insurance company within its rights to deny any payment on his claim? How so, or why not?
2. In 2009, Peter Calhoun gets a life insurance policy from Northwest Mutual Life Insurance Company, and the death benefit is listed as \$250,000. The premiums are paid up when he dies in 2011 after a getaway car being chased by the police slams into his car at fifty miles per hour on a street in suburban Chicago. The life insurance company gets information that he smoked two packs of cigarettes a day, whereas in his application in 2009, he said he smoked only one pack a day. In fact, he had smoked about a pack and a half every day since 1992. Is the insurance company within its rights to deny any payment on his claim? How so, or why not?

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5.3.5: Case

Misrepresentation to Insurer

Mutual Benefit Life Insurance Co. v. JMR Electronics Corp.

848 F.2d 30 (2nd Cir. 1988)

PER CURIAM

JMR Electronics Corporation (“JMR”) appeals from a judgment of the District Court for the Southern District of New York (Robert W. Sweet, Judge) ordering rescission of a life insurance policy issued by plaintiff-appellant The Mutual Benefit Life Insurance Company (“Mutual”) and dismissing JMR’s counterclaim for the policy’s proceeds. Judge Sweet ruled that a misrepresentation made in the policy application concerning the insured’s history of cigarette smoking was material as a matter of law. Appellant contends that the misrepresentation was not material because Mutual would have provided insurance—albeit at a higher premium rate—even if the insured’s smoking history had been disclosed. We agree with the District Court that summary judgment was appropriate and therefore affirm.

The basic facts are not in dispute. On June 24, 1985, JMR submitted an application to Mutual for a \$ 250,000 “key man” life insurance policy on the life of its president, Joseph Gaon, at the non-smoker’s discounted premium rate. Mutual’s 1985 Ratebook provides: “The Non-Smoker rates are available when the proposed insured is at least 20 years old and has not smoked a cigarette for at least twelve months prior to the date of the application.” Question 13 of the application inquired about the proposed insured’s smoking history. Question 13(a) asked, “Do you smoke cigarettes? How many a day?” Gaon answered this question, “No.” Question 13(b) asked, “Did you ever smoke cigarettes?” Gaon again answered, “No.” Based on these representations, Mutual issued a policy on Gaon’s life at the non-smoker premium rate.

Gaon died on June 22, 1986, within the period of contestability contained in policy, see N.Y. Ins. Law § 3203 (a)(3) (McKinney 1985). Upon routine investigation of JMR’s claim for proceeds under the policy, Mutual discovered that the representations made in the insurance application concerning Gaon’s smoking history were untrue. JMR has stipulated that, at the time the application was submitted, Gaon in fact “had been smoking one-half of a pack of cigarettes per day for a continuous period of not less than 10 years.” Mutual brought this action seeking a declaration that the policy is void. Judge Sweet granted Mutual’s motion for summary judgment, dismissed JMR’s counterclaim for the proceeds of the policy, and ordered rescission of the insurance policy and return of JMR’s premium payments, with interest.

Under New York law, which governs this diversity suit, “it is the rule that even an innocent misrepresentation as to [the applicant’s medical history], if material, is sufficient to allow the insurer to avoid the contract of insurance or defeat recovery thereunder.” *Process Plants Corp. v. Beneficial National Life Insurance Co.*, 366 N.E.2d 1361 (1977). A “misrepresentation” is defined by statute as a false “statement as to past or present fact, made to the insurer...at or before the making of the insurance contract as an inducement to the making thereof.” N.Y. Ins. Law § 3105(a) (McKinney 1985). A misrepresentation is “material” if “knowledge by the insurer of the facts misrepresented would have led to a refusal by the insurer to make such contract.” *Id.* § 3105(b)....

In the present case JMR has stipulated that Gaon’s smoking history was misrepresented in the insurance application. However, JMR disputes that this misrepresentation is material as a matter of law. JMR argues that under New York law a misrepresentation is not material unless the insurer can demonstrate that, had the applicant provided complete and accurate information, coverage either would have been refused or at the very least withheld pending a more detailed underwriting examination. In JMR’s view summary judgment was inappropriate on the facts of this case because a jury could reasonably have found that even “had appellee been aware of Gaon’s smoking history, a policy at the smoker’s premium rate would have been issued.” JMR takes the position that the appropriate remedy in this situation is to permit recovery under the policy in the amount that the premium actually paid would have purchased for a smoker.

We agree with Judge Sweet that this novel theory is without basis in New York law. The plain language of the statutory definition of “materiality,” found in section 3105(b), permits avoidance of liability under the policy where “knowledge by the insurer of the facts misrepresented would have led to a refusal by the insurer to make *such contract*.” (emphasis added) Moreover, numerous courts have observed that the materiality inquiry under New York law is made with respect to the particular policy issued in reliance upon the misrepresentation.

* * *

There is no doubt that Mutual was induced to issue the non-smoker, discounted-premium policy to JMR precisely as a result of the misrepresentations made by Gaon concerning his smoking history. That Mutual might not have refused the risk on *any* terms had it known the undisclosed facts is irrelevant. Most risks are insurable at some price. The purpose of the materiality inquiry is not to permit the jury to rewrite the terms of the insurance agreement to conform to the newly disclosed facts but to make certain that the risk insured was the risk covered by the policy agreed upon. If a fact is material to the risk, the insurer may avoid liability under a policy if that fact was misrepresented in an application for that policy whether or not the parties might have agreed to some other contractual arrangement had the critical fact been disclosed. As observed by Judge Sweet, a contrary result would reward the practice of misrepresenting facts critical to the underwriter's task because the unscrupulous (or merely negligent) applicant "would have everything to gain and nothing to lose" from making material misrepresentations in his application for insurance. Such a claimant could rest assured not only that he may demand full coverage should he survive the contestability period, N.Y. Ins. Law § 3203 (a)(3), but that even in the event of a contested claim, he would be entitled to the coverage that he might have contracted for had the necessary information been accurately disclosed at the outset. New York law does not permit this anomalous result. The judgment of the District Court is affirmed.

