NORTH EAST JOURNAL OF LEGAL STUDIES

Volume Thirteen **Spring 2005**

NORTH EAST JOURNAL OF LEGAL STUDIES

An official publication of the North East Academy of Legal Studies in Business, Inc. © 2005
ISSN: 1545-0597

INFORMATION FOR CONTRIBUTORS

The *North East Journal of Legal Studies* is a double blind refereed journal, published once a year. Its purpose is to encourage scholarly research in legal studies and pedagogy related thereto.

Articles may be submitted simultaneously to this journal and others with the understanding that the author(s) will notify this journal if the article is to be published elsewhere. We will not publish an article that will be published in another journal.

Papers should relate to the field of Business Law (including recognized topics within Business Law and the Legal Environment of Business) or to Legal Studies Education.

The Journal will consider submission of articles from those papers presented at the North East Academy of Legal Studies in Business Annual Conference. The paper designated the recipient of the Hoehlein Award for Distinguished Paper at the NEALSB Conference will serve as the lead article of the journal. Up to four articles from resources other than those presented at the NEALSB Conference may be published in the journal.

Articles offered for inclusion in the next issue of the journal shall be submitted to the editor by September 1.

PROCEDURE FOR SUBMITTING PAPERS

Articles submitted for publication should be three clean, camera ready originals (no photocopies) accompanied by a diskette version in Microsoft Word for Windows prepared as set forth below and sent to:

Professor Sharlene A. McEvoy
Charles F. Dolan School of Business
Fairfield University
North Benson Road
Fairfield, CT 06824-5195

Submission must include a check for $50.00 payable to North East Academy of Legal Studies in Business. If the article is notpublished, $25.00 will be returned.

FORMAT

1. Papers should be no more than 20 single-spaced pages, including footnotes. Use font 12 pitch, Times New Roman. Skip lines between paragraphs and between section titles and paragraphs. Indent paragraphs 5 spaces. Right-hand justification is desirable, but not necessary.
2. Margins: left and right hand margins should be set at 1 ¼ inches, top margin at 1 ½ inches and bottom margin at 1 ¾ inches.
3. Page Setup: Custom size your paper to have a 6 ¾ inch width and a height of 10 inches. Your hard copy should be printed on a standard 8 ½" x 11" paper size. This will allow for the proper binding and trimming for printing purposes.
4. Upon acceptance, the first page must have the following format: the title should be centered, in CAPITAL LETTERS. Two lines down center the word "by" and the author's name, followed by an asterisk(*). Begin text three lines under the author's name. Two inches from the bottom of the page, type a solid line 18 inches in length, beginning from the left margin. On the second line below, type the asterisk and the author's position of title and affiliation.
5. Headings"
   FIRST LEVEL (caps, flush with left margin)
   Second Level (center, italics)
   Third Level (flush with left margin, italics, followed by a colon[:]),
   Fourth Level (flush with left margin, italics, followed by a Colon[:], with text immediately following).
6. Endnotes should conform to *Uniform System of Citation*, 17th edition (2000), and should begin 3 lines after the end of the text

7. An IBM compatible, 3 ½ inch disc with the final version of your paper, in Microsoft Word, must accompany your paper.

Individual copies of the journal are available to non-members and libraries at $25.00 per copy. General correspondence, applications for membership in NEALSB or change of address notice should be addressed to the name above at the address therein stated.

West Legal Studies in Business is pleased to announce these NEW 2006 titles!

THOMSON WEST

Legal Environment

Bagley — Available July 2005
Managers and the Legal Environment: Strategies for the 21st Century, 5e
0-324-26951-X

Jennings — Now Available!
Business: Its Legal, Ethical and Global Environment, 7e
0-324-20488-4

Meiners/Ringleb/Edwards — Now Available!
The Legal Environment of Business, 9e
0-324-20485-X

Business Law - Survey Market

Beatty/Samuelson — Now Available!
Introduction to Business Law
0-324-31142-7

International Law

DiMatteo/Dhooge — Now Available!
International Business Law: A Transactional Approach, 2e
0-324-20491-4

Business Law & Ethics

Halbert/Ingulli — Available May 2005
Law and Ethics in the Business Environment, 5e
0-324-20490-6

Jennings — Available May 2005
Business Ethics: Case Studies and Selected Readings, 5e
0-324-20489-2

Business Law - Excerpted Cases

Mann/Roberts — Now Available!
Smith and Roberson's Business Law, 13e
0-324-20486-8

Miller/Jentz/Cross — Now Available!
West's Business Law: Extended Case Approach, 2e
0-324-20482-5

Business Law - Summarized Cases

Miller/Jentz — Now Available!
Business Law Today, The Essentials: Text and Summarized Cases - E-Commerce, Legal, Ethical and International Environment, 7e
0-324-20484-1

Miller/Jentz — Now Available!
Business Law Today, Standard Edition: Text and Summarized Cases - E-Commerce, Legal, Ethical and International Environment, 7e
0-324-20483-3

Real Estate Law

Siedel/Aalberts — Now Available!
Real Estate Law, 6e
0-324-20480-9

Supplements

Prentice — Now Available!
Student Guide to the Sarbanes-Oxley Act
0-324-39333-4

http://www.westbuslaw.com

Phone 1.800.423.0563
Fax 1.859.647.5020

Request Texts at
http://snapshot.westbuslaw.com

West's Digital Video Library

Bringing business law to life!

West Legal Studies in Business

http://digitalvideolibrary.westbuslaw.com

Looking for new ways to make legal ideas come alive for students and spark classroom discussion?

Would student tutorials on more difficult concepts be useful?

Interested in more support for students with varying learning styles?

West's Digital Video Library now offers four kinds of videos for classroom or student review. Over 60 online video clips in total bring business law alive, particularly for the visual learner, to help bridge common experiences to legal ideas, spark student discussion, and tutor core concepts.

- **Four different types** of videos cover core Business Law/Legal Environment topics:

LATEST ADDITION!!! *LawFlix* – widely-recognized, modern-day movie clips link the seemingly tangible reality of film scenes to abstract topics in law, offering students an intriguing visualization of concepts that are often hard to grasp in textbooks and lectures.

Ask the Instructor – straight-forward concept explanations for student review featuring an actual business law instructor.

Drama of the Law – classic legal business scenarios designed to spark class participation featuring scenes from a supermarket and a car dealership.

Legal Conflicts in Business – modern business scenarios at an ad agency and a dot.com company.

- Video segments (except *Ask the Instructor*) are accompanied by **critical thinking/discussion questions** to facilitate assignments.
- Access to West's Digital Library is available in an optional package with any new *West Legal Studies in Business* text at **no additional cost.**

Topics include:

- Accountant's Liability
- Agency
- Alternate Dispute Resolution
- Antitrust
- Bankruptcy
- Business Organization
- Constitutional Law
- Consumer Protection
- Contracts
- Court Procedure
- Cyberlaw
- Employment Law/Discrimination
- Environmental Law
- Ethics
- Intellectual Property
- International Law
- Negotiable Instruments
- Real/Personal Property
- Sales
- Torts

NORTH EAST JOURNAL OF LEGAL STUDIES

VOLUME 13 SPRING 2005

ARTICLES

PEDAGOGY

SOCIAL IMPLICATIONS OF TORT REFORM=

by

Mark J. DeAngelis*

[W]hat more is necessary to make us a happy and a prosperous people? Still one thing more, fellow-citizens—a wise and frugal Government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities.

- Thomas Jefferson, First Inaugural Address, March 4, 1801[1]

For the last three decades, "tort reform" has been a regular agenda item for both state legislatures and the United States Congress. Media descriptions of a lawsuit-crazed society abound. The purported deleterious social effects of this out-of-control tort system are reported in doctors eliminating their practices, towns dismantling their playscapes, and businesses closing their doors.[2] Empirical studies are usually commissioned and performed by advocates for one position or the other and create a dizzying array of statistical and economic propaganda for policy-makers to embrace or reject as they see fit. This paper considers two of the more common general tort

---

= Best Paper Award 2004

* Assistant Professor in Residence, Business Law; University of Connecticut

reform proposals and argues that adoption of either of the proposed reforms implicates significant social costs that may be masked by the advocacy. Policy-makers are encouraged to step back from the specific policy arguments of self-interested lobbyists on both sides of the tort reform debate and look afresh upon the goals and social value of the present tort litigation system. Undoubtedly, the system is not perfect and reform is warranted. But it may not be the type of reform that is most often proposed.

I. REFORMS LIMITING CAUSES OF ACTION

Tort reformers have proposed limiting the causes of action available to injured parties through a variety of methods. Some proposals involve granting immunity to industries (i.e. gun manufacturers or the food industry through the "Personal Responsibility in Food Consumption Act"[3]) while others propose limiting the available theories of recovery (i.e. strict liability, statutes of repose, etc.). Reforms that would tend to limit the causes of action available to potentially injured parties may, indeed, protect certain businesses and industries from the expense of litigation. However, there are significant social costs. Among them are a reduction in the potential sharing of information about dangerous products or services, an increase in the size and expense of government administrative regulation, a loss of legitimacy or confidence in the law, and a loss of a source of access to government for the marginalized, the weak, and the underrepresented.

A. Tort Litigation as Education

One of the principal arguments for the need for tort reform is that the present system threatens to put some businesses, manufacturers, service providers, and perhaps entire industries

out of business. An appropriate counter-argument might be that that is exactly what the tort system is supposed to do.

Orthodox free market theory attributed to Scottish philosopher and economist, Adam Smith, teaches that our system relies on the natural checks and balances in the capitalist market system to maintain equilibrium and promote the common good. As a society, we are advised, there is little need to worry about the proliferation of unsafe products, poor services or exploitive practices because the natural market mechanisms will control. The manufacturer, service provider or employer in pursuing his own profit maximization goal will be guided, as if by "an invisible hand" in aligning her conduct with societal needs.[4] If the product is unsafe, or the services poor, then the product or service will lose its appeal to consumers. If consumers stop buying the product or using the service, then the business will cease to manufacture the product or provide the service or make such changes as are necessary to make the product or services desirable once more. But how are these market-equilibrium mechanisms implemented in a vast and diverse modern society? In Adam Smith's late 18th century society, word that the cobbler made poor quality shoes could pass among the townspeople by word of mouth and have a significant effect on the cobbler's trade. Because the cobbler's market was limited, market conditions would force him to alter his product, change trades or relocate to a new market. Social conditions of the times rendered the first option the most feasible. Therefore, the free market system was internally regulatory.

In a modern society of unlimited markets, the natural regulation of the market can be effective only if reliable product information can be widely disseminated. People trust the opinions of their families, neighbors and acquaintances with respect to their experiences with products and services.

However, this information travels only as far as one's personal social circle. There is a need for reliable product information that is reported generally by the mass media.

Six types of mass media product information are readily available in modern society: 1) reports of government regulatory action, 2) investigative press reports, 3) consumer advocate interest group reports, 4) consumer product testing and rating systems, 5) news reports of product incidents and, 6) reports of tort or product liability lawsuits. Of these six information sources, reports of tort or product liability lawsuits provide the best and most durable source of product information.

Government agencies charged with regulating the safety of products suffer from many of the deficiencies of other government regulatory agencies. A change of administration results in changes of focus and enforcement. Agencies are often captured by the industries that they are charged with regulating. Since safety regulation is inherently negotiable (few products can be made to guarantee against every injury and still be useful, affordable, and desirable) the decision of what to regulate and what to allow is often a political decision. Consequently, it is surprising when any government action, such as product recall, takes place.[5]

Investigative press reports can be extremely informative and have a great effect on the public's perception of a product (i.e. Mark Dowie's influential "Pinto Madness" article in *Mother Jones*).[6] However, in order for an investigative report to be generated, there must first be a history of significant losses or injuries justifying the time and expense of the investigation. Media outlets are businesses and invest in what they can sell. A single, isolated injury or even a few injuries, regardless of

how catastrophic, are not likely to generate this kind of investigative interest from the media.

Consumer advocate interest group reports can be extremely detailed and informative. However, the reliability of interest group information is often dismissed because of inherent ideological bias. Likewise, media coverage of such reports is often limited. A consumer could find information on interest group websites, but that would limit the reach of the information to those few motivated consumers who were conducting pre-purchase research.

This limitation also applies to consumer product ratings and testing (i.e. *Consumer Reports*). Testing and reporting tend to be limited to high-ticket items. These are the types of products that consumers might research prior to purchase. The information is not in the general media flow that reaches the general public on a daily basis.

News reports of injuries caused by a product can be effective in educating the public about dangerous products. However, these reports tend to be newsworthy only for a short time after the incident occurs. "Follow-up" stories are unlikely (unless there is a pattern sufficient to warrant an investigative report). Also, the report usually focuses on the injury and the cause is often "undetermined" or misdirected at the time of the incident. A news report of a teenager killed in an SUV rollover would focus (rightfully) on the tragedy of the loss and explain that "investigators would not speculate at the scene if speed, alcohol or other factors contributed to the accident, which is under investigation." This report does not give much information about potentially dangerous product defects.

Tort and product liability litigation is a durable and reliable source of public education about dangerous and unsafe

products. First, the filing of a lawsuit for injuries from a product is noteworthy and is generally reported by news media. Unlike the incident causing the injury, the newsworthiness of which fades quickly, the lawsuit based on the incident may go on for several years. Each trip to court is a potentially newsworthy event that tends to keep the issue in the public eye. Verdicts, judgments and settlements – even those where the details remain private – are regularly reported by the mass media.[7] Second, plaintiff lawyers whose financial interests are tied to the result, can be tenacious investigators.[8] Lawyers want to win every lawsuit. Under our adversary system, the better experienced and equipped plaintiffs' lawyers will dig deeply and effectively for every bit of evidence of liability. Third, high profile plaintiffs' lawyers like to remain high profile. Therefore, any important information not privileged or otherwise subject to a confidentiality order or agreement is likely to show up in the press.[9] Fourth, despite the furor and fuss over frivolous lawsuits, the filing of a suit in court lends an air of legitimacy to a plaintiff's claim. The longer the suit remains on the court's docket, the stronger the judiciary's imprimatur of legitimacy becomes.

The U.S. Supreme Court has provided heightened scrutiny protection to non-deceptive advertising under the rationale that the consumer and society in general, is better served by the greater availability of product information.

> Advertising, however tasteless and excessive it sometimes may seem, is nonetheless dissemination of information as to who is producing and selling what product, for what reason, and at what price. So long as we preserve a predominantly free enterprise economy, the allocation of our resources in large measure will be made through numerous

> private economic decisions. It is a matter of public interest that those decisions, in the aggregate, be intelligent and well informed. To this end, the free flow of commercial information is indispensable.[10]

If, as posited here, tort litigation provides the best source of societal information about the dangers of a product, then policy decisions tending to limit this source of important information should not be adopted without considering the resulting detrimental effects. If dissemination of information is protected when it comes from the manufacturers, its value should be likewise recognized when the information comes from other sources.

Some staunch jurists and attorneys may bristle at the image of litigation as an information source. They may argue that the role of civil courts is to provide for the peaceful resolution of disputes – not to provide the public with information. Yet, in order to insure a fair and honest court system, its proceedings must be made open to the public. Indeed, the less attention that the press and the public devote to monitoring and reporting both the substance and procedure of the civil justice system, the greater chance there is of allegations of impropriety. But the argument is advanced here that open and public court proceedings play a greater role in society than merely the protection of the integrity of the judicial proceedings. Not only does civil litigation resolve disputes, it informs the public.[11] Doug Llewelyn, the former announcer for *The People's Court* T.V. show cheerfully concluded each broadcast with the reminder, "[I]f you are involved in a dispute and just can't seem to work it out, don't take the law into your own hands! You take 'em to court!!"[12] It is here, in the civil court, where we seek justice for civil wrongdoing. Malefactors are named and given an opportunity to justify their actions. When juries

assess liability, wrongdoers are made to pay. Society benefits from the public exposure of this wrongdoing. The exposed tortfeasor (the one who has caused the injury) will no longer be able to engage in the wrongful conduct unchecked.

This role of the civil justice system has been openly recognized and advocated. *Boston Globe* writer, Sacha Pfeiffer, won a Pulitzer Prize for her article entitled, "Critical Eye Cast on Sex Abuse Lawyers."[13] Pfeiffer chronicled the public outrage against lawyers who had negotiated confidential settlements on behalf of the victims of sexual abuse at the hands of Catholic priests. The charges were made that the confidential settlements with the Catholic Church had contributed to the proliferation of the problem. Had the Church and the perpetrating priests been forced to endure public trials, then the invidious conduct would have been publicly exposed and many who were later to fall victim to the same type of assaults could have been saved. This is a profound and troubling criticism for those who operate within the system. Every lawyer will respond that her first and foremost obligation lies in serving her clients' interests. Sometimes, those interests do not easily align with the public interest. But the fact that the criticism was raised and widely supported gives testament to both the role of the civil tort litigation system as a source of information and the public expectation and desire that it actually contribute in that regard.