CASE QUESTIONS

1. When you read this case, did you assume that Gaon died from lung cancer or some other smoking-related cause? Does the court actually say that?
2. Can you reasonably infer from the facts here that Gaon himself filled out the form and signed it? That is, can you know with some degree of certainty that he lied to the insurance company? Would it make any difference if he merely signed a form that his secretary filled out? Why or why not?
3. What if Gaon died of causes unrelated to smoking (e.g., he was in a fatal automobile accident), and the insurance company was looking for ways to deny the claim? Does the court's opinion and language still seem reasonable (e.g., the statement "there is no doubt that Mutual was induced to issue the non-smoker, discounted-premium policy to JMR precisely as a result of the misrepresentations made by Gaon concerning his smoking history")?
4. If Gaon had accurately disclosed his smoking history, is it clear that the insurance company would have refused to write any policy at all? Why is this question important? Do you agree with the court that the question is irrelevant?

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5.3.6: Summary and Exercises

19.5 Summary and Exercises

Summary

Insurance is an inescapable cost of doing business in a modern economy and an important service for any individual with dependents or even a modest amount of property. Most readers of this book will someday purchase automobile, homeowner's, and life insurance, and many readers will deal with insurance in the course of a business career.

Most insurance questions are governed by contract law, since virtually all insurance is voluntary and entered into through written agreements. This means that the insured must pay careful attention to the wording of the policies to determine what is excluded from coverage and to ensure that he makes no warranties that he cannot keep and no misrepresentations or concealments that will void the contract. But beyond contract law, some insurance law principles—such as insurable interest and subrogation rights—are important to bear in mind. Defenses available to an insurance company may be based upon representation, concealment, or warranties, but an insurer that is overzealous in denying coverage may find itself subject to punitive damages.

Exercises

1. Martin and Williams, two business partners, agreed that each would insure his life for the benefit of the other. On his application for insurance, Martin stated that he had never had any heart trouble when in fact he had had a mild heart attack some years before. Martin's policy contained a two-year incontestable clause. Three years later, after the partnership had been dissolved but while the policy was still in force, Martin's car was struck by a car being negligently driven by Peters. Although Martin's injuries were superficial, he suffered a fatal heart attack immediately after the accident—an attack, it was established, that was caused by the excitement. The insurer has refused to pay the policy proceeds to Williams. Does the insurer have a valid defense based on Martin's misrepresentation? Explain.
2. In Exercise 1, was it necessary for Williams to have an insurable interest in Martin's life to recover under the policy? Why?
3. In Exercise 1, if Williams had taken out the policy rather than Martin, could the insurer defend the claim on the ground that at the time of Martin's death, Williams had no insurable interest? Why?
4. If Williams had no insurable interest, would the incontestable clause prevent the company from asserting this defense? Why?
5. If the insurer pays Williams's claim, may it recover from Peters? Why?
6. Skidmore Trucking Company decided to expand its operations into the warehousing field. After examining several available properties, it decided to purchase a carbarn for \$100,000 from a local bus company and to convert it into a warehouse. The standard contract for a real estate purchase was signed by the parties. The contract obligated Skidmore to pay the seller on an apportioned basis for the prepaid premiums on the existing fire insurance policy (\$100,000 extended coverage). The policy expired two years and one month from the closing date. At the closing, the seller duly assigned the fire insurance policy to Skidmore in return for the payment of the apportioned amount of the prepaid premiums, but Skidmore failed to notify the insurance company of the change in ownership. Skidmore took possession of the premises and, after extensive renovation, began to use the building as a warehouse. Soon afterward, one of Skidmore's employees negligently dropped a lighted cigarette into a trash basket and started a fire that totally destroyed the building. Was the assignment of the policy to Skidmore valid? Why?
7. In Exercise 6, assuming the assignment is valid, would the insurer be obligated to pay for the loss resulting from the employee's negligence? Why?

SELF-TEST QUESTIONS

1. The substitution of one person for another in pursuit of a legal claim is called a. assignment
b. coinsurance
c. subrogation
d. none of the above
2. Most insurance questions are covered by a. tort law
b. criminal law
c. constitutional law
d. contract law
3. Common defenses used by insurance companies include a. concealment
b. false representation

- c. breach of warranty
 - d. all of the above
4. A coinsurance clause a. requires the insured to be insured by more than one policy
- b. requires the insured to maintain insurance equal to a certain percentage of the property's value
 - c. allows another beneficiary to be substituted for the insured
 - d. is none of the above
5. Property insurance typically covers a. ordinary wear and tear
- b. damage due to theft
 - c. intentional losses
 - d. damage due to earthquakes

SELF-TEST AnswerS

- 1. c
- 2. d
- 3. d
- 4. b
- 5. b

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5.4: WATCH - Bed, Bath and Beyond Bankruptcy Explained

Notes:

Watch this 5:21 video to learn more about corporate bankruptcy.



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5.5: READ or LISTEN - Bed Bath and Beyond follow up

Notes:

Read or Listen to this follow up on the Bed Bath & Beyond bankruptcy.

<https://www.npr.org/transcripts/1191406540>

5.5: READ or LISTEN - Bed Bath and Beyond follow up is shared under a [CC BY 4.0](#) license and was authored, remixed, and/or curated by Mabel Gehrett and Western Technical College.

5.6: READ - Subrogation

What is Subrogation?

Subrogation refers to the practice of substituting one party for another in a legal setting. Essentially, subrogation provides a legal right to a third party to collect a [debt](#) or damages on behalf of another party.