When, as in the vast majority of civil tort cases, the private interests of the client and the public interest of society are not inconsistent, the role of litigation as an information source cannot be ignored. Rather, it should be embraced and encouraged as a significant social benefit. Every legislative limitation on redress for injurious conduct carries consequences that are inconsistent with both the underpinnings of Constitutional protections as enunciated by the U.S.

Supreme Court and desirable public policy embraced by society at large.

B. Increase in Size and Expense of Government Regulation

The McDonald's Coffee case is a good example of how the present system works. Much maligned as an example of frivolous litigation, this lawsuit has contributed to the making of a safer society without implicating government regulatory intervention. While the specific facts can be spun in any direction, the simple description of the injury is that the plaintiff suffered third degree burns on her body after being served a cup of coffee at a McDonald's drive-up. McDonald's officials admitted that the temperature at which the coffee was served rendered it unfit for human consumption due to the certainty of the burn risk.[14] The plaintiff won a judgment in the trial court. The case was eventually settled without disclosure of terms after appeal. The relevant result is that McDonalds has turned down the temperature of the coffee that it serves. So have the other "fast food" chains. As a result of this suit, America is a safer place for coffee drinkers.

This may seem a simplistic example, but it points out the social benefits of implicating the deterrent effect of tort suits. As a society, we did not need to expand government regulation to include an army of coffee inspectors who, without warrants, would enter the establishments of unsuspecting businesses to stick thermometers in their coffee. Business was forced (or perhaps very strongly encouraged by its profit motive) to be more responsible in its conduct with a view toward public safety.

"Big government" exists as a counterbalance to "big business."[15] As a society, Americans suffer from an inherent conflict in our political psyche. We see a wrong (conduct that endangers the public) and we demand government action to address it. At the same time, we fear government action that might be overly broad or inefficient or bureaucratic or, even worse, directed at us. Addressing social ills through litigation brought by private parties does not implicate government regulatory action. Therefore, there is an institutional tilt in favor of using litigation to achieve social results.[16] Perhaps the most important consequence of the present tort system is its ability to influence socially responsible corporate conduct without the need for additional governmental action.[17]

C. Loss of Legitimacy or Confidence in the Law

Eliminating causes of action, or perhaps more aptly stated, granting immunity to select industries or activities, erodes public confidence in the legal system. Some lawsuits may be criticized as "frivolous" or "baseless." Still, it is the judicial system that should make that determination. The House of Representatives recently passed the "Personal Responsibility in Food Consumption Act" immunizing the food industry from lawsuits unless a state or federal regulation has been violated.[18] The measure is unlikely to pass the Senate.[19] Yet, the House action has drawn critical editorial response as being overly broad and violative of the basic principle that there should be a remedy for every wrong. In our collective notion of justice, the "wrongs" are evaluated on an individual basis. The lawsuit that looks frivolous from the defendant's chair is likely to appear righteous from the plaintiff's. The wholesale protection of certain industries and activities smacks of insider special interest favoritism at the expense of "average folks" who are deprived of the opportunity to have the merits of their individual claims fairly and impartially evaluated. If citizens

feel that they do not have a legal means of redress for wrongs done to them, confidence in the legal system erodes.

D. Further Limited Representation for Marginalized Groups

Legal Mobilization Theory and work on "Cause Lawyering" describe the courts as one of the few ways that marginalized and underrepresented groups in America may access the political system to have their voices heard.[20] Trial judges and purist lawyers may deny that trial courts should be used as instruments of social change, rather than as a dispute resolution mechanism. Yet, as much as orthodox law theory may praise the independence of the legal system from politics, there is overwhelming evidence that, in many situations, the two are inextricably intertwined.[21] And yet, there is no cause to cringe from the notion that courts provide a forum for those who are otherwise voiceless in the American political system. It has long been recognized that the judicial branch has the ability, if not perhaps the responsibility, to watch out for the interest of unpopular minorities in the face of oppressive majorities.[22] Tort actions, under the appropriate circumstances, present an opportunity to place a perceived social ill on the agenda of the public policy-makers in the same vein as lawsuits that sought school desegregation or privacy rights for intimate relations.[23] Tobacco litigation on tort theory gave voice to tobacco victims that stood no chance of being heard in the chambers of Congress over the roar of tobacco interest power and influence.[24] Pluralist political theory tells us that the most highly organized and best-funded interest groups have the greatest influence on public policy in America.[25] The converse conclusion is that the unorganized and unfunded have little impact on public policy. Without more, children, immigrants, the mentally ill, the disabled, the non-unionized worker, and other segments of society stand little chance of seeking redress

for injustices through the legislative process. Eliminating causes of action further reduces the opportunity for representation in government to those whose options for representation are the most limited.

II. CAPS ON RECOVERIES

Tort reformers have proposed to reduce the economic cost of injury litigation by placing caps on the amount that an injured party may recover. Typically, non-economic damages have been targeted for limitation. However, punitive damage limitations have also been sought in those jurisdictions where such awards are allowed. Caps on damages, whether non-economic compensatory damages or punitive damages, carry significant societal costs. Among them are a degradation of the morality of community care, an increase in uncertainty or erosion of social self-esteem, and loss of legitimacy or confidence in the law.

A. Degradation of the Morality of Community Care

In *A Theory of Negligence*, Judge Richard Posner posits a tort system where economic factors control. Posner acknowledges, "an enterprise will not spend $100 in safety appliances to avert a $90 accident when it can satisfy its legal obligations by paying a $90 judgment."[26] Posner's theories cast law in the image of economic principles such as efficiency, economy, rationality, and economies of scale. The principal problem with Posner's Law and Economics Theory is that it fails to recognize non-economic cost. Society should place value on some principles even if their maintenance is inefficient.[27] One of those is the principle of taking care to refrain from causing bodily injury to fellow humans. There is

no such thing as a "$90 accident." There may be an accident that results in an injury with certain specific economic costs, but the social costs (especially of a disabling injury) to the victim, her family and society in general cannot be measured in economic terms and balanced against "the expense" of avoiding the injury. It was this kind of economic analysis engaged in by the Ford Motor Co. in order to head off a government recall of the Pinto in the late '70's that has been so roundly criticized as unethical, immoral and anti-social corporate conduct.[28]

Reducing the amount of awards for the most catastrophically injured victims alters the delicate balance that even Posner's theories recommend. It reduces any incentive on the part of the manufacturer to avoid risk of catastrophic injury. If the recovery is capped, then the likelihood of a large award is limited. If the amount that a manufacturer is willing to spend to prevent an injury should not exceed the cost of the injury, then caps on awards push the upper limits of safety spending ever downward. If the likelihood of an injury award is $1 million, then, under Posner's theory, the system encourages the spending of up to $1 million to avoid the injury. However, if the likelihood of recovery, due to caps, is reduced to $.5 million, then the manufacturer is not interested in spending as much as $.5 million to avoid the injury. The natural operation of economic principles drives the value of safety downward. It also moves safety considerations further away from a consideration of the moral obligation to promote the physical well being of others. With the decline of economic deterrents, the failure to engage in more expensive safety procedures is more likely to rest upon and be justified in economic terms. Economic justification reduces the value of and opportunity for any dialogue on the moral considerations of enhancing public safety.

B. Increase in Uncertainty or Erosion of Social Self-Esteem

Another of Posner's examples criticizes a tort system that places safety responsibility on other than economic considerations. He posits that a requirement imposed by government regulation or by "law" that a dam be built 19 feet high (a level determined to be safe) should be abandoned in favor of a system that allows the builder to build it 15 feet high if the savings from the construction are sufficient to satisfy any ultimate damage resulting from the lesser height.[29] Again, Posner ignores the social cost of the injury, damage, loss, and disruption to those who live downstream. Posner's system encourages people who live downstream from dams to move out of harm's way, rather than encouraging the dam builder to be socially responsible. Expanding Posner's example into a mature consumer society, any manufacturer should be free to ignore safety regulations, best practices or industry standards as long as the manufacturer's savings will be sufficient to pay the judgments. Under this system, in what product may a consumer have confidence? Like the dam example, consumers are encouraged to stop using the product rather than incur the risk of injury, for which they may at some point in the future receive some measure of financial compensation. Consumers come to learn that they must assume that the world is dangerous. They live and breathe at their own risk and must act ever vigilantly to protect themselves rather than rely on the protection of public safety by the government or the system of "laws."

Capping potential compensation awards devalues safety. The predictive effects of this action will alter the conduct of the consumers, rather than the manufacturers, by creating an aura of uncertainty and lack of confidence in products generally. Almost everything we do on a daily basis becomes less safe.

C. Loss of Legitimacy or Confidence in the Law

As stated above, the elimination of causes of action diminishes confidence and legitimacy in the judiciary by closing the courthouse doors to those who have little opportunity of redress outside the courts. Placing caps on awards lets the victims into the courthouse, but sends them home without being made whole. The argument that $250,000 or some other cap is "enough" for "pain and suffering" should not be well received in an era when the average income of corporate CEO's exceeds $10.5 million.[30] If accident victims' losses are capped, why aren't CEO salaries capped? If no one really needs or deserves more than $250,000 for life-long suffering, then does anyone really need more than $250,000 per year income to live on? The income gap in America is widening and the "average person" is helpless to affect policy that will address this issue. If the policymakers choose to limit injury recoveries for the most catastrophically injured victims on the basis that "enough is enough," without addressing ballooning corporate executive compensation, then public confidence in the policymaking system will erode. The "law" through the courts provides the only access to policymaking for a large segment of society. Limiting the ability of the courts to fully compensate accident victims will cause a crisis of confidence.

III. CONCLUSION AND IMPLICATIONS

Much of what has been argued in this paper is not new. "Tort reform" has been around for decades and will probably continue to be around for many decades more. Empirical work in support of these theories is most certainly encouraged. However, regeneration of a robust normative theoretical discussion has value as well. If the principal call for "tort reform" is that the present system is harmful to business,

perhaps the proper response should be, "It's supposed to be harmful to business – to business that does not value public safety." If the principal call for reform is based on the fact that our trial and adversarial system do not sufficiently distinguish between worthy and unworthy claims, then a different response may be necessary and different reforms should be proposed. Closing the courthouse doors and limiting recoveries harm the worthy victim in an attempt to deny the spurious claim. Reforms designed to alter the operation of the litigation system are rarely well embraced. The same system that theoretically has difficulty distinguishing between a worthy and an unworthy claim has the same difficulty in distinguishing between a worthy and an unworthy defense. Consequently, advocating for reform in this area comes with the caveat that the reformer should, "Beware of what you wish for!"

ENDNOTES

---

[1] U.S. G.P.O., 1989. *Inaugural Addresses of the Presidents of the United States.* Washington, D.C.: G.P.O.; Bartleby.com (2001). www.bartleby.com/124/.

[2] Stuart Taylor & Evan Thomas, *Civil Wars*. Newsweek, Dec. 15, 2003, at 43.

[3] H.R. 339, 108th Cong. (2d. Sess. 2004).

[4] Patricia H. Werhane, Adam Smith and His Legacy For Modern Capitalism. New York: Oxford Univ. Press (1991).

[5] *See generally*, The Ford Pinto Case: A Study in Applied Ethics, Business and Technology (Douglas Birsch, & John Fielder ed.) Albany, New York: State University of New York Press (1994).

[6] Id. at 15.

[7] Steven Garber & Anthony G. Bower, *Newspaper Coverage of Automotive Product Liability Verdicts.* 33 (1) Law & Society Review 93-122 (1999).

[8] Anne Bloom, *Taking on Goliath: Why Personal Injury Litigation May Represent the Future of Transnational Cause Lawyering in* Cause Lawyering and the State in a Global Era 96-116 (Austin Sarat & Stuart Scheingold ed.) New York: Oxford University Press (2001); Louise Trubek, & Elizabeth Kransberger. *Critical Lawyers: Social Justice and the Structures of Private Practice, in* Cause Lawyering: Political Commitments and Professional Responsibilities 201-226 (Austin Sarat & Stuart Scheingold ed.) New York: Oxford University Press (1998).

[9] Richard Zitrin & Carol Langford. The Moral Compass of The American Lawyer: Truth, Justice, Power and Greed. New York: Ballantine Books (1999).

[10] Virginia Bd. of Pharmacy v. Virginia Citizens Consumer Council, Inc., 425 U.S. 748, 765, (1976). *See also*, 44 Liquormart, Inc. v. Rhode Island, 116 U.S. 1495 (1996).

[11] Jon S. Vernick, Julie Samia Mair, Stepehn P. Teret & Jason W. Sapsin. *Role of Litigation in Preventing Product-related Injuries.* 25 Epidemiologic Reviews, 90-98 (2003). http://epirev.oupjournals.org/cgi/content/full/25/1/90 .

[12] Mr.Llewellyn's advice has become a part of America's popular culture of law. Interested readers and class instructors who wish to use this famous phrase in class can access an audio clip at http://www.home-turf.com/wavfil26.html .

[13] Sacha Pfeiffer, *Critical Eye Cast on Sex Abuse Lawyers.* Boston Globe, June 3, 2002, at 1.; http://www.pulitzer.org/year/2003/public-service/works/globe19.html .

[14] Jay Feinman, Law 101: Everything You Need to Know About the American Legal System 133. New York: Oxford Univ. Press (2000).

[15] E.E. Schattschneider, The Semisovereign People: A Realists View of Democracy in America. Hinsdale, Illinois: The Dryden Press. [1960] 1975.

[16] Thomas F Burke, Lawyers, Lawsuits and Legal Rights: The Battle Over Litigation in American Society 16. Berkeley: University of California Press (2002); Robert A. Kagan, Adversarial Legalism: The American Way of Law. Cambridge, Massachusetts: Harvard University Press (2001); Yesim Yilmaz, *Private Regulation: A Real Alternative for Regulatory Reform,* 303 Cato Policy Analysis (1998). http://www.cato.org/pubs/pas/pa-303.html .

[17] Burke, *supra*; *Contra*, Susan Rose-Ackerman, *Regulation and the Law of Torts,* 81(2) The American Economic Review 54-58 (1991); Robert E. Litan, *The Safety and Innovation Effects of U.S. Liability Law: The Evidence,* 81(2) The American Economic Review 59-64 (1991); Lawrence M Friedman, *Litigation and Society,* 15 Annual Review of Sociology 17-29 (1989).

[18] Carl Hulse, *Vote in House Offers a Shield in Obesity Suits*, New York Times, March, 11, 2004, at A1.

[19] The senate version of the bill entitled, "Commonsense Consumption Act" introduced by Senator Mitch McConnell (R, Ky) is pending at the time of submission for publication. Most commentators believe that the Senate will consider the bill to be overly broad and too restrictive of consumer remedies. However, this remains merely a prediction.

[20] Bloom, *supra*; Tom Christoffel & Stephen P. Teret, Protecting the Public: Legal Issues in Injury Prevention. New York: Oxford University Press (1993); Michael W. McCann, Rights at Work: Pay Equity Reform and the Politics of Legal Mobilization. Chicago: University of Chicago Press (1994); Michael W. McCann, *Courts and Law in American Society, in* Leveraging the Law: Using Courts to Achieve Social Change, 319-349 (David A. Schultz ed.) New York: Peter Lang, (1998); Aryeh Neier, Only Judgment: The Limits of Litigation in Social Change, Middletown, Connecticut: Wesleyan University Press (1982); Frances Kahn Zemans, *Legal Mobilization: The Neglected Role of the Law in the Political System,* 77 (3) The American Political Science Review 690-703 (1983).

[21] Walter F. Murphy, Elements of Judicial Strategy. Chicago: Univ. of Chicago Press. (1964).

[22] United States v. Carolene Products Co., 304 U.S. 144 (1938).

[23] Lynn Mather, *Theorizing about Trial Courts: Lawyers, Policymaking, and Tobacco Litigation.* 23 (4) Law and Social Inquiry 897- 940 (1998).

[24] Mather, *supra*; Peter Pringle, Cornered: Big Tobacco at the Bar of Justice, New York: Henry Holt and Co. (1998); W. Kip Viscusi, Smoke-Filled Rooms: A Postmortem on the Tobacco Deal, Chicago: University of Chicago Press. (2002).

[25] David B. Truman, The Governmental Process: Political Interests and Public Opinion. Berkeley, CA: Institute of Governmental Studies. [1971] (2d. ed, 1993).

[26] Richard A. Posner, *A Theory of Negligence, in* Perspectives on Tort Law 14-32 (Robert L. Rabin. ed.) Boston: Little Brown and Co. [1972] (1983).

[27] Ruth Colker, American Law in the Age of Hypercapitalism: The Worker, The Family and The State. New York: New York University Press (1998).

[28] The Ford Pinto Case, *supra*.

[29] Posner, *supra*.

[30] Patrick McGeehan, *Again, Money Follows the Pinstripes,* New York Times, April 6, 2003.