▮ [Subrogation - Defined How it Work Example Importance.pdf](#)

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5.7: 5.7 DISCUSSION - Bankruptcy

Notes:

This week, we discussed bankruptcy. Find a current event article or video about a business facing or finishing the bankruptcy process. What type of bankruptcy was it? What causes did you identify that led to the bankruptcy? What did you find most interesting about the story? Include your article/video and your summary.

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CHAPTER OVERVIEW

6: Module 6 - Disputes and Dispute Settlement

6.1: Key Ideas

6.2: Disputes and Dispute Settlement

6.2.1: Introduction

6.2.2: Negotiation

6.2.3: Mediation

6.2.4: Arbitration

6.2.5: End Notes

6.2.E: Assessment Questions

6.3: READ - Mediation and the Conflict Resolution Process

6.4: WATCH - A Hostage Negotiator on How to Resolve Conflict

6.5: REVIEW - Savage Theory of Resolution

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6.1: Key Ideas

Module 6: Key Ideas

- Negotiation
- Mediation
- Arbitration
- Fines
- Torts
- Bare Bones
- Reasoned

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SECTION OVERVIEW

6.2: Disputes and Dispute Settlement

6.2.1: Introduction

6.2.2: Negotiation

6.2.3: Mediation

6.2.4: Arbitration

6.2.5: End Notes

6.2.E: Assessment Questions

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6.2.1: Introduction

Learning Objectives

- Explain the theory, practice, and law of disputes and resolution.



Figure 6.2.1.1: Introduction (Credit: rawpixel/ pixabay/ Attribution 2.0 Generic (CC BY 2.0))

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6.2.2: Negotiation

We frequently engage in negotiations as we go about our daily activities, often without being consciously aware that we are doing so. Negotiation can be simple, e.g., two friends deciding on a place to eat dinner, or complex, e.g., governments of several nations trying to establish import and export quotas across multiple industries. When a formal proceeding is started in the court system, **alternative dispute resolution (ADR)**, or ways of solving an issue with the intent to avoid **litigation**, may be employed. Negotiation is often the first step used in ADR. While there are other forms of alternative dispute resolution, negotiation is considered to be the simplest because it does not require outside parties. An article in the **Organization Behavior and Human Decision Processes** defined **negotiation** as the “process by which parties with nonidentical preferences allocate resources through interpersonal activity and joint decision making.” Analyzing the various components of this definition is helpful in understanding the theories and practices involved in negotiation as a form of dispute settlement.

Negotiation Types and Objectives

Per the above definition, negotiation becomes necessary when two parties hold “non-identical” preferences. This statement seems fairly obvious, since 100% agreement would indicate that there is not any need for negotiation. From this basic starting point, there are several ways of thinking about negotiation, including how many parties are involved. For example, if two small business owners find themselves in a disagreement over property lines, they will frequently engage in **dyadic negotiation**. Put simply, dyadic negotiation involves two individuals interacting with one another in an attempt to resolve a dispute. If a third neighbor overhears the dispute and believes one or both of them are wrong with regard to the property line, then **group negotiation** could ensue. Group negotiation involves more than two individuals or parties, and by its very nature, it is often more complex, time-consuming, and challenging to resolve.

While dyadic and group negotiations may involve different dynamics, one of the most important aspects of any negotiation, regardless of the quantity of negotiators, is the objective. Negotiation experts recognize two major goals of negotiation: relational and outcome. **Relational goals** are focused on building, maintaining, or repairing a partnership, connection, or rapport with another party. **Outcome goals**, on the other hand, concentrate on achieving certain end results. The goal of any negotiation is influenced by numerous factors, such as whether or not there will be contact with the other party in the future. For example, when a business negotiates with a supply company that it intends to do business with in the foreseeable future, it will try to focus on “win-win” solutions that provide the most value for each party. In contrast, if an interaction is of a one-time nature, that same company might approach a supplier with a “win-lose” mentality, viewing its objective as maximizing its own value at the expense of the other party’s value. This approach is referred to as **zero-sum negotiation**, and it is considered to be a “hard” negotiating style. Zero-sum negotiation is based on the notion that there is a “fixed pie,” and the larger the slice that one party receives, the smaller the slice the other party will receive. Win-win approaches to negotiation are sometimes referred to as **integrative**, while win-lose approaches are called **distributive**.



Figure 6.2.2.1: Certain negotiation styles adopt a mindset in which the extent of one's win is proportional to the other's loss.
(Credit: Sebastian Voortman/ pexels/ License: CC0)

Negotiation Style

Everyone has a different way of approaching negotiation, depending on the circumstance and the person's personality. However, the **Thomas-Kilmann Conflict Mode Instrument (TKI)** is a questionnaire that provides a systematic framework for categorizing five broad negotiation styles. It is closely associated with work done by conflict resolution experts Dean Pruitt and Jeffrey Rubin. These styles are often considered in terms of the level of self-interest, instead of how other negotiators feel. These five general negotiation styles include:

- **Forcing.** If a party has high concern for itself, and low concern for the other party, it may adopt a competitive approach that only takes into account the outcomes it desires. This negotiation style is most prone to zero-sum thinking. For example, a car dealership that tries to give each customer as little as possible for his or her trade-in vehicle would be applying a forcing negotiation approach. While the party using the forcing approach is only considering its own self-interests, this negotiating style often undermines the party's long-term success. For example, in the car dealership example, if a customer feels she has not received a fair trade-in value after the sale, she may leave negative reviews and will not refer her friends and family to that dealership and will not return to it when the time comes to buy another car.
- **Collaborating.** If a party has high concern and care for both itself and the other party, it will often employ a collaborative negotiation that seeks to maximize the gain for both. In this negotiating style, parties recognize that acting in their mutual interests may create greater value and synergies.
- **Compromising.** A compromising approach to negotiation will take place when parties share some concerns for both themselves and the other party. While it is not always possible to collaborate, parties can often find certain points that are more important to one versus the other, and in that way, find ways to isolate what is most important to each party.
- **Avoiding.** When a party has low concern for itself and for the other party, it will often try to avoid negotiation completely.
- **Yielding.** Finally, when a party has low self-concern for itself and high concern for the other party, it will yield to demands that may not be in its own best interest. As with avoidance techniques, it is important to ask why the party has low self-concern. It may be due to an unfair power differential between the two parties that has caused the weaker party to feel it is futile to represent its own interests. This example illustrates why negotiation is often fraught with ethical issues.

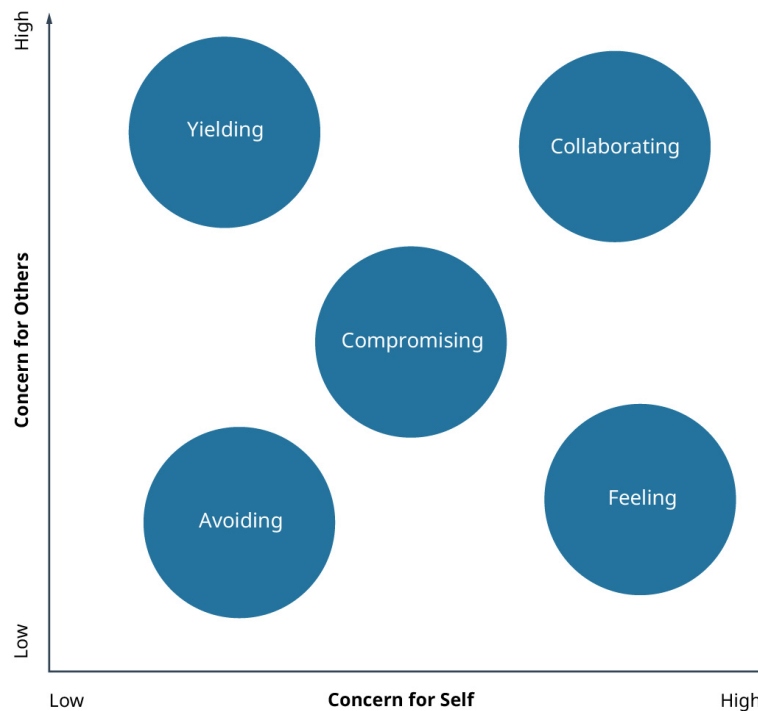


Figure 6.2.2.2: Concern for self vs. others leads to the differences in negotiating styles. (Modification of art by BNED/Rubin
Credit: CC BY NC SA)

Negotiation Styles in Practice

Apple's response to its treatment of warranties in China, i.e., giving one-year warranties instead of two-year warranties as required by law, serves as an example of how negotiation may be used. While Apple products continued to be successful and popular in China, the issue rankled its customers, and Chinese celebrities joined the movement to address the concern. Chinese consumers felt that Apple was arrogant and didn't value its customers or the customers' feedback. In response, Tim Cook issued a public apology in which he expressed regret over the misunderstanding, saying, "We are aware that insufficient communications during this process has led to the perception that Apple is arrogant and disregards, or pays little attention to, consumer feedback. We express our sincere apologies for any concern or misunderstanding arising therefrom." Apple then listed four ways it intended to resolve the matter. By exhibiting humility and concern for its customers, Apple was able to diffuse a contentious situation that might have resulted in costly litigation.

Negotiation Laws

Negotiations are covered by a medley of federal and state laws, such as the **Federal Arbitration Act** and **Uniform Arbitration Act**. The Federal Arbitration Act (FAA) is a national policy that favors arbitration and enforces situations in which parties have contractually agreed to participate in arbitration. Parties who have decided to be subject to binding arbitration relinquish their constitutional right to settle their dispute in court. It is the FAA that allows parties to confirm their awards, as will be discussed in the following chapters. When considering negotiation laws, it is important to keep in mind that each state has laws with their own definitions and nuances. While the purpose of the Uniform Arbitration Act in the United States was to provide a uniform approach to the way states handle arbitration, it has only been adopted in some form by about 35 states.

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6.2.3: Mediation

Court or Agency-Connected Mediation

Mediation is a method of dispute resolution that relies on an impartial third-party decision-maker, known as a **mediator**, to settle a dispute. While requirements vary by state, a mediator is someone who has been trained in conflict resolution, though often, he or she does not have any expertise in the subject matter that is being disputed. Mediation is another form of alternative dispute resolution. It is often used in attempts to resolve a dispute because it can help disagreeing parties avoid the time-consuming and expensive procedures involved in court litigation. Courts will often recommend that a **plaintiff**, or the party initiating a lawsuit, and a **defendant**, or the party that is accused of wrongdoing, attempt mediation before proceeding to trial. This recommendation is especially true for issues that are filed in small claims courts, where judges attempt to streamline dispute resolution. Not all mediators are associated with public court systems. There are many agency-connected and private mediation services that disputing parties can hire to help them potentially resolve their dispute. The American Bar Association suggests that, in addition to training courses, one of the best ways to start a private mediation business is to volunteer as a mediator. Research has shown that experience is an important factor for mediators who are seeking to cultivate sensitivity and hone their conflict resolution skills.

For businesses, the savings associated with mediation can be substantial. For example, the energy corporation Chevron implemented an internal mediation program. In one instance, it cost \$25,000 to resolve a dispute using this internal mediation program, far less than the estimated \$700,000 it would have incurred through the use of outside legal services. Even more impressive is the amount it saved by not going to court, which would have cost an estimated \$2.5 million.