COMPARATIVE ASPECTS OF UNITED STATES, CHINESE, AND EUROPEAN CONTRACT LAW

by

Roy J. Girasa*
Richard J. Kraus**

INTRODUCTION

The globalization of the world's economy with its concomitant growth of international trade and the rise of free trade and customs unions has brought about a greater need for the unification of those areas of the law that affect the global environment. The transformation of former Communist countries to market economies both in Europe and Asia created a need to adopt laws that would assist in the transition. This paper will review and compare the respective treatment of one major area of legal concerns, that of the law of contracts – including contracts for the sale of goods - among the countries of the European Union, the People's Republic of China (P.R.C.), and that of the United States. The article will also discuss the proposed

---

*Professor of Law and Program Chair, Department of Legal Studies and Taxation, Pace University, Lubin School of Business, Pleasantville, New York

**Professor of Law, Department of Legal Studies, Pace University, Lubin School of Business, Pleasantville, New York

Principles of European Contract Law, (PECL) which are, in effect, a restatement and an attempt to bring together varying European approaches to the law of contracts.[1] In doing so, it should be borne in mind that the common elements of the laws of contract of the various jurisdictions have far more in common than their differences. It is assumed that the reader has a fairly complete knowledge of the basic elements of U.S. contract law, including that of the Uniform Commercial Code, Article 2 – Contracts for the Sale of Goods. Cases indicate, furthermore, that many transactions may be governed not only by local law, but also by the UN Convention for the International Sale of Goods (CISG), where applicable.

On March 26, 2002, the United States District Court for the Southern District of New York, in *St. Paul Guardian Insurance Company v. Neuromed Medical Systems & Support, GmbH,*[2] granted defendant Neuromed's motion to dismiss for failure to state a cause of action concerning a contract for the delivery of magnetic resonance imaging system (MRI) equipment sold to Shared Imaging.

Shared Imaging, Inc., a United States corporation, contracted with Neuromed, a German corporation, for the sale and delivery of a Siemens Harmony 1.0 Tesla mobile MRI; the parties contracted with various agencies to transport, insure and provide custom service entry for the MRI. The MRI was damaged in transport. Shared Imaging and its subrogees originally named all of the delivery and entry entities as defendants, but the action was discontinued against all defendants except Neuromed by agreement of the parties. Plaintiffs, St. Paul Guardian Insurance Company and Travelers

Insurance Company, as subrogees of Shared Imaging, Inc. sought to recover the $285,000.00 they paid to Shared Imaging for the damage.

In granting the defendant's motion to dismiss the cause of action the United States District Court noted that the forum selection clause in the contract between Neuromed and Shared Imaging --"German law will apply at the court of justice in Castrop-Rauxel" –does not require that the dispute be decided in Germany. The court reasoned that forum selection clauses are presumptively valid, absent fraud or unreasonableness but that the clause must be mandatory - indicating the intent of the parties to make jurisdiction exclusive - rather than permissive. The Court noted, furthermore, that an agreement conferring jurisdiction upon one forum does not automatically exclude jurisdiction elsewhere. A clear renunciation of other fora would explicitly indicate the parties' intent to use one jurisdiction to settle a dispute; such words as "will" or "shall" have been interpreted as being permissive rather than mandatory. The Court based its decision upon United States Supreme Court, Second Circuit Court of Appeals and Southern District of New York case reasonings;[3] it did not consult any pertinent German statutes or cases despite the fact that the parties had agreed that German law applied to the dispute.

The court then proceeded to decide the meaning and impact of the delivery terms of the contract "CIF New York Seaport" in order to support the defendant's argument that the complaint should be dismissed. As mentioned above, the parties to the dispute agreed that the contract between Shared Imaging and Neuromed mandated that German law apply to the dispute and the

Court did apply the local law of the foreign jurisdiction to the delivery term controversy. Pursuant to German law, the U.N. Convention on Contracts for the International Sale of Goods (CISG) governs this transaction because both the U.S. and Germany are signatories of the Convention and neither party to the agreement expressly chose not to use the Convention's provisions. The Court observed that German courts uphold the application of the Convention unless an express exception appears in the contract.[4]

"CIF" signifies that cost, insurance and freight of the delivery is to be paid by the seller in accord with the international commercial terms 1990 (INCOTERMS) adopted by the International Chamber of Commerce. These INCOTERMS are incorporated into the CISG by its Article 9(2), which states:

> The parties are considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.[5]

The Court noted that INCOTERMS 1990 applied to the agreement between the parties; the CIF New York Seaport term, which named the point of destination, signifies that the seller delivers the goods to the buyer at the ship's rail in the port of shipment; the seller does pay the cost, freight and insurance to bring the goods to the destination, but the risk of loss passes from the seller to the buyer upon delivery of the goods at the point of shipment.

The Court additionally noted that defendant Neuromed's explicit retention of title in the contract until the goods had been received by Shared Imaging does not affect the passage of risk of loss because the CISG indicates that risk passes without taking into account who owns the goods; this is also the case under the Uniform Commercial Code in effect in the United States as well as in accord with Section 447 of the German Civil Code (Bugerliches Gesetzbuch [BGB]).

The court remarked, finally, that delivery terms which require the buyer to pay customs and arrange further transport, that final payment was to be made upon buyer's acceptance of the machine in Calumet City and that a hand written note upon the contract which indicated "Acceptance upon inspection" did not change the force and application of the CIF terms.

Because the risk of loss had passed at the time of delivery to the carrier and the MRI machine was undamaged at that time, Neuromed's motion to dismiss for failure to state a cause of action was granted.

CHINESE CONTRACT LAW

Prior to 1979, China[6] did not have a developed legal system due to entrenched ideological principles that made law subservient to the interests of the state. With the opening of China to the West, particularly by the enactment of its Joint Venture Law in 1979[7] after the death of its xenophobic leader, Mao Zedong, in 1976,[8] China signaled to the West its intention to open the doors to market reforms. The changes, under the new leadership of Chairman Deng XiaoPing were part of the

Four Modernizations program instituted by the post Mao government.[9] For example, prior to 1978, the government controlled commodity flows; thereafter, agricultural reforms allowed profits to be made by farmers who could use communal lands to grow crops. In order to become modernized, however, the government had to reform its infrastructure including the creation of a legal system with a tri-fold judicial structure and the creation of laws that assured the protection of commercial rights within the country. Accordingly, China initiated the creation of laws to govern the contractual relationship among parties to an agreement. The latest incarnation of the law of contracts took place as a result of China's request for entry into the World Trade Organization.[10]

Chinese Contract Law Prior to 1999

The present law of contracts, The Contract Law of the People's Republic of China (CLC),[11] which was enacted on March 15, 1999 and became effective on October 1, 1999, replaced four prior contractual statutes that were enacted between 1981 and 1987. The earlier statutes were The Economic Contract Law (ECL) of 1981,[12] followed by The Foreign Economic Contract Law (FECL) of 1985,[13] The General Principles of the Civil Law (GPCL) of 1986,[14] and The Technology Contract Law (TCL) of 1987.[15] In addition, the P.R.C. became a member state of The United Nations Convention for the International Sale of Goods (CISG) in 1988.

The first statute that was passed was The Economic Contract Law of 1981. As in the later Contract Law of China (CLC), the statute was made applicable to

"economic contracts,"[16] i.e., specific types of contracts (those covering particular forms such as leases, insurance, and sales) as well as other forms of contracts which did not have specific designations.[17] Natural persons were excluded from the statute's coverage; it applied only to legal entities, defined as corporations, firms, and, later, to farmers entering into an agricultural responsibility contract.[18] Contracts had to be contained in writings which include documents, telegrams, and charts agreed to by the parties, unless the contracts were immediately concluded.[19] A later revision of the statute in 1993 extended the scope to include individual business households but not individuals per se who were not engaged in business activities. The earlier statutes were symptomatic of extensive state control and central planning that were characteristic of communist governmental enactments.[20]

The Foreign Economic Contract Law of 1985 was particularly concerned with economic contracts between Chinese enterprises "or other economic organizations" and foreign enterprises including also other economic organizations and individuals.[21] Again, the statute did not apply to Chinese individuals but rather to Chinese business and economic entities. There is no definition of a "contract" within the statute other than stating that the Law would apply to contracts to be performed within the P.R.C. to wit, equity and contractual joint ventures between Chinese entities and foreign persons as well as Chinese-foreign cooperative explorations and development of natural resources.[22] Thus, the statute would apply to all categories of contracts coming within the joint venture rubric. The parties thereto are to conclude their agreement on the basis of equality and mutual benefit,[23] which poses the

question of whether so-called one-sided contracts are enforceable. The parties to an agreement may select the choice of law to be applicable to the contract and, in the absence thereof, the law of the country having the closest connection to the contract would apply.[24] The statute does specify the requirements of a writing, the terms that should generally be set forth therein, performance, liability for breach, assignments, modification, rescission, termination, and settlement of disputes. The principle of freedom of contract underlies the FECL.[25]

The Technology Contract Law of 1987 was made applicable, unlike prior contractual legislation, between Chinese persons including individuals but did not apply to foreign persons. The statute applied to four types of contracts, namely, technology development contracts, technology transfer contracts, technology consultant contracts, and technology service contracts. Included were contracts concerning patents, and hardware and software design. Individual rights were now being given certain legal protections under Chinese law including the right to own one's inventions provided they were not connected to the individual's employment or made use of the state enterprise facilities.[26]

The Contract Law of China of 1999

In order for China to become a modern state it was necessary to build an infrastructure that included the creation of a legal landscape that would enable foreign and domestic companies to be assured of enforceable rights and obligations. The opening to the West and the change from an internalized government controlled

economy to a market-oriented "Western" style economy has caused significant debate and dissent within China. Nevertheless, the market-based transition has clearly diminished the role of communist ideology within China although the Communist Party still remains officially the sole party within the nation.[27] The latest enactment was the passage of The Contract Law of China.[28] It revoked and replaced the ECL, the FECL, and the TCL. The statute consists of 23 chapters containing 428 provisions. It is divided onto two parts: Part I which contained eight chapters that concerned the principles, formation, performance, modification, transfer, termination, and liability for breach of contract. Part 2, containing fifteen chapters, concerned "nominated" contracts, i.e., specific types of contracts including sales, loans, leases, warehouses and other particular forms of contract.[29] So called "economic contracts" were abolished.[30]

ICI Swire Paints Ltd. V. Techni Motor Engineering & Trading Co., decided on January 29, 2003 in the Hong Kong Court of First Instance,[31] illustrates the formation of a sales contract, its performance, wrongful termination, and liability for breach.

The plaintiff, ICI Swire, had contracted with the defendant, Mr. Cheung Kim Man doing business as Techni Motor and Techni Paints, to purchase paint products for mainland distribution in China through Techni Motor and for the Hong Kong market through Techni Paints. The plaintiff, by means of written agreements with the defendant, promised to deliver the paints in accord with a stated schedule for the calendar year 1994; when the plaintiff became insecure about the payment of the purchase price, the plaintiff brought this

action and terminated delivery of the goods five months after the signing of the agreement. The Court indicated that the plaintiff possessed a cause of action to recover payments due but that the contract had not been fundamentally breached, so that the termination of the sales agreements gave rise to counterclaims by the defendant. In particular, the wrongful termination of the Techni Motors sales agreement, which made provisions for trading and payment discounts and for an annual rebate, made the plaintiff liable for damages; but the plaintiff was also liable for incidental and consequential damages to Techni Paints.

The court observed that the principle for assessing damages for breach of contract was to save the innocent party from any losses which would not have occurred if there were no breach. The court adopted a proportional projection schema described by the defendant's expert witness to determine the exact amount of loss. Under Clause 2 of the Techni Motor agreement a payment discount ranging from 5.5% to 1% was given to Techni Motor provided there was no overdue payment; under Clause 3 an annual rebate of 3% for purchases between 95,000 liters and 4% for 130,00 liters and above were given to Techni Motor. In June, 1994, ICI stopped supplying the paint products to the defendant; the defendant admitted at the trial that both Techni Motor and Techni Paint had not yet paid for April and May of 1994, but counterclaimed for wrongful termination; the trial court accepted the admission of liability by the defendant but also agreed that ICI had wrongfully terminated the two agreements and would be liable for damages due to the breach.

The Court of First Instance assessed specific damages against the plaintiff ICI to compensate for losses upon the plaintiff's breach to the annual rebate, lost profits, the lost discounts, wasted rentals and wasted salaries of the defendants. The court took great pains to describe the damages:

A. Damages for Techni Motor

(1) 4% annual rebate on purchase from January-May 1994: HK$ 444,375.91
(2) Lost profits from paint tins promotions: HK$ 116,043.13
(3) Loss of profits for the lost months: HK$ 1,312,724.00
(4) Loss of 3% rebate for the lost months: HK$ 800,000.00
(5) Loss of the 2% discount for the lost months: HK$ 200,000.00

Sub-total: HK$ 2,873,143.04

B. Damages for Techni Paints

(6) Wasted rental of Techni Paint's facility: HK$ 42,500.00
(7) Wasted salaries of Techni Paint employees: HK$ 23,100.00

Sub-total: HK$ 65,600.00

Total Damages HK$ 2,938,743.04

The Contract Law of China mirrors many provisions of Western Contract Law. The statue is far more extensive than the prior enactments and applies to all persons, including entities and individuals.[32] A "contract" is defined as:

> [A]n agreement establishing, modifying and terminating the civil rights and obligations between subjects of equal footing, that is, between *natural persons*, legal persons or other organizations [emphasis added].

The principles of freedom of contract,[33] equal legal status between parties,[34] good faith,[35] fairness,[36] and the prohibition of illegal interference of contract by a social entity or individual,[37] are enunciated. Unlike prior enactments stated above, the CLC explicitly states that a contract may be in writing, oral, or may come into existence by the use of other forms unless otherwise required by law.[38] The UCC Art. 2 also permits oral contracts, but excepts those that come within the Statute of Frauds. There is no requirement in the CLC that requires a writing if the value of the goods is of a certain value unlike the *UCC* 2-201(1) which requires a writing if the value of the goods is $500 or more. A writing is one that describes the contents visibly and includes a written contractual agreement, letters, telegrams, telexes, facsimiles, and e-mails.[39] The U.S., with the passage of The Electronic Signatures in Global and National Commerce Act (E-sign)[40] and The Uniform Electronic Transfers Act (UETA),[41] now permit enforceable contracts to include those communicated electronically.

The CLC does specify the contents that, if there is a written agreement, it should contain the names and addresses of the parties, the subject matter, quantity quality, price, time limit, place and method of performance, liability for breach, and methods for resolving disputes.[42] United States common law requires that all of the major terms be known in order to have an enforceable contract but the UCC allows substantial discretion to the trial judge in sales contracts to fill in missing terms such as price, place of delivery, and even the quantity if course of performance or usage in trade will supply the customary amount.[43]

European, United States and Chinese Contract Law Compared

There have been significant efforts to unify European contract law especially after the rise of the European Union.[44] Earlier successful efforts to unify European law include the Convention for International Carriage by Rail, the Warsaw Convention of 1929, and the global United Nations Convention for the International Sale of Goods (CISG). The current effort is a major proposal prepared by the Commission on European Contract Law entitled The Principles of European Contract Law (PECL).[45] Professor Ole Lando, whose many efforts and commentaries have given credence to the unification effort, has spearheaded the effort.[46] There are a number of "general principles"[47] underlying European contract law. They are: freedom of contract, conclusion of contract (offer and acceptance), the validity of a contract, breach, enforced performance, damages, and termination.[48]

Freedom of contract: The most basic principle of European contract law and that of modern global contractual conventions[49] is that of the freedom of contract. With some exceptions for illegality and other comparable provisions, the freedom of parties to choose whether or not particular statutory rules are to apply is left to the parties. The parties have the freedom to determine whether it wishes to enter into a contract, with whom it wishes to contract with, and the specific terms of the agreement. The key ostensible reason for such freedom is that it underlies the basis of the market economy, to wit, the omission of governmental interference in the contractual relations of parties thereto.[50] It is the opposite of a planned (communist) economy, which renders almost all contractual arrangements subject to the needs, and wants of the centralized economy as determined by governmental agents. Thus, interestingly, the CLC also provides for the freedom of contract[51] thereby adding another indicia that China is no longer "communist" other than having an autocratic, one-party system that is a carryover of its 1949 Civil War.[52]

Offer and acceptance: The second basic principle is that of conclusion of the contract or offer and acceptance. Like that of the U.S., a contract is formed when the offeree has accepted the terms of the offer as rendered by the offeror. The third principle is that concerning the validity of the contract. Here there are varying European approaches. In German-speaking countries, Scandinavia, and in Eastern European countries, a promise made by a promisor with the intention that it be binding may be legally binding even in the absence of the Anglo-Saxon (Great Britain) requirement of consideration (something of legal value

given in exchange for the other party's promise or performance).[53] The exception wherein an offer may be binding in the absence of consideration is found in U.S.'s UCC 2-205 "Firm Offers" whereby a merchant who offers to buy or sell goods in a signed writing indicating that the merchant is not revocable will be held bound by such offer not to exceed three months. Similarly, CISG, Article 16(2), provides for the irrevocability of an offer if it so indicates by stating a fixed period of time for acceptance or that it is irrevocable or it was reasonable for the offeree to rely on the alleged irrevocability of the offer in reliance thereto. CLC, Art. 19, takes the CISG approach concerning irrevocability.[54]

United Technologies International, Inc. v. Magyar Legi Kozlekedesi Vallalat[55] describes offer and acceptance in the formation of a contract between Magyar Legi Kozlekedesi Vallalat (Malev Hungarian Airlines), the defendant, and the Pratt and Whitney division of United Technologies International, Inc., the plaintiff; the case was decided in the Metropolitan Court of Budapest.