Mediation is distinguished by its focus on solutions. Instead of focusing on discoveries, testimonies, and expert witnesses to assess what has happened in the past, it is future-oriented. Mediators focus on discovering ways to solve the dispute in a way that will appease both parties.

Other Benefits of Mediation

- **Confidentiality.** Since court proceedings become a matter of public record, it can be advantageous to use mediation to preserve anonymity. This aspect can be especially important when dealing with sensitive matters, where one or both parties feels it is best to keep the situation private.
- **Creativity.** Mediators are trained to find ways to resolve disputes and may apply outside-the-box thinking to suggest a resolution that the parties had not considered. Since disagreeing parties can be feeling emotionally contentious toward one another, they may not be able to consider other solutions. In addition, a skilled mediator may be able to recognize cultural differences between the parties that are influencing the parties' ability to reach a compromise, and thus leverage this awareness to create a novel solution.
- **Control.** When a case goes to trial, both parties give up a certain degree of control over the outcome. A judge may come up with a solution to which neither party is in favor. In contrast, mediation gives the disputing parties opportunities to find common ground on their own terms, before relinquishing control to outside forces.

Role of the Mediator

Successful mediators work to immediately establish personal rapport with the disputing parties. They often have a short period of time to interact with the parties and work to position themselves as a trustworthy advisor. The Harvard Law School Program on Negotiation reports a study by mediator Peter Adler in which mediation participants remembered the mediators as "opening the room, making coffee, and getting everyone introduced." This quote underscores the need for mediators to play a role beyond mere administrative functions. The mediator's conflict resolution skills are critical in guiding the parties toward reaching a resolution.

Steps of Mediation

As explained by nolo.com, mediation, while not being as formal as a court trial, involves the following six steps:

- **Mediator's Opening Statement:** During the opening statement, the mediator introduces himself or herself and explains the goals of mediation.
- **Opening Statements of Plaintiff and Defendant:** Both parties are given the opportunity to speak, without interruption. During this opening statement, both parties are afforded the opportunity to describe the nature of the dispute and their desired solution.
- **Joint Discussion:** The mediator will try to get the two disagreeing parties to speak to one another and will guide the discussion toward a mutually amicable solution. This part of the mediation process usually identifies which issues need to be resolved and

explores ways to address the issues.

- **Private Caucus:** During this stage, each party has the ability to meet and speak privately with the mediator. Typically, the mediator will use this time to learn more about what is most important to each party and to brainstorm ways to find a resolution. The mediator may ask the parties to try to put aside their emotional responses and resentments to work toward an agreement.
- **Joint Negotiation:** After the private caucuses, the parties are joined again in the same room, and the mediator presents any newly discovered insight to guide them toward an agreement.
- **Closure:** During this final stage, an agreement is reached, or it is determined that the parties cannot agree. Either way, the mediator will review the positions of each party and ask them if they would like to meet again or explore escalating options, such as moving the dispute to court.

Ethical Issues

Both the disputants themselves, and those who attempt to facilitate dispute resolutions, i.e., mediators and attorneys, must navigate a myriad of ethical issues, such as deciding whether they should tell the entire truth, or only offer a partial disclosure. This conflict has long roots in history and has often been considered in terms of consequentialist and deontological ethical theories. **Consequentialist ethics**, sometimes known as situational ethics, is a way of looking at difficult decisions by considering their implications. Someone who follows consequentialist ethics in mediation or arbitration would consider the impact of his or her decision on the parties in light of their unique circumstances. In contrast, **deontologist ethics** bases its decision on whether the action itself is right or wrong, regardless of its consequences.

Imagine a situation in which a professional accountant holds a consequentialist ethical viewpoint and believes that there are certain scenarios in which the disclosure of only part of the truth is a commendable course of action. For example, if an accountant is interviewed regarding how the company handled a certain transaction in its retirement account, he might choose to withhold certain information because he is afraid it will harm the retirees' ability to retain the full benefits of their pensions. In this case, the accountant is utilizing "the ends justify the means" logic because he feels that the omission of truth will result in more benefit than its revelation. A mediator or arbitrator who also follows a consequentialist viewpoint would consider the accountant's motivation and the circumstances, in addition to his or her actions.

Ethical situations like these are not only part of dispute mediation in business law scenarios, but also happen in daily life. Consider the case of a parent who is on his way home from work when he receives a call from the babysitter, telling him that his child's forehead feels hot and that she is complaining of not feeling well. Sitting in traffic, the parent remembers that he does not know the whereabouts of the digital thermometer, so he decides to stop and purchase one. The parking lot at the store is extremely busy, so the parent decides to park in a handicapped spot, even though he does not have any mobility challenges. These types of situations have been addressed by philosophers such as Immanuel Kant, who spoke of the **categorical imperative**, which he defined as, "Act only according to that maxim whereby you can, at the same time, will that it should become a universal law." In other words, one's action should be considered in light of what would happen if everyone were to engage in the same action. While it might not seem like a harmful infraction, if everyone were to do it, then it would cause a true inconvenience and possible suffering for mobility-impaired individuals, for whom those spaces were designated. A deontological ethical viewpoint would determine that it is always wrong to park in the handicapped space, regardless of the situation. In real life, it is very difficult to adopt a 100% deontological viewpoint for dispute resolution. Often, the reason the dispute has arisen in the first place is because of some ambiguity inherent in the situation. In these cases, mediators must apply their best judgment to help the disagreeing parties see one another's viewpoints and to guide them toward a mutually amicable solution.



Figure 6.2.3.1: Sometimes ethical issues have no clear-cut answers and mediators must rely upon their best judgement. (Credit: George Becker/ pexels/ License: CC0)

Future Directions in Mediation

As technology continues to change the ways we interact with one another, it is likely that we will see advances in mediation techniques. For example, there are companies that offer online mediation services, known as **e-mediation**. E-mediation can be useful in situations where the parties are geographically far apart, or the transaction in dispute took place online. Ebay uses e-mediation to handle the sheer volume of misunderstandings between parties. Research has shown that one of the benefits of e-mediation is that it allows people the time needed to “cool down” when they have to explain their feelings in an email, as opposed to speaking to others in person.

In addition to technological advancements, new findings in psychology are influencing how disputes are resolved, such as the rising interest in canine-assisted mediation (CAM), in which the presence of dogs is posited to have an impact on human emotional health. Since the presence of dogs has a positive impact on many of the neurophysiological stress markers in humans, researchers are beginning to explore the use of therapy animals to assist in dispute resolution.



Figure 6.2.3.2: Mediation experts are considering the benefits of therapy dogs for canine-assisted mediation. (Credit: Garfield Besa/ pexels/ License: CC0)

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6.2.4: Arbitration

The American Bar Association (ABA) defines arbitration as the “private process where disputing parties agree that one or several individuals can make a decision about the dispute after receiving evidence and hearing arguments.” Arbitration is overseen by a neutral **arbitrator**, or an individual who is responsible for making a decision on how to resolve a dispute and who has the ability to decide on an **award**, or a course of action that the arbiter believes is fair, given the situation. An award can be a monetary payment that one party must pay to the other; however, awards need not always be financial in nature. An award may require that one business stop engaging in a certain practice that is deemed unfair to the other business. As distinguished from mediation, in which the mediator simply serves as a facilitator who is attempting to help the disagreeing parties reach an agreement, and arbitrator acts more like a judge in a court trial and often has legal expertise, although he or she may or may not have subject matter expertise. Many arbitrators are current or retired lawyers and judges.

Types of Arbitration Agreements

Parties can enter into either voluntary or involuntary arbitration. In **voluntary arbitration**, the disputing parties have decided, of their own accord, to seek arbitration as a way to potentially settle their dispute. Depending on the state’s laws and the nature of the dispute, disagreeing parties may have to attempt arbitration before resorting to litigation; this requirement is known as **involuntary arbitration** because it is forced upon them by an outside party.

Arbitration can be either binding or non-binding. In **binding arbitration**, the decision of the arbitrator(s) is final, and except in rare circumstances, neither party can appeal the decision through the court system. In **non-binding arbitration**, the arbitrator’s award can be thought of as a recommendation; it is only finalized if both parties agree that it is an acceptable solution. This fact is why non-binding arbitration can be useful for what the American Arbitration Association describes as “disputes where the parties may be too far apart in their viewpoints to mediate or are in need of an objective evaluation of their respective positions.” Having a neutral party assess the situation may help disputants to rethink and reassess their positions and reach a future compromise.

Issues Covered by Arbitration Agreements

There are many instances in which arbitration agreements may prove helpful as a form of alternative dispute resolution. While arbitration can be useful for resolving family law matters, such as divorce, custody, and child support issues, in the domain of business law, it has three major applications:

- **Labor.** Arbitration has often been used to resolve labor disputes through interest arbitration and grievance arbitration. **Interest arbitration** addresses disagreements about the terms to be included in a new contract, e.g., workers of a union want their break time increased from 15 to 25 minutes. In contrast, **grievance arbitration** covers disputes about the implementation of existing agreements. In the example previously given, if the workers felt they were being forced to work through their 15-minute break, they might engage in this type of arbitration to resolve the matter.
- **Business Transactions.** Whenever two parties conduct business transactions, there is potential for misunderstandings and mistakes. Both business-to-business transactions and business-to-consumer transactions can potentially be solved through arbitration. Any individual or business who is unhappy with a business transaction can attempt arbitration. Jessica Simpson recently won an arbitration case in which she disputed the release of a fitness video she had made because she felt the editor took too long to release it.
- **Property Disputes.** Business can have various types of property disputes. These might include disagreements over physical property, e.g., deciding where one property ends and another begins, or intellectual property, e.g., trade secrets, inventions, and artistic works.

Typically, civil disputes, as opposed to criminal matters, attempt to use arbitration as a means of dispute resolution. While definitions can vary between municipalities, states, and countries, a **civil matter** is generally one that is brought when one party has a grievance against another party and seeks monetary damages. In contrast, in a **criminal matter**, a government pursues an individual or group for violating laws meant to establish the best interests of the public. While the word **crime** often invokes the idea of violence, there are many crimes, such as embezzlement, in which the harm caused is not physical, but rather monetary.

Ethics of Commercial Arbitration Clauses

As previously discussed, going to court to solve a dispute is a costly endeavor, and for large companies, it is possible to incur millions of dollars in legal expenses. While arbitration is meant to be a form of dispute resolution that helps disagreeing parties find a low-cost, time-efficient solution, it has become increasingly important to question whose expenses are being lowered, and to what

effect. Many consumer advocates are fighting against what are known as **forced-arbitration clauses**, in which consumers agree to settle all disputes through arbitration, effectively waiving their right to sue a company in court. Some of these forced arbitration clauses cause the other party to forfeit their right to appeal an arbitration decision or participate in any kind of **class action lawsuit**, in which individuals who have a similar issue sue as one collective group. For example, in 2006, Enron investors initiated a class action lawsuit against executives who hid the company's losses and were awarded \$7.2 billion dollars. While this example represents a case where the company being sued was clearly in the wrong, it is important for large companies to be ethical in their use of arbitration clauses. They should not be used as a way to keep wrongdoings "quiet" or to limit consumers' abilities to obtain rightful retribution for products and services that do not perform as promised.