Pratt and Whitney delivered a written offer to the defendant on December 14, 1990; it described the "support services proposal in connection with Malev Hungarian Airlines' purchase of two 767-200 ER aircraft, powered by Pratt and Whitney PW4056 engines... and the purchase of one PW4056 spare engine all of which are scheduled to be delivered as stated in Attachment 1"; the letter and its attachment describe the engines in particular and the purchase prices for each. The letter also noted that the buyer's acceptance would be conditional on the agreement

being approved by the governments of both Hungary and the United States.

On December 21, 1990, the defendant airline sent a letter to the plaintiff accepting all the terms and conditions set out in the plaintiff proposal, but asked only that the letter be kept confidential so that the parties could make a joint public announcement of the agreement.

Since the parties had agreed that the contract was governed by the United Nations Convention on Contracts for the International Sale of Goods (CISG) the Court reasoned that a contract was formed. As CISG Article 14(1) notes, "A contract addressed to one or more specific persons constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance"; additionally, the article mandates that "[the] proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity and the price."

The offer not only was definite and certain, but the defendant's letter of acceptance indicated an unambiguous consent to the terms of the offer even though the offer had mentioned government approval and the acceptance had mentioned a request for secrecy until public announcement of the contract could be made.

The court reasoned that the statement in the acceptance was merely a request to keep the contract secret, rather than a modification which under Article 19(1) of the CISG would render the acceptance a

counter-offer. The court also noted that the government approval statement in the offer was merely a condition, rather than an impediment to the formation of the contract. The court observed, finally, that the Hungarian Civil Code states that if a contract requires approval of any third party, the contract will not come into effect until the approval is obtained; that code, however, did not apply to the facts of this case because an agreement between the parties, to be subject to the CISG, supersedes any local law.

Avoidance: Another European law general principle concerns the genuineness of consent. A party may "avoid" (void) a contract if the other contracting party knew or should have known of the defect or cause the defect in the consent to the agreement. The avoidance extends to clauses that are illegal or "immoral." In the U.S., the agreement may either be voidable or void dependent on the nature of the defect (void for illegality, fraud in the execution, duress if personal harm is imminent and voidable for other circumstances such as mutual mistake, fraud in the inducement, undue influence, and duress of a less forceful nature). China's CLC also nullifies a contract where there is use of "malicious collusion," fraud or coercion to damage the interests of the State, illegality, immunity clauses in a contract that cause personal injury or property damage to a party.[56] The CISG does not determine the validity of a contract but, rather, leaves such determination to domestic courts.[57]

The Principles of European Contract Law (PECL) is similar to U.S. law but with some variations. Contracts, which are illegal in aspects which are fundamental to the laws of the Member States of the European Union,[58]

are of no force or effect. Courts are to examine a variety of factors in making the determination including the purpose of the rule upon which infringement is taking place, the persons for whom the rule was intended, the sanction that may be imposed, the seriousness of the infringement, whether it was intentional, and the closeness of the relationship between the infringement and the contract.[59] Whereas the U.S. court "leaves the parties where it finds them," under the PECL, restitution and damages may be granted where appropriate considering the above factors, the degree of knowledge of illegality by the party making claim, and whether the other party know or ought to have known of the illegality.[60] The PECL also provides for avoidance of the contract for mutual mistake, where the mistake of fact or law was due to the information given by the other party, or where either know of the mistake, ought to have known, or did not act in good faith and fair dealing. There is no avoidance if the mistake was inexcusable or the risk thereof was assumed.[61] Avoidance may be had for fraudulent misrepresentation or non-disclosure[62] and for imminent and serious wrongful threat (in the United States it would be "duress").[63] The PECL appears to be more liberal in allowing avoidance of a contract for "excessive benefit or unfair advantage." Although the United States courts do recognize the concept of unconscionability," such concept is generally applicable only in exceptional cases, almost never permitted if the party seeking to avoid the contract is a business entity. The UCC 2-302 does give court explicit, broader powers than the common law to refuse or limit enforcement of a contract.[64]

Agency Principles: Agency law recognizes the increasing importance of the dissemination of contractual obligations by means of third party actors. China appears to combine common law contractual principles with civil law principles that are based on statutory enactments. Nevertheless, Chinese law is rooted on legislative enactments rather than precedent binding decisions making. Moreover, German law, with its specific formulation of legal principles, is the general basis of Chinese contract law.[65] For example, China' laws concerning direct agency relationships are akin to German law.[66] China distinguishes between "direct" agency (in the United States it would be called "express" agency) and "indirect" agency," (in the United States "silent," "undisclosed," or "secret" agency). A contract concluded by an agent in the United States is binding upon the principal under common law irrespective of whether it is a disclosed, partially disclosed, or undisclosed agency relationship provided it was concluded by an agent acting within the scope of his or her authority. The common law, of course, makes the agent personally liable if the agency relationship is not disclosed.[67]

China follows closely German law concerning agency. Both nations do not recognize indirect agency. German Civil Code Article 164 clearly recognizes the conclusion of an agreement by an agent acting within the scope of his or her authority on behalf of a known principal. It also explicitly refuses to recognize such a relationship where the principal is not named.[68] The agent is solely bound with respect to an agreement that does not name the principal or where the principal is not known given the circumstances of the transaction. In China, the GPCL recognizes the validity of a

contract entered into by an agent (called the "mandatary") with a third party on behalf of the principal (called the "mandator") provided the third party is made aware of the agency relationship, which relationship binds the principal to the agreement unless the contract clearly states to the contrary.[69] On the other hand, where the agent (mandatary) enters into a contract in his or her own name with a third party, then the agent is solely bound thereby. Nevertheless, where the agent subsequently reveals the existence of the principal (mandatory), then the third party may elect to proceed against either the principal or the agent.[70]

The PECL appears to have essentially accepted the German formulation concerning the authority and liability of agents with respect to undisclosed principals. Thus, Article 3:301 provides that the intermediary (agent) and a third party with whom the agent has contracted with are "bound to each other" where the intermediary acts on behalf of and pursuant to the instructions of a principal who is undisclosed or the third party had no reason to believe that such agency had taken place. The principal and the third party are bound to each other only under very specific conditions. They are: (1) if the intermediary becomes insolvent or commits a fundamental non-performance vis-à-vis the principal, then the intermediary, on principal's demand, is to communicate that fact to the third party and the third party may exercise such rights under the contract between the intermediary and the third party, subject to defenses of the third party;[71] and (2) similarly, if the intermediary becomes insolvent or commits a fundamental breach, on the third party's demand, the intermediary is to communicate the name and address of the principal to the third party and the

third party may exercise such rights that the third party possessed against the intermediary, subject to defenses of the principal.[72] Otherwise, the intermediary is solely bound by the agreement.

CLC, Art. 48 makes a purported agent liable for a contract entered into with a third party, where such agent had no power of agency, oversteps the power of agency, or where the power of agency had expired. The CLC, which is later than the GPCL, appears to permit a principal[73] to ratify the agreement thereby binding the third party to the principal in place of the agent. Without such ratification, the purported agent would be personally liable. The CLC did not change the earlier statute inasmuch as the principal is known herein but not the disabilities of the agent.[74]

Excuses for breach of contract: Breach of contract presents varying rules that differ substantially among the United States Anglo-Saxon countries in general, and other European states. Anglo-Saxon countries generally take a strict approach to the enforcement of contracts and the results of a breach. The concept of *force majeure* (some external circumstances excusing a party from performing its obligations under a contract) is generally not recognized within the United States in Europe, as well as in almost all non-Anglo-Saxon countries, a party to a contract may be excused from performance under certain circumstances. In France, a court may dissolve a contract for alleged grave reason whereas in Germany, the inability to perform a main obligation of the contract may be excused.[75] The CISG excuses the performance of a party if the failure to perform is due to circumstances beyond the control of the said party and which could not reasonably be

expected at the time of the making of the agreement.[76] In addition, both Germany and the CISG have adopted the concept of the *nachfrist* notice, i.e., either party may give the other party an additional reasonable time within which to perform its contractual obligations and that it will refuse to accept performance after the stated period of time. Failure to perform within the said period would excuse the other party from performance and may give rise to a claim of damages.[77]

In China, the statute speaks of *force majeure* in permitting the exemption from liability under circumstances generally recognized as constituting the exception but such exemption may not be utilized if the *force majeure* takes place after the party has delayed its performance and has given immediate notice to the other party. The circumstances giving rise to exemption from liability must be "unforeseeable, unavoidable, and insurmountable."[78] The PECL also recognizes *force majeure* where performance has become "excessively onerous" due to a change in circumstances provided that the change took place after the conclusion of the agreement, was not anticipated at the time of the making of the contract, and the risk of the change of circumstances was one that a the party, in accordance with the contract, was not required to bear. A court is permitted to end the contract, or adapt it in such manner as to cause a just result. Damages may nevertheless be awarded against a party who initially refuses to negotiate in good faith and fair dealing to resolve the dispute prior to judicial submission.

Specific performance: Another general principle of contract law in Europe is that of compelling specific performance of the contract. In U.S. law, specific

performance is an equitable principle, which is permitted exclusively for contracts concerning the purchase of realty and for contracts concerning the sale or purchase or personal property if the subject matter is unique or commercially impracticable to obtain.[79] Other claims for specific performance, as for performance of services, are almost never permitted. Continental European countries have a broader concept of compelling performance owing to its principle of the sanctity of a contract, albeit in practice requests for specific performance are rarely sought. The principle provides as follows: the payment of money can always be demanded as well as any other performance with exceptions for impossibility, unreasonable effort or expense, the performance is one for personal services, the performance can be accomplished elsewhere, or the aggrieved party does not request the performance within a reasonable period of time.[80] The French Civil Code requires performance of the contract but leaves it to the non-breaching party to elect between specific performance and other substituted remedies. Germany requires courts to enforce contracts unless the remedies clearly illustrate that the disadvantages of impossibility of performance make such relief impossible or inadvisable.[81]+

In China, the CLC is somewhat comparable to the European approach by stating that "Where one party to a contract fails to perform the non-monetary debt or its performance of non-monetary debt fails to satisfy the terms of the contract, the other party may request it to perform it" with certain exceptions. The exceptions concern the inability to perform, the object of the contract is either not suitable for performance or the expenses for performance are excessive, or the creditor

fails to make such demand within a reasonable period of time.[82]

Damages for breach: The principle of damages is based on the theory that the law wishes to place the aggrieved party in the position that the party would have been in had the contract been fulfilled. There are some exceptions of the principle that the quantum of damages should equal or approximate the degree of the loss sustained by the aggrieved party. For example, the United States laws permit nominal damages even though no damages exist, punitive damages as stated hereinafter, and liquidated damages (damages pre-agreed to by the parties in their contract) provided they are not unreasonably excessive given the circumstances and intentions of the parties. In addition, a party in the United States law is generally not permitted to receive legal fees, which often are up to a third of the amount recovered. Also, recovery may be lessened due to failure to mitigate damages, unreasonable behavior by the party seeking recovery, and amounts saved or recoverable as a result of the breach. Interest on the amount recovered is generally allowed although Great Britain, in the past, did not permit interest to accrue on judgments.

The PECL provides a range of remedies unless the defaulting party is excused from performance due to an impediment beyond its control and which could not have been anticipated.[83] Remedies include recovery of monetary damages for losses sustained.[84] In addition thereto, the aggrieved party may seek non-monetary penalties including specific performance,[85] the withholding of performance,[86] termination of the contract including for anticipatory breach,[87] recovery of

money and property paid,[88] price reduction,[89] and interest (at average commercial bank short-term lending rate to prime borrowers) if the payment of moneys due are delayed.[90]

The CLC has a number of possible remedies for breach of contract. They include if the quality of the goods is at issue, the compulsion of performance, damages, repairs, substituted performance, return of goods, or reduction of price.[91] If a party failures to perform under the contract, the aggrieved party may seek damages equal to the losses or probable losses caused by the breach of contract.[92] Liquidated damages are permitted under Chinese law but the court or arbitration tribunal may raise or lower the sums if lower than the injury caused or is excessive.[93] The parties may further agree that a party pays a deposit to the other party to guaranty performance which deposit is either returned upon completion of the contract or act as an offset against losses.[94] As stated previously, the defenses of *force majeure* is permitted as well as failure to mitigate damages.[95] In the event both parties breach the contract, the damages are to be allocated proportionately to the degree of breach.[96]

In 1994, the German Court of Appeals at Frankfurt am Main decided a *Shoe Sale Case*[97] in which, in accord with German law, the parties to the proceeding are not identified. This case examines the necessity of a timely nachfrist notice by the defendant German buyer, the lack of fundamental breach by the plaintiff Italian seller and the damages recoverable by the plaintiff seller of shoes.

In January 1991, the seller and the buyer of the goods entered a contract for the sale and purchase of women's shoes. The shoes arrived late from Italy; they had stitching and coloring faults; they tended to wrinkle because of the fabric used, which was allegedly different from the sample fabric shown to the purchaser. The defendant purchaser, however, accepted the goods, but then refused to pay two of the plaintiff's invoices for them. The plaintiff brought this action to recover the remainder of the purchase price.

The court observed that the United Nations Convention on Contracts for International Sale of Goods (CISG) applies to the contractual dispute because the convention came into effect in Germany on January 1, 1991 and in Italy on January 1, 1988.

The Court of Appeals affirmed the District Court ruling that the plaintiff may recover damages from the defendant. The defendant may not have void the contract due to the late delivery because CISG Article 49(1) in conjunction with Article 47(1) required the buyer to give the seller a timely nachfrist notice setting an addition fixed time period for the seller to deliver the goods before avoidance is permitted by the buyer. The defendant, furthermore, never proved that the non-conforming goods fundamentally breached the contract as required by CISG Article 49(1)(a); she did not describe the exact nature of the defects at trial and that she was unable to use the goods in any way. The court noted in passing that Germany's national sales law permits the buyer to avoid the contract if the goods are defective, but that the CISG expects the buyer to accept non- conforming goods which do not fundamentally breach the contract. The buyer may then invoke

remedies other than avoidance, such as reduction of the price and damages.

Punitive damages: Among the various jurisdictions in Europe, penalty provisions differ. In the United States, a party may seek punitive damages form a defaulting party where there is evidence of an intentional tortious act such as fraud.[98] So-called "judicial penalties" in Europe vary from penalties for violation of a court order (in the United States, it would be for contempt of court) wherein the fine for failure to comply with the order for specific performance are either payable to the state treasury (England), or to the aggrieved party (the United States and a few others). Germany and most West European countries generally do not recognize the concept of a judicial or punitive penalty.[99] The PECL does not provide for punitive damages.

Termination of contract: The principle of termination of contract permits a party to cease performing when the other party fundamentally[100] breaches the contract. Under English law, the breach must be one of a condition rather than a warranty. In France, a contract may be dissolved only by a judicial decree and only for a grave reason. In Germany, the violation must be one that concerns a main obligation under the contract and not merely an incidental reason.[101] The consequences of a termination of a contract vary under the laws of the various countries. Whereas most countries not only may allow termination of the contract but also permit damages to be assessed against the breaching party, Germany, however, makes termination an exclusive remedy.[102]

The CLC has extensive provisions concerning termination of the contract.[103] Termination is permitted under seven circumstances: (1) where the obligations under the contract have been performed; (2) where the contract has been rescinded; (3) Where the debts have been offset against each other; (4) When the obligor has deposited the object according to law;[104] the debt obligations exempted by the obligee; the assumption of the creditor's rights and obligations by the same person; and other circumstances as stipulated or agreed upon by the parties.

CONCLUSION

The law of contracts, which for centuries often differed substantially among common law, civil law, and, later, communist states, have many more similarities than differences. This paper is designed to highlight the relatively minor differences, albeit in some contexts important, among the global trading states. Just as there was a call for a unified commercial law governing international contracts for the transaction of goods among commercial parties, there is increasingly a call for the further unification of contract law in general. CISG leaves substantial segments of the law of contracts to national discretionary observances and limits its scope to non-consumer parties.[105] Also, it does not concern the validity of the contract, the effect that the contract may have on the property of the goods sold, and does not apply to liability of the seller for physical injury or death caused by the goods to any person.[106] Thus, it would appear that a more comprehensive code of contract of contract law may be considered that would further unite regions if not a more expansive group of nations. Certainly, among the

soon-to-be 25-nation European Union, the unification of contract law as envisioned by the European Contract Law under consideration or a less expansive Global Commercial Code[107] would be beneficial to the nations adopting the enactment.

ENDNOTES

[1] The PECL has been advocated by a Danish law professor, Ole Lando, and others, for review and adoption by European governments and legal systems.

[2] *St. Paul Guardian Ins. Co. v. Neuromed Medical Systems & Support*, GmbH, 00 Civ.9344 (SHS), 2002 U.S. Dist. LEXIS 5096 (S.D.N.Y., March 26, 2002)

[3] *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10, 15, 32 L. Ed. 2d 513, 92 S. Ct. 1907 (1972); *New Moon Shipping Co., Ltd. V. Man B & W Diesel AG,* 121 F.3d 24, 29 (2d Cir. 1997); *John Boutari and Son, Wines and Spirits, S.A. v. Attiki Importers and Distributors, Inc.*, 22 F.3d 51, 53 (2d Cir. 1994), *City of New York v. Pullman, Inc.*, 477 F. Supp. 438, 442 n.11, 443 (S.D.N.Y 1994); *Hartford Fire Insur. Co. v. v. Novovargo USA Inc.*, 156 F. Supp. 2d 372 (S.D.N.Y. 2001); *Weiss v. La Suisse*, 69 F. Supp. 2d 449 (S.D.N.Y. 1999); *Mobil Sales and Supply Corp. v. Lithuania,* 1998 U.S. Dist. LEXIS 5693, No. 97 Civ. 4045, 1998 WL 196194, at *1 (S.D.N.Y. Apr. 23, 1998); *AGR Financial, L.L.C. v. Ready Staffing, Inc.*, 99 F. Supp 2d 399 (S.D.N.Y. 2000); *United States Fidelity & Guaranty Co. v. Petroleo Basiliero S.A.*, 2001 U.S. Dist. LEXIS 3349, No. 98 Civ. 3099, 2001 WL 300735 (S.D.N.Y. Mar. 27, 2001).

[4] See Martin Karollus, Judicial Interpretation and Application of the CISG in Germany 1988 through 1994 at http://www.cisg.law.pace.edu/cisg/biblio/karollous.html.

[5] CISG, art. 9(2), reprinted in 15 *U.S.C.A.* App.

[6] The People's Republic of China ("P.R.C.") is hereinafter referred to as "China" including Hong Kong and excluding Taiwan to which the P.R.C. claims is part of China. It is beyond the scope of this paper to explore the political and legal issues concerning the respective claims of both areas. For a one-volume history of China, see J.A.G. ROBERTS, THE COMPLETE HISTORY OF CHINA (Phoenix Mill: Sutton Publishing Ltd., 2003). For an extensive survey of Chinese history, see THE COMBRIDGE HISTORY OF CHINA (Roderick MacFarquhar et al. eds., 15 vols., Cambridge Univ. Press 1987)

[7] The Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures was adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, promulgated by Order No. 7 of the Chairman of the Standing Committee of the National's People's Congress on and effective as of July 8, 1979. It was the first statute that permitted foreign companies to commence doing business within the P.R.C.

[8] Mao Zedong died in September, 1976 having led the nation from 1949 after the overthrow of the President of China, Chiang KaiShek, who proceeded to remove the remnants of his Army to the Island of Formosa (now Taiwan). Mao's Communist government caused great consternation within the U.S. that finally abated when President Nixon visited Mao and the P.R.C. in February, 1972 and caused the resumption of diplomatic relations between the two countries.

[9] The Four Modernizations were in industry, agriculture, science, and military defense.

[10] For a discussion of the rule of law and cultural impact in China as it enters the World Trade Organization, see Patricia Pattison and Daniel Herron, *The Mountains are High and the Emperor is Far Away: Sanctity of Contract in China,* 40 AM. BUS. L.J. 459 (Spring, 2003).

[11] Adopted at the Second Session of the Ninth National People's Congress on March 15, 1999.

[12] Economic Contract Law of the People's Republic of China, adopted at the Fourth Session of the Fifth National People's Congress and promulgated by Order No. 12 of the Chairman of the Standing Committee of the National People's Congress on December 13, 1981, and effective as of July 1, 1982. For a copy of the statute, see THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1979-1982 (Beijing: Foreign Languages Press, 1987).

[13] Law of the People's Republic of China on Economic Contracts Involving Foreign Interest, adopted at the Tenth Session of the Standing Committee of the Sixth National People's Congress on March 21, 1985, effective July 1, 1985. A copy of the statute may be found in CHINA'S FOREIGN ECONOMIC LEGISLATION, Vol. IV (Beijing: Foreign Languages Press, 1991).

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

[15] Technology Contract Law of the People's Republic of China, adopted at the Sixth National People's Congress, 1987.

[16] Defined as "agreements between legal entities for the purpose of realizing certain economic goals and clarifying each other's rights and obligations" (ECL, Art.2).

[17] ECL, Art. 8 which states that the statute's provisions are to apply "to all contracts for purchase and sale, construction projects, processing transportation of goods, supply and use of electricity, warehousing, lease of property, loans, property insurance, scientific and technological cooperation and other economic contracts." U.S. contract law is comparable with its division of the common law of contracts and specific provisions under the Uniform Commercial Code for contracts relating to transactions of goods, leases, letters of credit, negotiable instruments, and other specific provisions. Much of the discussion concerning the historical bases of the law of contracts is taken from Feng Chen, *The New Era of Chinese Contract Law: History, Development, and a Comparative Analysis*, 27 BROOKLYN J. INT'L L. 153 (2001).

[18] Article 2 of ECL. Contrast Art. 2 of the ECL with Article 2 of the CLC which provides that "A contract in this Law refers to an agreement establishing, modifying and terminating the civil rights and obligations between subjects of equal footing, that is, between *natural persons*, legal persons, or other organizations [emphasis added]." The translation of the CLC is by Feng Xuewei, Li Xiangdong, Li Mingzheng, Zhang Fu, Peng Gaojian, and Li Shishi, CONTRACT LAW OF THE PEOPLE'S REPUBLIC OF CHINA (China Legal System Publishing House 1999).

[19] ECL, Art. 3.

[20] Feng Chen *supra* note 10 at 155.

[21] FECL, Art. 1.

[22] FECL, Art. 5.

[23] FECL, Art. 3.

[24] FECL, Art. 5.

[25] FECL Art. 28 ("A contract may be modified if both parties agree through consultation"). See comments of Feng Chen, *supra*, note 10 at 165.

[26] Feng Chen, *id,* at 167.

[27] For a discussion of the divergent views of ideology and pragmatism, see Tahirih V. Lee (ed. Richard B. Bilder), *Book Review and Note of Su Lizhu, Review Essay: Contemporary Scholarship on Global Law in the People's Republic of China: Fazhi ji jiben tuzi yuan [Politics and Law and Fundamental Principles of Property and Capital] and Zhang Xiang, Guoji shangwu tanpan—yuanzi, fangfa, yishu [International Business Negotiation—Principles, Methods, and Techniques]*, 94 A.J.I.L. 439 (April, 2000), wherein the author reviewed the said two works that offer contrasting views of contemporary Chinese approaches to international business and order. Su Lizhu argues that China should look inward in its framing of laws and that China' opening to then West have come at a great cost to China's people and

culture. Translating and taking laws from the West allegedly is devoid of the context within which these laws are being applied. The adoption of foreign law, e.g., the 1986 Civil Code was based on the German Civil Code contain incongruities that are in opposition to Chinese concerns. In contrast to the internal, conservative viewpoint is the work by Zhang who advocates the incorporation of international law and Western law into Chinese law. Such incorporation not only is needed for international business, especially in Shanghai, but also protects Chinese China in prior years would note the sudden resurrection of Chairman Mao from a diminished role during the 1980s and 1990s to one of renewed prominence. Evidence can be seen in the new currency that prominently features Mao as the central figure in china. This author has a similar experience with a government official in a closed, private hotel facility in Wuhan, China, wherein the official complained bitterly about China's forays to the West and away form Communist ideals that included free medical care and education in contrast to the current increasing divergences among the rich and the poor persons.

[28] A translation of the CLC may be found in THE CONTRACT LAW OF THE PEOPLE'S REPUBLIC OF CHINA, (Beijing: China Legal System Publishing House, 1999).

[29] The fifteen chapters are as follows: (1) Chapter 9, Contracts for Sales; (2) Chapter 10, Contracts for Supply and Use of Electricity, Water, Gas or Heating; (3) Chapter 11, Contracts for Donation (gifts); (4) Chapter 12, Contracts for Loans; (5) Chapter 13, Contracts for Lease; (6) Chapter 14, Contracts for Financial Lease; (7) Chapter 15, Contracts for Work; (8) Chapter 16, Contracts for Construction Projects; (9) Chapter 17, Contracts for Transportation; (10) Chapter 18, Contracts for Technology; (11) Chapter 19, Contracts for Storage; (12) Chapter 20, Contracts for Warehousing; (13) Chapter 21, Contracts for Commission; (14) Chapter 22, Contracts for Brokerage; and (15) Chapter 23, Contracts for Intermediation (agency-type contracts).

[30] An "economic contract" is one in which legal parties agree to fulfill specified economic goals, and which specify the rights and obligations of the parties thereto. Economic contracts were adopted

from the former Soviet Union, which enacted such contracts for use among Soviet controlled factories.

[31] ICI Swire Paints Ltd. V. Techni Motor Engineering & Trading Co. [2003] 3 HKC 432 from http://web.lexis-nexis.com/universe/document_m=4d91c0cc1b2237b0b1385310580a69be...

[32] CLC, Art. 2. Prior enactments restricted coverage to entities. For example, *ECL*, Art. 2 states: "This law shall apply to economic contracts concluded between enterprises or other economic organizations of the People's Republic of China and foreign enterprises..."

[33] CLC, Art. 4.

[34] CLC, Art. 3.

[35] CLC, Art. 6.

[36] CLC, Art. 5.

[37] CLC, Art. 8.

[38] CLC, Art. 10. See, for example, ECL, Art. 7 that provides in part: "A contract shall take form as soon as the parties to it have reached agreement in writing on the terms and attached their signatures...."

[39] CLC, Art. 11.

[40] Publ. L.No. 106-229, 114 Stat. 464 (2000) (codified at 15 U.S.C. section 7001 et seq.).

[41] UETA is a model code for adoption by the states in lieu the promulgation of E-Sign. It is presently the law of over 40 states. A copy of the code may be found at: http://www.law.upenn.edu/bll/ulc/ulc_frame.htm.

[42] CLC, Art. 12.

[43] UCC sections 2-305 to 2-309.

[44] The European Union was founded in 1951 with 6 countries as initial members (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands). It was spurred on by the efforts of U.S. through its use of the Marshall Plan, and by French leaders (Monet, Schumann) as well as Winston Churchill who wished to see the creation of a "United States of Europe." It comprises 15 countries of Western Europe and will be expanded to an additional 10 countries from Eastern Europe later this year.

[45] A text of the proposed *PECL* may be found at http://www.cbs.dk/departments/law/staff/...1/PECL%20engelsl/engelsk_partI_og_II.htm.

[46] For discussions of the proposed principles, see Ole Lando, *Some Features of the Law of Contract in the Third Millennium,* http://www.cbs.dk/departments/law/staff/ol/commission_on_ecl/literature/lando01.htm. Additional discussions may be found in Carlo Castronovo, *Contract and the Idea of Codification in the Principles of European Contract Law:* Danny Busch, *Indirect Representation and the Lando Principles;* and Arthur Hartkamp, *Perspectives for the Development of a European Civil Law;* which can be found in: http://www.cbs.dk/departments/law/staff/ol/commission/_on_ecl/literature.htm.

[47] By 'general principles" we refer to the principles of law applicable commonly to all representative states as distinguished from "specific principles' that are indigenous and peculiar to specific countries.

[48] For a discussion of this topic, see ULRICH DROBNIG, *General Principles of European Contract Law*, in *INTERNATIONAL SALE OF GOODS*: DUBROVIK LECTURES, ch. 9, pp. 305-332 (Petar Sarcevic and Paul Volken eds. (Oceana Publications, 1986).

[49] See, for example, Art. 6 of CISG that provides: "The parties may exclude the application of this convention or, subject to article 12, derogate from or vary the effect of any of its provisions."

[50] *Id.* at 311.

[51] See CLC, Articles 2-4, especially Article 4 that provides that: "The parties shall have the rights to be voluntary to enter into a contract in accordance with the law. No unit or individual may illegally interfere."

[52] If by "communism" one refers to an economic system wherein the government owns all or almost all means of production, the present market economy in China is a direct contradiction of the underlying basis for Marxist principles. Thus, a visitor to Shanghai, China and other areas of China will find, as this author in his travels has discovered, that there is a thriving market economy wherein only a small segment of the economy is directly controlled by the central government in Beijing and, generally, concerns business enterprises that are not saleable due to their lack of profit potential.

[53] S*upra*, note 36 at 313-314.

[54] CLC, Art. 19, provides:

> An offer may not be revoked, if
> (1) the offeror indicates a fixed time for acceptance or otherwise explicitly states that the offer is irrevocable; or
> (2) the offeree has reasons to rely on the offer as being irrevocable and has made preparation for performing the contract.

[55] *United Technologies International, Inc. v. Magyar Legi Kozlekedesi Vallalat,* Hungary, Metropolitan Court of Budapest, 1992. Case No. 3.G.50289/1991/32 from www.cisg.law.pace.edu/cisg/wais/db/cases2/920110h1.html.

[56] CLC, Art. 52-53.

[57] CISG, Art. 4, provides:

> This Convention governs only the formation of the contract and the rights and obligations of the seller and the buyer arising from such a contract.

> In particular except as otherwise expressly provided in this Convention, it is not concerned with:
>
> (a) the validity of the contract or of any of its provisions or of any usage;
>
> (b) the effect which the contract may have on the property in the goods sold.

[58] PECL, Art. 15:101.

[59] PECL, Art. 15:102(3).

[60] PECL, Art. 15-104-105.

[61] PECL, Art. 4:103.

[62] PECL, Art. 4:107.

[63] PECL, Art. 4: 108.

[64] E. ALLAN FARNESWORTH, CONTRACTS, 2d. ed. (Boston: Little, Brown & Co. 1999) at sections 4:27-4:28. *UCC* section 2-302 provides:

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

[65] For a discussion, see Lutz-Christian Wolff and Bing Ling, *The Risk of Mixed Laws: The Example of Indirect Agency under Chinese Contract Law,* 15 COLUM. J. ASIAN L. 173 at 176(Spring, 2002).

[66] *Id.* German agency principles are found in Articles 164-181 of the German Civil Code. Chinese agency principles may be found in CLC Art. 47-51.

[67] RESTATEMENT SECOND OF AGENCY, sections 186, 302.

[68] Art. 164 of the German Code provides in part as follows:

> (1) A declaration of intention which a person makes in the name of a principal within the scope of his agency operates directly both in favor of and against the principal. It makes no difference whether the declaration is made expressly in the name of the principal, or if the circumstances indicate that it was to be made in his name.
> (2) If the intention to act in the name of another is not apparent, the agent's absence of intention to act in his own name is not taken into consideration.

[69] GPCL, Art. 402.

[70] GPCL, Art. 403.

[71] PECL, Art. 3:302. For a discussion of this topic, see Busch, *supra*, note 41.

[72] PECL, Art. 3:303.

[73] The CLC now uses the term "principal" instead of "mandator."

[74] CLC, Art. 48.

[75] *Supra*, note 36 at 327-328.

[76] CISG, Art. 79(1).

[77] CISG, Art. 47, 49(1)(b). The CLC has no comparable provision.

[78] CLC, Art. 117-118.

[79] UCC section 2-716 which provides: "(1) specific performance may be decreed where the goods are unique or in other proper circumstances."

[80] *Supra*, note 36 at 321-322. For a discussion, see Robert Bejesky, *The Evolution in and International Convergence of the Doctrine of Specific Performance in Three Types of States,* 13 UBD. INT'L & COMP. L. REV. 353 (2003). The author distinguishes the approaches of the several states (nations) owning to philosophical differences and historical evolutions. In China, its former Communist planned economy demanded that contracts with the government be obeyed and complied with as duties owed to society In the U.S. and Great Britain, the jurisprudential goal was to satisfy the desires of the parties but not to inflict punitive measures. In France and Germany, the dominant ideological principle was based on natural law principles as applied to contract and property law doctrines. These governments affecting a balance between societal norms and individual conduct affected an middling approach that provides for enforcement if not disadvantageous to the party seeking relief or where there was clearly an impediment that was not practical to overcome by judicial decree (at pp. 374-402).

[81] Bejesky *id.* at 367 citing The French Civil Code, Art. 1184 and the German Civil Code, Art. , section 241.

[82] CLC, Art. 110.

[83] PECL, Art. 8:101 and 8:108.

[84] PECL, Art. 9:101. Compare UCC section 2-708 and 2-709.

[85] PECL, Art. 9:102. Compare UCC section 2-716.

[86] PECL, Art. 9:201. Compare UCC section 2-609.

[87] PECL, Art. 9:301 and 9:304. Compare UCC section 2-611.

[88] PECL, Art. 9:307 and 9:308.