Arbitration Procedures

When parties enter into arbitration, certain procedures are followed. First, the number of arbitrators is decided, along with how they will be chosen. Parties that enter into willing arbitration may have more control over this decision, while those that do so unwillingly may have a limited pool of arbitrators from which to choose. In the case of willing arbitration, parties may decide to have three arbitrators, one chosen by each of the disputants and the third chosen by the elected arbitrators.

Next, a timeline is established, and evidence is presented by both parties. Since arbitration is less formal than court proceedings, the evidence phase typically goes faster than it would in a courtroom setting. Finally, the arbitrator will make a decision and usually makes one or more awards.

Not all arbitration agreements have the same procedures. It depends on the types of agreements made in advance by the disputing parties. Consider the following scenario: the owner of a large commercial office building uses a lease agreement, which stipulates that arbitration will be used to settle the renewal terms of a lease. For example, the lease may state that, at the end of year one, the second year's lease payment will be at current market value, and if the tenants cannot agree on that value, they will then allow an arbitrator to decide. If the building owner feels that the renewal rate should be \$40/square foot and the tenant feels it should be \$20/square foot, an arbiter who may not be an expert in local real estate values might decide to resolve the dispute by using a rule of thumb, such as "splitting the difference." In this case, the arbiter might decide that \$30/square foot represents a fair lease renewal rate.



Figure 6.2.4.1: Various types of arbitration can be employed depending on what the parties think is best for their situation. (Credit: Tim Eiden/ pexels/ License: CC0)

To overcome this shortcoming, the building owner could write a lease agreement that stipulates that the parties use binding **baseball arbitration** and use subject matter experts as arbitrators. In this case, that might include real estate attorneys or commercial real estate investors. In baseball arbitration, each party would submit a lease renewal figure to an arbitrator. For example, imagine that the renewing tenant submits an offer of \$10/per square foot, which is very much under market value, while the building owner submits an offer of \$35/square foot. In this scenario, the arbitrator chooses one offer or the other, without

modification. This type of arbitration incentivizes both parties to be fair in their dealings with one another because to do otherwise would be to their own detriment.

Arbitration Awards

An arbiter can issue either a “bare bones” or a reasoned award. A **bare bones** award refers to one in which the arbitrator simply states his or her decision, while a **reasoned** award lists the rationale behind the decision and award amount. The decision of the arbitrator is often converted to a judgement, or legal tool that allows the winning party to pursue collection action on the award. The process of converting an award to a judgement is known as confirmation.

Judicial Enforcement of Arbitration Awards

While it might seem that the party that is awarded a settlement by an arbitrator has reason to be relieved that the matter is resolved, sometimes this decision represents just one more step toward actually receiving the award. While a party may honor the award and voluntarily comply, this outcome is not always the case. In cases where the other party does not comply, the next step is to petition the court to enforce the arbitrator’s decision. This task can be accomplished by numerous mechanisms, depending on the governing laws. These include writs of execution, garnishment, and liens.

- **Writ of Execution.** Cornell Law School defines a writ of execution as “A court order that directs law enforcement personnel to take action in an attempt to satisfy a judgment won by the plaintiff.”
- **Garnishment.** A garnishment refers to a court order that seizes the money, typically wages, to satisfy a debt. A myriad of laws apply to wage garnishment, e.g., certain types of income, such as Social Security Disability Income (SSDI), cannot be garnished. In addition, depending on state laws, sometimes only debtors who make over a certain amount, e.g. \$1,600 gross/month, are subject to wage garnishment.
- **Liens.** A lien gives the entitled party in a judgement the right to seize the property of another to satisfy a debt. Commonly, liens can be placed on real estate and personal property, such as automobiles and boats. Property that has a lien cannot be sold because the title is encumbered and often cannot be legally transferred until the lien is satisfied, or paid. Depending on state laws, only certain property is subject to a lien. For example, the winning party in an arbitration case may only be able to place a lien on the other party’s vehicle if it has a market value of over \$7,500.

The enforcement of arbitration awards is governed by a number of laws, such as Federal Arbitration Act and Uniform Arbitration Act.

Summary

Negotiation, mediation, and arbitration are alternatives form of dispute resolution that attempt to help disagreeing parties avoid the time and expense of court litigation. While negotiation is involved in all three forms, mediation and arbitration involve a neutral third party to help the parties find a solution. Frameworks that consider self-interest, as opposed to interest in the other party, can help negotiators craft successful negotiation approaches. Mediators, arbitrators, and groups of arbitrators all follow certain steps and play in important role in trying to help parties reach common ground and avoid court proceedings. Mediators who establish rapport with disputing parties can facilitate dispute resolution, as mediation is very much solution-focused. Arbitrators must often decide upon awards when parties cannot reach an agreement. Even when an aggrieved party attains an arbitration award, it may still have to pursue the other party by using a variety of legal techniques to enforce the payment or practice stipulated by the award. Staying current with federal and state laws associated with negotiation proceedings is essential for businesses looking to maximize their relational and outcome goals.

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6.2.E: Assessment Questions

1. A process in which a third party selected by the disputants helps the parties to voluntarily resolve their disagreement is known as:
 - a. Mediation.
 - b. Discovery.
 - c. Arbitration.
 - d. Settlement.

Answer

a

2. What's the first step in Alternative Dispute Resolution?
 - a. Conciliation.
 - b. Mediation.
 - c. Negotiation.
 - d. Arbitration.
3. What's the definition of negotiation?

Answer

The process by which parties with nonidentical preferences allocate resources through interpersonal activity and joint decision making.