[89] PECL, Art. 9:401. Compare UCC section 2-717.

[90] PECL, Art. 9:508.

[91] CLC, Art. 110-111.

[92] CLC, Art. 113.

[93] CLC, Art. 114.

[94] CLC, Art. 115-116.

[95] CLC, Art. 119.

[96] CLC, Art. 122.

[97] Germany, Court of Appeals, Frankfurt am Main, 1994, Case 5 U/1593, 14 JOURNAL OF LAW AND COMMERCE 201 (1995); excerpted as *The Shoe Seller's Case*, in RAY AUGUST, INTERNATIONAL BUSINESS LAW (4Ed) p.577; for a parallel 1989 Stuttgart District Court case, see http://cisgw3.law.pace.edu/cases/h90831g1.html.

[98] There are some limitations albeit few to the quantum of punitive damages that a court will uphold. See *BMW of North America v. Gore*, 116 S.Ct. 1589 (1996).

[99] *Supra*, note 36 at 322.

[100] CISG, Art. 25 defines a fundamental breach as follows:

> A breach of contract committed by one of the parties is fundamental if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result.

[101] *Supra*, note 36 at 326-327.

[102] *Id.* at 327-328.

[103] CLC, Art. 91.

[104] See CLC, Art. 115, which permits a party to pay a deposit to the other party as the guaranty of performance.

[105] CISG, Art. 2 explicitly states that the Convention does not apply to sales of goods for consumer purposes as well as a number of other categories of sales including securities, ships, aircraft, and electricity.

[106] CISG, Art. 2-3.

[107] For a discussion of the Global Commercial Code proposition, see Michael Joachim Bonell, *Creating International Legislation for the Twenty-First Century: Do We Need a Global Commercial Code,* 106 DICK. L. REV. 87 (Summer, 2001).

RULES FOR MULTIJURISDICTIONAL PRACTICE: A TIME FOR CHANGE

by

Susan Lorde Martin*

I. INTRODUCTION

The nature of law practice has changed as the nature of many businesses has gone from being predominately local to being interstate and international. An obvious example involves business done on the Internet. Internet enterprises can do business everywhere and often have no need for any local affiliations at all. Thus, the argument can be made that the multijurisdictional practice of law, untethered to one particular state or nation, should be the norm.[1] Nevertheless, although clients may be located all over the map, lawyers remain very tied to individual states by virtue of the regulatory structure.

Until the second half of the twentieth century, state regulation of and restrictions on lawyers were seldom questioned because, in fact, most of a lawyer's clients were located in the same state as the lawyer's office and most of the clients' business was also conducted there.[2] Thus, most lawyers had little need to practice in any state other than one in which they were admitted and had their office. It was also in clients' interests to have a lawyer who was particularly

---

* Cypres Family Distinguished Professor of Legal Studies in Business and Director of the Center for Teaching and Scholarly Excellence, Frank G. Zarb School of Business, Hofstra University

knowledgeable in the law of their mutual state home. In the twenty-first century, on the other hand, many lawyers have clients who, because of the globalization of business, need advice about and help with transactions and laws in many different states or nations.[3]

Because lawyers are licensed by an individual state to practice law in that state, clients may face a conundrum when they want to have their usual lawyer, with whom they have developed a relationship and who knows their business, advise them about their interstate transactions.[4] To explain the problem and proposed solutions, this article will first present current state requirements for the practice of law. Then it will discuss cases that have arisen because of the incompatibility of business needs and state regulation. Next, it will summarize the proposals for change of the American Bar Association's Commission on Multijurisdictional Practice and report on the progress of implementing those proposals. Finally, the article will point out additional issues states face in dealing with multijurisdictional practice, concluding that the law regulating lawyers should reflect the reality of national and international business by permitting lawyers to practice across state boundaries when the needs of their clients require it, and the rights of the public are protected.

II. STATE REGULATIONS

Lawyers in the United States are licensed to practice law in a particular state by the highest court of that state.[5] There are a number of very good reasons for this structure as opposed to a national licensing procedure. Through its own admission requirements, a state can promote its interest in having its citizens served by lawyers who are well-versed in the law of the state.[6] In addition, states can promote their interest in having lawyers act ethically and professionally because it is

easier for them to discipline lawyers within the state.[7] Furthermore, lawyers serve, not only as advocates for clients, but as officers of the court with a responsibility to maintain a just legal system and as community volunteers on court committees, in public office, and in charitable organizations.[8] They can serve in those roles much more easily and effectively when they are tied to a local community.

Although every state requires lawyers to be admitted in that state to practice there, every state also has some exceptions. For example, every state permits *pro hac vice*[9] admission for lawyers admitted in another jurisdiction who are going to appear before a court in the state in which they are not admitted. All states limit the number of appearances a lawyer can make *pro hac vice,* most by "court discretion;" in Connecticut, on a "special and infrequent occasion"; in Alabama, the District of Columbia, and Mississippi up to five appearances in twelve months; in Nevada up to five appearances in three years; in Florida up to three appearances in twelve months; and in Montana a total of two appearances ever.[10] Most states also require *pro hac vice* lawyers to affiliate with local counsel.[11]

Most states, however, have no exception corresponding to *pro hac vice* admission for lawyers doing transactional or counseling work. Only a few states pldo specifically authorize such occasional practice.[12] Some states also have exceptions for lawyers employed by corporations or not-for-profit organizations to practice for their employers in the state even though they are not admitted there.[13] The public does not need protection from such lawyers because they are providing legal services only to their employers.[14]

Thus, for most lawyers, the only way to practice law in a particular state is to be admitted to the bar in that state. Some states permit lawyers to be admitted on motion if they are in good standing and have actively practiced in another state that offers reciprocal admission.[15] Most states, however, do not permit admission on motion and, thus, the only way for lawyers to practice in those states is to take the states' bar examinations. Four states[16] use only the standardized national Multistate Bar Examination, but all the other states also include their own questions based on their specific laws, making it highly impractical for anyone to consider being admitted to the bar in every state.[17]

III. PROBLEMS WITH THE CURRENT SYSTEM OF STATE REGULATION OF THE PRACTICE OF LAW

Although state regulation of law practice does provide safeguards for the public, it has costs for clients engaged in interstate business. It may deprive such clients of their lawyer of choice with whom they have developed relationships, in whom they have confidence, and to whom they have given all relevant information about their business.[18] In addition, it will be more expensive for such clients who will have to engage new lawyers in the state of the transaction or litigation.

Although these problems had been developing for years, little attention was paid, perhaps because there was little enforcement of the regulations prohibiting practice in a state in which a lawyer was not admitted when the lawyer was admitted to practice in another state.[19] Ignoring the issue of multijurisdictional practice was no longer possible, however, after the California Supreme Court rendered its opinion in *Birbrower, Montalbano, Condon & Frank v. Superior Court*[20] in 1998.

In that case the court had to decide whether the Birbrower law firm which was a professional law corporation incorporated in New York and having its principal place of business in New York,[21] violated the California statute providing that "[n]o person shall practice law in California unless the person is an active member of the State Bar."[22] In 1992 and 1993 two of the firm's lawyers, Hobbs and Condon, had performed legal work for client ESQ in California although neither they nor any Bribrower lawyer were admitted to practice law in California.[23] The fee agreement between Birbrower and ESQ, a California corporation with its principal place of business in California, was negotiated and executed in New York, and provided that Bribrower would perform legal services for ESQ including those related to an agreement between ESQ and Tandem Computers Inc., a Delaware corporation with its principal place of business in California.[24] The ESQ-Tandem agreement provided that California law would apply.[25]

When a dispute between Birbrower and ESQ arose, ESQ sued Birbrower for malpractice, Birbrower counterclaimed for attorney fees, and ESQ argued that the fee agreement between them was unenforceable because Birbrower violated section 6125 by practicing law without a license in California.[26] During the period of their representation, Hobbs and Condon had met with ESQ, its accountants, and Tandem representatives in California several times and, during the meetings, had given advice to ESQ and negotiated on its behalf with Tandem.[27] They also filed a demand for arbitration with the American Arbitration Association in San Francisco on ESQ's behalf, although the dispute with Tandem was settled and never did go to arbitration.[28]

The California Supreme Court recognized the importance of the *Birbrower* case before it. It noted the tension between interjurisdictional practice and a state-regulated bar.[29] It described the exceptions to section 6125 when an out-of-state lawyer may be permitted practice in California without being admitted there: for example, when a California trial judge consents for such a lawyer to appear in a particular pending action; or when a California court approves a *pro hac vice* application for a lawyer in good standing in another state who affiliates with a member of the California bar; or if a lawyer is practicing in California in a federal court (which is not regulated by section 6125).[30] None of these exceptions applied to the Birbrower lawyers.

The court considered the *Williamson v. John D. Quinn Construction Corporation*[31] case in which a lawyer admitted in New Jersey, but not admitted in New York, represented a client at a New York arbitration.[32] The federal district court in New York allowed the New Jersey law firm to recover its arbitration fees because the court decided that "an arbitration tribunal is not a court of record," relying on a report of the Bar of the City of New York that concluded that "representing a client in an arbitration was not the unauthorized practice of law."[33] The *Birbrower* court distinguished its case on the facts, but also declined to provide an exception to section 6125 for representing a client in an arbitration, declaring that to be the province of the Legislature.[34]

The California Supreme Court also declined to follow *Freeling v. Tucker*,[35] a case in which the Idaho Supreme Court allowed a lawyer admitted to practice in Oklahoma, but not admitted to practice in Idaho, to recover fees for work done in an Idaho probate court.[36] The Idaho court excused the Oklahoma lawyer because he had not falsely represented to his client that he was licensed in Idaho.[37] The California court

stated that to follow Idaho would contravene the California statute and would not assure the competence of lawyers practicing in California.[38] Thus, the California court refused to enforce the fee agreement Birbrower had with ESQ, although it did allow that Bribrower might be able to collect for those services it performed for ESQ in New York.[39]

The *Birbrower* case caught the attention of the legal community, although it certainly was not the first case to deal with the right to practice law or to collect legal fees for the practice of law in a state in which the lawyer was not admitted.[40] When the California Supreme Court denied a fee to lawyers who were working for a California client for whom they had previously done work in New York where they were admitted, an increasingly commonplace situation became one fraught with negative consequences. Furthermore, the California court explicitly noted that a lawyer could be guilty of practicing without a license even if the lawyer had never been physically present in California.[41]

Professor Carol Needham has presented the following examples of commonplace business situations that could give rise to issues concerning the unlicensed practice of law.[42] A lawyer who works for a national lending company in New York as its consumer credit expert gives her employer advice about consumer credit regulations in many states. If she travels to branch offices throughout the country, she will not be able to give branch managers legal advice in California, Nevada, Pennsylvania, Florida, Illinois, Texas, and many other states.[43] Another lawyer works for a national company that rotates its middle managers, including those in its legal department, through all of its five divisions located in five different states. The lawyer is concerned that he has to become a member of all five bars or he will be guilty of practicing law without a license.[44] Another example hypothesizes the lawyer who is

admitted to the bar in Virginia where he works for a large corporation. He lives in Maryland and is concerned that if he does legal work in his home office on weekends, he will be violating Maryland's unauthorized practice of law prohibition.[45]

In response to these circumstances, in 2000 the American Bar Association (ABA) created its Commission on Multijurisdictional Practice (CMP) to study the rules governing multijurisdictional practice and to make recommendations about those rules.[46]

IV. ABA RECOMMENDATIONS

In 2002 the ABA adopted the recommendations of the CMP, first, by affirming its support for the continuing regulation of the practice of law by state judiciaries and for the continuing jurisdictional limits on legal practice.[47] Instead of advocating elimination of state control, the CMP recommended that states recognize particular areas in the law for which out-of-state lawyers could receive temporary authority to practice similar to *pro hac vice* representation for out-of-state lawyers appearing in court.[48]

Among its other actions in response to the CMP's recommendations, the ABA adopted an amended Rule 5.5 of the *Model Rules of Professional Conduct* that says, in pertinent part, that a lawyer admitted and in good standing in another jurisdiction may provide temporary legal services if one of the following circumstances applies: the lawyer associates with a lawyer admitted in the state who is actively participating in the matter; the lawyer's services are reasonably related to another proceeding or alternative dispute resolution proceeding in which the lawyer, or someone the lawyer is assisting, is authorized to appear; or the lawyer's services are reasonably

related to the lawyer's practice in a state in which the lawyer is admitted.[49] In addition, a lawyer admitted and in good standing in another jurisdiction may provide systematic and continuous legal services to the lawyer's employer or services authorized by federal law.[50] This last provision provides a safe harbor for in-house counsel.

The ABA also adopted a *Model Rule on Pro Hac Vice Admissions* to standardize the procedures across state borders.[51] Although courts in all states routinely admit lawyers *pro hac vice*, the *Model Rule* was designed to provide consistency and to eliminate some unnecessarily restrictive provisions in a few states, to make it easier for lawyers with a national practice.[52] The commentary on the *Model Rule* makes it clear that admission *pro hac vice* is meant only for lawyers who are in the state temporarily, that is, who usually live and work in another state; lawyers who live or regularly work in the state would have to seek bar admission in the usual way by exam or on motion.[53]

As of 2003, only five states had adopted versions of the new Rule 5.5.[54] In North Carolina, out-of-state lawyers who are in good standing in another jurisdiction may provide legal services on a temporary basis if they "arise out of or are reasonably related to" legal work done in a jurisdiction in which the lawyers are admitted.[55] In Colorado, out-of-state lawyers may practice in the state on a temporary basis as long as they do not open an office in Colorado, solicit or accept Colorado clients, or establish a domicile in Colorado.[56] In Nevada, out-of-state lawyers who are employed by a single governmental or business entity, other than a provider of legal services, may practice law in Nevada only on behalf of their employers in matters related to their employers' business.[57] This rule provides a safe harbor for in-house counsel, but not for other lawyers, like the ones in *Birbrower* who were

following up work for a California client begun in New York, where they were admitted, with temporary work in California where they were not.

In Delaware, out-of-state lawyers in good standing "may provide legal services on a temporary basis" if they associate with a Delaware lawyer who actively participates in the matter; if they are admitted, or expect to be admitted, *pro hac vice*; or if they are working on a matter that arises from or is reasonably related to work they were doing in a jurisdiction where they are admitted.[58] The last is identical to the new ABA rules. In New Jersey, on the other hand, its Supreme Court adopted new rules about multijurisdictional practice that are somewhat different from the ABA rules. The New Jersey rules permit out-of-state lawyers to engage in occasional practice to avoid "inefficiency, impracticality or detriment to the client."[59] They also permit practice, including alternative dispute resolution, that is related to the jurisdiction in which the lawyer is licensed or is done on behalf of an existing client in the jurisdiction in which the lawyer is licensed.[60]

In about nineteen other states, bar associations or court committees are in the process of conducting reviews of the ABA proposals expanding the situations in which out-of-state lawyers can temporarily practice in a state in which they are not admitted, and most of those are contemplating rules that are either identical to or very similar to the ABA rules.[61] Among the differences in proposed rules, is the omission of the requirement that out-of-state lawyers may practice only on a "temporary" basis. For example, as noted above, New Jersey does not require that practice be only temporary when there is a connection, either through an existing client or the subject matter at hand, to the jurisdiction in which the lawyer is admitted. New York is also considering adopting a rule that avoids the word "temporary," requiring only that the out-of-

state lawyer not establish an office in New York or hold himself or herself out as being admitted in New York.[62]

V. OTHER CONSIDERATIONS IN EXPANDING MULTIJURISDICTIONAL PRACTICE

A. Discipline

One of the reasons advanced for maintaining the regulatory structure for lawyers in the states is to make it easier to take disciplinary action against lawyers who violate their professional responsibilities. States have asserted that it would be too difficult to discipline out-of-state lawyers, if necessary. To eliminate such problems, the New Jersey Supreme Court in its new rules requires out-of-state lawyers not only to comply with the New Jersey Rules of Professional Conduct, but also to submit to the authority of the New Jersey Supreme Court and to in personam jurisdiction in New Jersey for any legal proceedings that may arise out of their legal practice in New Jersey.[63] This kind of arrangement should eliminate most of the practical difficulties in disciplining errant lawyers. Furthermore, a discipline problem has not arisen in the *pro hac vice* admission situation and, therefore, there is no reason to think that existing disciplinary mechanisms would be inadequate.[64]

B. Registration Fees

States may view the presence of out-of-state lawyers practicing in their jurisdiction as an opportunity to raise funds by mandating significant annual fees for out-of-state lawyers. Or such fees might be viewed as the way to pay for the increase in disciplinary costs created by out-of-state lawyers. In either case, states should avoid making the fees too expensive because that would act as a deterrent to

multijurisdictional practice, once again limiting client choice.