4. How does the process of negotiation work?
5. Explain the Thomas-Kilmann Conflict Mode Instrument.

Answer

The Thomas-Kilmann Conflict Mode Instrument (TKI) is a questionnaire that provides a systematic framework for categorizing five broad negotiation styles. It is closely associated with work done by conflict resolution experts Dean Pruitt and Jeffrey Rubin. These styles are often considered in terms of the level of self-interest, instead of how other negotiators feel. These five general negotiation styles include:

Forcing. If a party has high concern for itself, and low concern for the other party, it may adopt a competitive approach that only takes into account the outcomes it desires. This negotiation style is most prone to zero-sum thinking. For example, a car dealership that tries to give each customer as little as possible for his or her trade-in vehicle would be applying a forcing negotiation approach. While the party using the forcing approach is only considering its own selfinterests, this negotiating style often undermines the party's long-term success. For example, in the car dealership example, if a customer feels she has not received a fair trade-in value after the sale, she may leave negative reviews and will not refer her friends and family to that dealership and will not return to it when the time comes to buy another car. Collaborating.

Collaborating. If a party has high concern and care for both itself and the other party, it will often employ a collaborative negotiation that seeks to maximum the gain for both. In this negotiating style, parties recognize that acting in their mutual interests may create greater value and synergies.

Compromising. A compromising approach to negotiation will take place when parties share some concerns for both themselves and the other party. While it is not always possible to collaborate, parties can often find certain points that are more important to one versus the other, and in that way, find ways to isolate what is most important to each party.

6. A person trained in conflict resolution is considered:
 - a. An arbitrator.
 - b. A mediator.
 - c. A negotiator.
 - d. A judge.
7. Mediation focuses on:

- a. Solutions.
- b. Testimony.
- c. Expert witnesses.
- d. Discoveries.

Answer

a

- 8. Name the steps in Mediation.
- 9. What's the main benefit of e-mediation?

Answer

E-mediation can be useful in situations where the parties are geographically far apart, or the transaction in dispute took place online. Ebay uses e-mediation to handle the sheer volume of misunderstandings between parties. Research has shown that one of the benefits of e-mediation is that it allows people the time needed to “cool down” when they have to explain their feelings in an email, as opposed to speaking to others in person.

In addition to technological advancements, new findings in psychology are influencing how disputes are resolved, such as the rising interest in canine-assisted mediation (CAM), in which the presence of dogs is posited to have an impact on human emotional health. Since the presence of dogs has a positive impact on many of the neurophysiological stress markers in humans, researchers are beginning to explore the use of therapy animals to assist in dispute resolution.

- 10. Roger and Larry are having a dispute regarding their joint business. They want to have a binding resolution to their dispute, but they would prefer to have the dispute handled privately and by someone with special expertise. The best form of dispute resolution for their problem would be:
 - a. Arbitration.
 - b. Litigation.
 - c. Mediation.
 - d. Summary Jury Trial.
- 11. All of the following are methods to enforce an arbitrator's decision except:
 - a. Writs of Execution.
 - b. Garnishment.
 - c. Fines.
 - d. Liens.

Answer

c

- 12. Describe the typical steps in Arbitration.
- 13. Explain the differences between binding and non-binding arbitration.

Answer

In binding arbitration, the decision of the arbitrator is final, and except in rare circumstances, neither party can appeal the decision through the court system. In non-binding arbitration, the arbitrator's award can be thought of as a recommendation: it is only finalized if both parties agree that it is an acceptable solution.

- 14. All of the following are the most common applications of arbitration in the business context except:
 - a. Labor.
 - b. Business Transactions.
 - c. Property Disputes.
 - d. Torts.
- 15. The following are the type of awards that may be issue by an arbitrator:
 - a. Bare Bones.

- b. Reasoned.
- c. Both a and b.
- d. Neither a nor b.

Answer

c

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6.3: READ - Mediation and the Conflict Resolution Process

Notes:

"It's often the case that when two people or organizations try to resolve a dispute by determining who is right, they get stuck. That's why so many disputes end up in court. There is a better way to resolve your dispute: mediation by hiring an expert mediator who focuses not on rights but on interests—the needs, desires, or concerns that underlie each side's positions. If someone asks you why a dispute is important to you, your answer will reveal your interests."

Read the brief article below about mediation. As you grow in your business careers, you will likely experience conflicts of differing importance. Resolving conflict through mediation is one tool to get to resolution.

▮ [Mediation and the Conflict Resolution Process.pdf](#)

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6.4: WATCH - A Hostage Negotiator on How to Resolve Conflict

Notes:

Watch this 10:09 video to learn more about conflict, negotiation, and resolution.

Remember, "**What do you want and how would you like to get there.**" Consider how this can help during a business conflict.



6.4: WATCH - A Hostage Negotiator on How to Resolve Conflict is shared under a [CC BY 4.0](https://creativecommons.org/licenses/by/4.0/) license and was authored, remixed, and/or curated by Mabel Gehrett and Western Technical College.

6.5: REVIEW - Savage Theory of Resolution

Savage Theory of Resolution®

5 universal skills my clients use to resolve conflicts



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CHAPTER OVERVIEW

7: Module 7 - Key Assessment

[7.1: Key Assessment](#)

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7.1: Key Assessment

Overview/Purpose: To review the concepts of Business Law.

Connected Course Competencies and Program Outcomes:

- Describe the sources that establish American law.
- Compare types of corporations.
- Analyze sources of criminal & civil exposure in business.
- Relate the principles of contract law and how they apply to businesses.
- Examine laws pertaining to unfair trade practices.
- Compare insurance for individuals and businesses.
- Distinguish laws covering bankruptcy.
- Explain the theory, practice, and law of disputes and resolution.
- Control Business Processes.

Directions/Task:

To complete this assignment you should complete the following tasks/actions in order.

1. Read each question and provide your answers in the spaces provided in the **ATTACHED DOCUMENT**

▮ [KEY ASSESSMENT.docx](#)

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Index

A

abnormally dangerous activity standard
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