VI. CONCLUSION

To give full respect to clients' right to choose the lawyer who will give them advice and represent them, state laws governing the regulation of lawyers should adapt to allow out-of-state lawyers to practice under certain conditions. The ABA proposed multijurisdictional rules present reasonable changes to accommodate the realities of current business needs and legal practice. The goal of state judiciary committees should be to allow out-of-state lawyers who are not establishing an office or regular practice in the state to continue to advise clients with whom they have had a professional relationship in the state of their admission and to continue to work on matters that are related to matters in their office in their home state. In addition, because there is no adverse effect at all on the public when in-house lawyers advise only their employers, those lawyers should be able to do their jobs in states in which they have not been admitted to the bar.

ENDNOTES

[1]ABA Commission on Multijurisdictional Practice, Client Representation in the 21st Century 3 (2002) [hereinafter ABA on MJP].

[2] *Id.*

[3] This article will focus on interstate practice. A similar discussion would be appropriate for international practice, but there are additional issues for those circumstances.

[4] *See* ABA on MJP, *supra* note 2, at 6. In New York, the exception to this rule, licenses for the practice of law are granted by the four intermediate appellate courts. *Id.* n. 8.

[5] *Id.* at 8; Don Burnett, *Multijurisdictional Practice: An Emerging Issue for a Changing Profession*, Advocate, June 2003, at 33; *see also* J.W. v. Superior Court, 22 Cal. Rptr. 2d 527 (Ct. App. 1993) (noting that the prohibition against unauthorized practice of law is designed to insure competence).

[6] Burnett, *supra* note 6.

[7] Burnett, *supra* note 6.

[8] Black's Law Dictionary (7th ed. 1999) ("Temporary admission of an out-of-jurisdiction lawyer to practice before a court in a specified case or set of cases.")

[9] ABA Commission on Multijurisdictional Practice, Comparison of ABA *Model Rule for Pro Hac Vice Admission* with State Versions, Aug. 19, 2003, *at* http://www.abanet.org/cpr/jclr/prohac_admin_comp.pdf.

[10] *Id.* Exceptions not requiring affiliation with local counsel are Illinois, Maine, Massachusetts, Ohio, and Pennsylvania. *Id.*

[11] *See, e.g.*, Cal. Rules of Ct., Rule 983.4 (authorizing lawyers not admitted in California to represent clients in arbitrations); Mich. Comp. Laws Ann. § 600.916 (2002) (permitting work on "a particular matter" by a lawyer not admitted in Michigan who is temporarily in the state); Va. State Bar Rule, Pt. 6, § 1(C) (permitting work by a lawyer not admitted in Virginia for a "client whom the attorney represents elsewhere"); *In re* Opinion 33 of Comm. On the Unauthorized Practice of Law; 733 A.2d 478 (N.J. 1999) (authorizing lawyers not admitted in New Jersey to work on bond matters).

[12] *See,* e.g., Ala. State Bar, Ethics Op., RO-86-52; Colo. Sup. Ct. Rule 222; Rules D.C. Ct. App. 49(c)(6); Rules Reg. Fla. Bar R.17-1.1 to 17-1.8; Idaho Bar Comm'n R. 220; Kan. Rules Relating to Admission of Att'ys R. 706; Ky. Rules Sup. Ct. 2.111; Md. Code Ann. Bus. Occ. & Prof. § 10-206(d) (2000); Mich. Rules. Bd. L. Exam'rs R. 5; Minn. Stat. Admission Bar R. 9; Mo. Sup. Ct. R. 8.105; Nev. Sup Ct. R. 49.10; Comm. On Unauthorized Pracitce of Law (N.J.) Op. 14; N.C. Rules Admission §.0502; Ohio Sup. Ct.

Rules Gov't Bar R. VI §4(A); Okla. Rules Admission R. 2 §5; Or. Rules Admission R. 16.05; S. C. App. Ct. R. 405; Wash. Admission to Practice R. 8(f).

[13] *See* Needham, *supra* note 1, at 1340.

[14] *See, e.g.,* Alaska Bar Rule 2, § 2; Colo. Admission Rule 201.3(1); Conn. Rules of the Super. Ct. Regulation Admission to the Bar, § 2-13; Ill. Admission Rule 705; Mo. Sup.Ct. Rules Governing the Mo. Bar, Rule 8.10; N.Y., Rules of the Ct. of App. for the Admission of Attorneys & Counselors at Law, § 520.10; N.C. Sup. Ct. Rules Governing Admission to the Practice of Law, § .0502; Okla. Rules Governing Admission to the Practice of Law, Rule 2; Penna. Bar Admission Rule 204; Va. Sup. Ct. Rule 1A:1; Wash. Admission to Practice Rule 18; W. Va. Supreme Ct. Of App. Rules for Admission, Rule 4.0-4.5; Wisc. Sup.Ct. Rule 40.05; Wyo. Statute 33-5-110.

[15] Nebraska, North Dakota, South Dakota, and West Virginia. *See* ABA on MJP, *supra* note 2, at 7 n.12.

[16] *See* ABA on MJP, *supra* note 2, at 7.

[17] *See* Burnett, *supra* note 6; ABA on MJP, *supra* note 2, at 12.

[18] *See* Burnett, *supra* note 6, at 34.

[19]949 P.2d 1 (Cal. 1998).

[20] *Id.* at 2-3.

[21] Cal. Bus. & Prof. Code § 6125 (1998).

[22] *Birbrower*, 949 P.2d at 3.

[23] *Id.*

[24]*Id.*

[25] *Id.* at 4.

[26] *Id.* at 3.

[27] *Id.*

[28] *Id.* at 6.

[29] *Id.*

[30]537 F. Supp. 613 (S.D.N.Y. 1982).

[31] *Birbrower*, 949 P.2d at 8.

[32] *Id.*

[33] *Id.* at 9. After the *Birbrower* decision, the California Legislature amended section 1282.4 of the California Code of Civil Procedure so that an attorney admitted to the bar of any other state may represent parties, in the course of, or inconnection with,an arbitration in this state, provided that the attorney, if not admitted to the State Bar of California, timely files the certificate [that states the attorney's residence and office address, courts before which the attorney is admitted to practice and currently in good standing of, etc.] and the attorney's appearance is approved by the arbitrator . . . .

[34]289 P. 85 (Idaho 1930).

[35] *Id.* at 86.

[36] *Id.*

[37] *Birbrower*, 949 P.2d at 11.

[38] *Id.*

[39] *See, e.g.,* McRae v. Sawyer, 473 So. 2d 1006 (Ala. 1985); Taft v. Amsel, 180 A.2d 756 (Conn. Super. Ct. 1962); Lozoff v. Shore Heights, Ltd., 362 N.E. 2d 1047 (Ill. 1977); Ranta v. McCarney, 391 N.W. 2d 161 (N.D. 1986).

[40] *Birbrower*, 949 P.2d at 5.

[41] *See* Needham, *supra* note 1, at 1340-42.

[42] *Id.* at 1340-41.

[43] *Id.* at 1342.

[44] *Id.* at 1343.

[45] ABA on MJP, *supra* note 2, at 1.

[46] ABA on MJP, *supra* note 2, at 13.

[47] ABA on MJP, *supra* note 2, at 16.

[48] ABA on MJP, *supra* note 2, at 18.

[49] ABA on MJP, *supra* note 2, at 18.

[50] ABA on MJP, *supra* note 2, at 41, 46.

[51] ABA on MJP, *supra* note 2, at 46.

[52] ABA on MJP, *supra* note 2, at 47.

[53] ABA Center for Professional Responsibility Joint Committee on Lawyer Regulation, *Adoption of MJP Rules*, *available at* http://www.abanet.org/cpr/jclr/state_mjp_rules.pdf (last viewed Feb. 17, 2004).

[54] N.C. State Bar Rule 5.5 (2003).

[55] Colo. R. Civ. P. 220 (2003).

[56] Nev. Sup. Ct. Rule 49.10 (2003).

[57] Del. Lawyers' Rules of Professional Conduct, Rule 5.5 (2003).

[58] N.J. Rules of Professional Conduct, Rule 5.5(b)(3)(iv) (2003).

[59] *Id.* at Rule 5.5(b)(3)(i)-(ii).

[60] *See* ABA Center for Professional Responsibility Joint Committee on Lawyer Regulation, *Status of State Review of Professional Conduct Rules*, *available at* http://www.abanet.org/cpr/jclr/state_contact_list.doc (last viewed Feb. 19, 2004); *see also* Needham, *supra* note 1, at 1366.

[61] *See*, Needham, *supra* note 1, at 1373.

[62] N.J. Rules of Professional Conduct, Rule 5.5(c)(2)-(3) (2003).

[63] *See, e.g.,* Stephen Gillers, *Lessons from the Multijurisdictional Practice Commission: The Art of Making Change*, 44 Ariz. L. Rev. 685, 698-99 (2002).

[64] *See* Needham, *supra* note 1, at 1374.

THE FACTUAL AND LEGAL BASIS UNDER FEDERAL LAW FOR OPPOSING A CORPORATION'S DEMAND FOR A PRELIMINARY INJUNCTION

by

Mitchell J. Kassoff*

The purpose of this article is to discuss the reasons and bases for opposing the demand of a corporation for a preliminary injunction. In today's legal environment knowledge of injunctive relief is critical in the business world.

THE REASONS AND BASES

I. ESTABLISH THAT THE CORPORATION HAS FAILED TO ESTABLISH A RIGHT TO PRELIMINARY INJUNCTIVE RELIEF

It is axiomatic that preliminary injunctive relief is an "extraordinary" remedy that should be granted sparingly.[1] A "prohibitory" or typical injunction is used to maintain the *status quo* pending a trial on the merits.[2] A party moving for such an injunction in the Second Circuit must show (a) irreparable harm, (b) either (1) likelihood of success on the merits, or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and (c) a balance of hardships tipping decidedly in its favor.[3]

---

*Professor of law and taxation at Pace University, New York City

A "mandatory" injunction, on the other hand, seeks to alter the *status quo* by commanding some positive act.[4] A party moving for a mandatory injunction is required to make a more rigorous showing of a *clear or substantial* likelihood of success on the merits.[5] This far greater remedy is that which is requested by the corporation and should not be granted.

II. SHOW THAT THE CORPORATION HAS UNCLEAN HANDS THAT WILL BAR THE RELIEF SOUGHT

On this basis alone the corporation is barred from seeking equitable relief. "[a] Court may deny injunctive relief based on the defense of unclean hands 'where the party applying for such relief is guilty of conduct involving fraud, deceit, unconscionability, or bad faith related to the matter at issue to the detriment of the other party.'"[6]

"[o]ne who has defrauded his adversary to his injury in the subject matter of the action will not be heard to assert a right in equity."[7]

"[i]t is one of the very first principles of equity that he who asks for equity must do equity; that a party coming into a Court of equity must come in with clean hands, free from wrong himself in relation to the matter in which they ask equitable relief.'[8]

III. SHOW THAT THE CORPORATION HAS NOT DEMONSTRATED A LIKELIHOOD OF SUCCESS ON THE MERITS

Regardless of what type of injunction relief (prohibitory or mandatory) the corporation seeks, show that it has failed to establish any likelihood of success on the merits of any of it

claims. This failure is fatal to its request for it requested preliminary injunction.[9]

If the corporation has asserted claims for breach of contract show that this is not sufficient. To state a viable claim for breach of contract under New York law, a complaint needs to allege: (i) the existence of an agreement; (ii) adequate performance of the contract by the corporation; (iii) breach of contract by the Defendant; and (iv) damages.[10] Show that it is clear that the corporation fails as to defendant, Inc. and has failed to prove the facts for the Original Corporations.

If the corporation has asserted claims for fraud show that the claims are not sufficient. In order to succeed on a claim for fraud, the corporation must show that (1) the corporations misrepresented a material fact, (2) which the corporations knew to be false, (3) that such statement was made for the purpose of inducing the corporation to rely thereon, (4) that the corporation rightfully did so rely in ignorance of the statements' falsity, and (5) that the corporation was injured as a result of such reliance. Show that the corporation has failed to make this requisite showing here.

IV. SHOW THAT THE CORPORATION WILL NOT SUFFER IRREPARABLE HARM IF THE INJUNCTION IS NOT GRANTED

Show that the corporation request for injunctive relief must also be denied because it faces no irreparable harm. It is well settled that irreparable harm is "injury that is neither remote nor speculative, but actual and imminent and that cannot be remedied by an award of monetary damages."[11] Accordingly, show that the corporation's claim of irreparable injury is immediately not applicable to any causes of action that demand money damages. Even if the corporation stated a claim, any

damages would be readily calculable based upon past performance. Therefore, money damages would be sufficient in this case.

A corporation sought a preliminary injunction after its agreement had been terminated. In denying the corporation's request for a preliminary injunction, the court concluded the corporation faced no irreparable harm. [12]

In the seminal case on preliminary injunctions[13] the party moving for a preliminary injunction alleged irreparable harm based on a "disruption of (Jackson's) sales and delivery relations with its customers."[14]

In refusing to grant the injunction, the Second Circuit Court of Appeals held:

> Even if Jackson shows this injury, however, we do not see why it would not be rather readily compensable in monetary damages. We recognize that the parties provided for a long period of notice of termination of the underlying distributorship contract to give Jackson "sufficient time to provide substitute sources of supply." But this, we think, has little bearing on the compensability of that loss of customers or business in dollars and cents, the traditional requirement for injunctive relief.[15]

Based upon the foregoing, show that the corporation has failed to demonstrate that it will suffer any irreparable harm. This will require denial of its request for a preliminary injunction for this reason as well.[16]

V. SHOW THAT THE BALANCE OF THE HARDSHIPS DO NOT FAVOR THE CORPORATION

The final prerequisite for a preliminary injunction is a showing that a balance of hardships is in favor of the corporation.[17] Show that the defendant has negotiated in good faith, made investments and begun operation of its business it should not lose its entire investment, especially prior to a full trial on the merits of the case. Thus, show that the balance of hardships clearly do not favor corporation seeking the injunction.

VI. EVEN IF THE COURT DETERMINES THAT GROUNDS FOR A PRELIMINARY INJUNCTION EXIST, SHOW THAT THE CORPORATION SHOULD BE REQUIRED TO POST A SUBSTANTIAL BOND PURSUANT TO RULE 65(c) OF THE FEDERAL RULES OF CIVIL PROCEDURE

A bond is required upon the issuance of a preliminary injunction "in such sum as the court deems proper, for the payment of such costs and damages as may be incurred or suffered by any party who is found to have been wrongfully enjoined or restrained."[18]

Consequently, if the Court determines that some form of injunctive relief is necessary, the corporation must be required to post a bond to cover any costs and damages that may be suffered by Corporations should the corporation not prevail in the underlying action in this matter.[19]

Since the scope of any injunctive relief ordered cannot be known at the time of request (and the defendant will submit that none is necessary), the face amount of the bond should be sufficient to cover any damages unjustly incurred as a result of the issuance of the preliminary injunction, plus an additional amount to account for potential consequential damages resulting from the injunction.

The bond should cover, at a minimum, the potential loss of goodwill, revenues and defendant's business opportunity.

CONCLUSION

By showing the proper facts and law it is quite possible for a defendant to defeat a corporation's demand for preliminary injunctive relief.

ENDNOTES

---

[1] *Jamaica Ash and Rubbish Removal, Inc. v. Ferguson, 85* F. Supp. 2d 174 (E.D.N.Y. 2000); *Winner Intern, LLC v. Omori Ent.,* 60 F. Supp. 2d 62 (E.D.N.Y. 1999).

[2] *Tom Doherty Assoc., Inc. v. Saban,* 60 F.3d 27 (2d Cir. 1995).

[3] *e.g., Forest City Daly Housing Inc. v. Town of North Hempstead,* 175 F.3d 1999 (2d Cir. 1999) (Pohorelsky, M.J.); *The Southland Corp. v. Froelich,* 47 F. Supp. 2d 227 (E.D.N.Y. 1999) (Pohorelsky, M.J.). (denying a corporation's motion for a preliminary injunction to revive an agreement).

[4] *Forest City,* 175 F.3d at 12.

[5] *Forest City, supra; Froelich, supra.*

[6] *The Estate of John Lennon,* 934 F. Supp. 287 (S.D.N.Y. 1996)

[7] *The Original Great Am. Chocolate Cookie Co., Inc. v. River Valley Cookies, Ltd.,* 970 F.2d 273 (7th Cir. 1992)

[8] *Beermart, Inc. v. The Stroh Brewery Co.,* 804 F.2d 409 (7th Cir. 1986)

[9] *Froelich, supra.*

[10] *Harsco Corp. v. Segui,* 91 F.3d 337 (2d Cir. 1996).

[11] *Forest City,* 175 F.3d at 25.

[12] *Truglia v. KFC Corp.,* 692 F. Supp. 271 (S.D.N.Y. 1988)

[13] *Jackson Dairy Inc. v. H.P. Hood & Sons, Inc.*, 596 F.2d 70 (2d Cir. 1979)

[14] *Jackson Dairy*, 596 F.2d at 72.

[15] *Jackson Dairy*, 596 F.2d at 72-73 (footnotes omitted).

[16] *Forest City, supra.*

[17] *Wright v. Giuliani*, 230 F.3d at 545.

[18] Rule 65(c) of the Federal Rules of Civil Procedure.

[19] First Jewellery Co. of Canada v. Internet Shopping Network, LLC, 2000 WL 122175 (S.D.N.Y. 2000).

DISNEY v. DISNEY: CAN A SHAREHOLDER DERIVATIVE SUIT CHANGE THE CULTURE OF CORPORATE GOVERNANCE?

by

Catherine C. Giapponi*
and
Sharlene A. McEvoy**

Corporate shareholders have legitimate concerns about how corporate assets are spent and how diligent the Board of Directors is in protecting the interests of the corporation. This article analyzes the 2004-2005 litigation of Disney shareholders against the Board of Directors to secure the return of an excessive executive severance package and issues it has raised regarding Director responsibility and corporate governance.

INTRODUCTION

After seven years of legal maneuvers, a case brought by disgruntled shareholders of the Walt Disney Co. was heard in the fall, 2004 in the Chancery Court of Delaware.[1] The gravaman of the shareholder's complaint is that the Board of Directors was guilty of gross mismanagement and waste in

---

* Visiting Professor of Management in the Charles F. Dolan School of Business at Fairfield University.

** Professor of Business Law at the Charles F. Dolan School of Business at Fairfield University.

hiring Michael Ovitz a former high-powered Hollywood agent and co-founder of the industry's leading talent agency, Creative Artists Agency (CAA). Ovitz's stint at Disney began in 1995 and ended in 1996, a scant fourteen months later, but his tenure garnered him $140 million in cash and stock options.[2]

Under Chancery court rules, the plaintiffs were permitted to call only three expert witnesses while the Disney witness list included all the Board members, a compensation expert, Ovitz himself, and Disney CEO Michael Eisner.[3]

Disney shareholders' attorneys believe that the Chancery Court decision to permit the case to be tried was a "wake up call that corporate officers owe a real duty of care to the corporation they serve."[4] The shareholders maintain that Disney's board failed that duty in hiring Ovitz in the first place and in agreeing to an excessive severance package upon terminating him. The plaintiffs argue that the payout "was an unwarranted and massive waste of corporate resources."[5] They seek a remedy of disgorgement which means that Ovitz and the Board members from 1995-96 would be obliged to return the money plus interest which totals $200 million.[6] While board members carry "directors and officers" insurance, it is unclear if it covers such a situation.

The suit was dismissed in 1998 when the judge found that the Board did not violate its duty of care. When the plaintiffs appealed, the Delaware Supreme Court concluded that the Disney Board's actions in approving Ovitz's severance were "casual, if not sloppy and perfunctory"[7] and the plaintiffs were given a second opportunity to file the case. When the complaint reached Judge Chandler again he refused to dismiss it, a decision which sent shock waves through boardrooms across the country. The judge concluded that if the allegations

were true, they would show that the Board "failed to exercise any business judgment and failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its shareholders."[8] If the plaintiffs proved the claims, then the Board would be "outside the protection from liability granted by the business judgment rule."[9]

The judge allowed the case to proceed after listing numerous reasons why the Board remained passive as Eisner hired Ovitz, who had never worked for a public company and did nothing when the CEO and Ovitz negotiated a no fault termination which allowed the former agent to leave the company with the full severance package. In addition, Eisner hired Ovitz over the objections of three board members, all of whom later informed Ovitz shortly thereafter, that they would not be reporting to him.[10]

The board also failed to hire a compensation expert and the compensation committee met for less than an hour before deciding to hire Ovitz. During that hour most of the committee's time was devoted to a discussion of one member's fee for negotiating Ovitz's contract.[11] The contract was not finalized for three months after Ovitz's hire despite the fact that Eisner knew that things were not working out. Eisner even changed the severance portions of the deal so that Ovitz would get full payment unless he was fired for gross negligence or misfeasance. Originally, he would have gotten full payment only if wrongfully terminated. The revised contract also gave Ovitz more favorable terms for determining the price of his stock options.[12]

Eisner and Ovitz worked alone on how the latter would leave the company. Eisner was concerned about saving face at this point and arranged it so that Ovitz's exit from Disney would be a win-win situation.[13] He permitted Ovitz to

negotiate with Sony for a CEO position, but that was unsuccessful. The hope was that Ovitz would leave quietly and there would be no lawsuit.

The board and Eisner maintain that the board was fully engaged in the decision to hire and dismiss Ovitz and that he received "not one penny more than his contract required."[14] Testimony showed that Ovitz' hiring was greeted with almost unanimous acclaim and that Disney's market capitalization rose $1 billion upon the announcement.[15]

The defendants maintain that Ovitz's salary was fair because it was less than he had been offered by Universal and less than the $25 million a year he had earned at CAA.[16] In its defense, Disney says that in addition to allowing Ovitz to negotiate with Sony, it rescinded a $7.5 million bonus. Moreover, the Board was told that there were no grounds to fire Ovitz for cause so Disney would have to pay the full severance.[17]

SHAREHOLDERS' EXPERTS

The plaintiffs' employment law expert John Donohue III of Yale Law School testified that Ovitz should not have received the $140 million severance because Eisner, a major shareholder, and other executives had complained about Ovitz's "actions and attitude".[18] The professor opined:

> If there's repeated instances of dishonest and untrustworthy behavior by the president of the company that undermines the trust that the other officers of the company have in him, in my opinion there's a basis for termination for cause.[19]

Donohue testified that Ovitz should have been fired for cause because of gross negligence as he failed to achieve any of the goals set for him when he was hired, namely to take some of the burden off Eisner. Ovitz did just the opposite by adding to the CEO's burden because "Eisner had to repeatedly clean up after Ovitz's mess."[20] Disney officials were also concerned about his propensity to lie and his excessive spending of $5 million mostly for the renovation of his office but also for gifts, parties, meals, and travel.[21] Ovitz also declined to work on Hollywood Records, one of his assignments. He hired numerous secretaries and assistants.[22]

The plaintiffs' compensation expert, Kevin Murphy testified that Eisner and the directors were negligent in agreeing to the generous pay package "especially because it contained a no fault termination clause."[23] The USC business and law professor testified:

> "The initial contract was one of the most generous if not the most generous contract ever offered to a non-CEO level individual in the history of corporate America."[24]

Murphy pointed to specific aspects of Ovitz's compensation i.e., starting on October 1, 1995, the five year contract provided for a $1million base salary and $7.5 million in annual bonuses. Eisner earned $750,000.[25] Second, the five million stock options had a term of five years, three years longer than was the usual case at Disney. Murphy emphasized that the options were worth $107 million.[26] Ovitz also was guaranteed a special payout of $10 million and lump sum payments of his salary and bonuses. Two million of the options would expire, but the remaining three million would vest immediately and could be exercised up to September 30, 2004.[27]

Ovitz's base salary alone was far higher than his counterparts in other large media or entertainment companies. The $7.5 million in annual bonuses was more than double the value of the next highest salary and the stock options were ten times larger than the next highest garnered by other executives.[28]

Murphy's analysis revealed that of all the executives in corporate America from 1992-1995 Ovitz's compensation was the highest.[29] Ironically, the next largest was one valued at $71 million given to Eisner in 1989.[30]

DEFENDANTS' TESTIMONY

Michael Ovitz testified that he felt frozen out by Disney executives from the beginning of his tenure. He stated that he had masterminded a series of deals that were rejected by Eisner and that executives at Disney who should have been reporting to him as President and Chief Operating Officer (COO) continued to report to Eisner.[31]

Disney's case was not helped by the testimony of Irwin Russell who stated that the compensation committee never met in the summer 1995 to discuss the terms of Ovitz's contract but he, as chair of the committee, discussed the matter individually with each member. The contract was approved in September 1995 after Ovitz joined Disney.[32] Russell testified that a compensation expert assented to the terms in light of Ovitz's pay level at CAA. He admitted that it was unusual for him, as head of the compensation committee, to negotiate for a $250,000 fee an employment contract that his committee would ratify. Russell testified that Eisner allowed him to draft and negotiate the contract but that such an arrangement not unheard of in corporate America.[33]

The negotiations were kept as confidential as possible even if board members had to be kept in the dark. Eisner only discussed the issue with board members he thought should know about it.[34] The full compensation committee did not meet before Ovitz's hiring was announced. Ignacio Lozano, a member of the compensation committee, admitted that he never interviewed Ovitz personally nor did he understand the Black-Sholes method used for evaluating stock options: "I don't really understand it. It's much too complicated for me."[35]

By negotiating with Eisner, Russell admitted that "he was stepping outside of the normal duties as chairman of Disney's compensation committee.[36]

> "Normally, the compensation committee members do not negotiate agreements. We would approve agreements but we would not negotiate them."[37]

Russell confided his misgivings about Ovitz to Eisner because "he had been an entrepreneur and a boss and built a company from scratch and he could do whatever he wanted and that corporate culture would be different."[38]

Russell stated that some board members including actor Sidney Poitier were told about the Ovitz hire only the night before the press release was issued in August, 1995.[39] In fact, there was some doubt about how engaged certain directors like Poitier were in the process.[40] Poitier, however, testified that Eisner did keep directors in the loop, "even if he didn't do it with formal board meetings."[41]

Executive pay consultant "Bud" Crystal believed that to get Ovitz to join Disney "you're going to have to pay a lot money

to get him" because he had been dubbed "the most powerful man in Hollywood."[42] Crystal admitted that he never met with two of the compensation committee members.[43] The plaintiffs believe that members of the negotiating committee were not in the loop regarding Ovitz's hiring.[44]

Russell testified that he believed that Ovitz's behavior on the job did not rise to the level of "gross negligence or malfeasance", the standard required to terminate his contract without giving Ovitz the $140 million severance package.[45] Russell further stated:

> "In my experience in entertainment, this is a relatively common standard. It has a very, very high standard of misbehavior before it would apply. In my 40 odd years of experience, I was not aware of any situation where an executive was fired based on good cause and it was publicly acknowledged.[46]

Yet, in an embarrassing e-mail written in December 1996, Eisner described Ovitz as a psychopath who "doesn't know right from wrong." Basically, he has a character problem, too devious, too untrustworthy to everybody, only out for himself, and he is "totally incompetent."[47]

The compensation committee did not consider what acts would get Ovitz fired or the meaning of the gross negligence, malfeasance, or other actions that would constitute good cause termination and thus spare Disney from having to pay him $140 million nor did it vet Ovitz's full contract.[48] They merely reviewed an abstract of key terms and conditions because they were not lawyers and language was still being finalized.[49]

Russell's testimony revealed two other issues that illustrated the Disney board's laxity with regard to Ovitz. Ovitz had signed onto Disney's ethical guidelines in which he agreed to abide by the company policy that no gifts greater in value than $75.00 be accepted by employees. The policy also requires employees not to give gifts "that could be interpreted as an inducement for future service."[50] Ovitz himself admitted that he was overly generous in giving gifts during his short tenure, such as gifts of eighty watches valued at $300 each. Eisner was aware that Ovitz was not reporting the gifts.[51] A consequence of failing to observe this ethical policy could be dismissal, Russell admitted under cross-examination. [52]

A second blunder was that Ovitz's hiring violated company by-laws because at the time the president was also the chief operating officer and Ovitz was hired only as president. Russell admitted that Ovitz was not hired to be an administrator or manager.[53]

Eisner tried to soft-pedal his anti-Ovitz e-mails and memos. He testified that they were "gross hyperbole" not to be taken at face value.[54] Eisner's testimony gave credence to the shareholders' claims that both Eisner and the Disney board acted irresponsibly in hiring Ovitz.[55] Eisner admitted on the witness stand that he had not thought through the consequences of the Ovitz hiring on the other executives.[56]

Eisner also confessed that there was sloppy record keeping at board meetings. Minutes of the Disney board "were often abbreviated, inaccurate or non-existent."[57] No minutes of the executive session in which Eisner is alleged to have told the board of Ovitz's firing have been produced.[58]

Eisner admitted that the board "voted Ovitz a $7.5 million bonus after they'd already agreed to fire him!"[59] He agreed that

the decision was a mistake that was rescinded immediately and that it was only a coincidence that the bonus was revoked after a protest arose once news of Ovitz's firing reached the media.[60]

Stanley Gold, a board member who is often an antagonist of Eisner and who sought his ouster as CEO because of what he regards as his mismanagement, also did not help Disney's cause at the trial by stating that five directors were "unprepared and ill-equipped to manage the oversight and executive strategic direction" of Disney.[61] Even more damning to the defendant's cause was the testimony of George Mitchell, who served as chairman of Disney's Board during the Ovitz hiring. The former Senator portrayed the Board as "passive" with "directors asking few questions, checking few facts, and acquiescing to management initiatives."[62] Mitchell testified that the board "never scrutinized" Ovitz's qualifications and relied on his personal representation that he had earned between $20-25 million a CAA.[63] All that board members saw was his resume before hiring him. Mitchell also stated that he did not bother to ask what Frank Wells, Ovitz's predecessor as president, was making nor did he see a report prepared by compensation expert Bud Crystal.[64] He also testified that the Board held a substantive discussion on the hiring of Ovitz at a September 26, 1995 meeting. Mitchell asked about the three million stock options and potential for two million more, but was given assurances by compensation committee chair Irwin Russell and operations chief Raymond Watson that Ovitz would actually be taking a pay cut.[65]

Mitchell relied on Disney chief counsel in agreeing to terminate Ovitz with a $140 million payment but acknowledged that no outside lawyer was consulted nor did any board member call for a special meeting to discuss his departure.[66] Sandy Litvack, who served as chief counsel, said that Ovitz's failures did not amount to the gross negligence

required to fire him without paying severance. He too admitted that he did not ask outside counsel to review his findings or "examine employment-law cases to reaffirm his opinion."[67] He testified, "I didn't think it was necessary."[68] Like Mitchell, other directors, including Leo Donovan, Reveta Bowers, and Richard Nunis, all indicated that they relied on Litvack's judgment that Ovitz could not be terminated for cause.[69]

Mitchell's testimony did nothing to dispel the notion of an overly cozy board "...and consistent unanimity where a dissenting voice might well have been expected."[70] Even the so-called "outside" directors were of little help. They were described as "clueless when it came to understanding the entertainment industry."[71]

Mitchell said that it would not have been a good idea to demote or reassign Ovitz, not that the idea was even suggested to the Board. The directors were advised that the only option was to terminate Ovitz without cause.[72]

The basic theme of the Board members' testimony is that Ovitz had to go, but there was no basis for firing him and thus make him ineligible for the lucrative severance package. Although Thomas Murphy, chairman of CapCities/ABC Broadcasting, testified that Ovitz was a "cancer" "eating at the company", he stated that Ovitz had "signed a good contract, and he should get paid on it."[73] Stephen Bollenbach, former finance chief, testified that Ovitz alienated Disney executives, struggled to fit into Disney's corporate culture, and although he had lots of ideas, Ovitz had no follow through.[74] Still, Bollenback saw no reason to fire him for cause.[75] Sandy Litvack, who dismissed plaintiff accusations that Ovitz's violation of company gift giving policy constituted cause,[76] stated: "He was guilty of not being able to do the job. But

failure at a job does not amount to gross negligence or malfeasance."[77]

WALL STREET'S REACTION: IMPACT ON STOCK VALUE

Disney's announcement of its plans to bring Ovitz on board met with favorable reactions from Wall Street analysts. Economist Frederick Dunbar testified that the stock gained $1.1 billion in value upon the announcement on August 14, 1995.[78] He further noted that there was no significant stock movement when details of the compensation package were released later in September, indicating that the "market anticipated more or less correctly that Ovitz was going to be expensive."[79] Dunbar also testified that Ovitz's departure, with his $140 million severance package, created little stock movement and he theorized that Ovitz's salary and severance package were acceptable.[80] Dunbar's testimony indicates some degree of market acceptance of executive pay packages that some would view as excessive and adds another dimension of complexity to the issue of board accountability. Two questions emerge. First, if the Wall Street analysts and the investment community did not object to Ovitz's salary and severance, should the Board be held to a higher level of accountability for perceptions that align with those of the external market? Second, what was the material impact of the Ovitz settlement on the shareholders and the value of the Disney stock?

THE ROLE OF THE BOARD OF DIRECTORS: GOVERNANCE AND EXECUTIVE COMPENSATION DECISIONS

In a 1998 ruling related to the case, Judge Chandler stated that as long as Delaware law was followed "a large severance

package is just as valid as an authorization to borrow."[81] The key issue in this case is whether Disney directors followed the law in exercising their duty of care and loyalty when they hired Michael Ovitz in September 1995 and fired him in December 1996.[82] Directors and officers owe the duties of diligence and loyalty to the corporation that were originally imposed by common law and later codified by statute. In the discharge of their responsibilities, directors must exercise ordinary care and prudence which means that the directors must exercise the same degree of care that they would exercise in their own business affairs.[83]

Most state statutes require that directors discharge their duties in good faith, as an ordinary prudent person in a similar situation would exercise and in a manner the director reasonably believes to be in the best interests of the corporation.[84] The business judgment rule prevents directors from being held liable for honest mistakes of judgment. But directors can be held liable for bad faith or negligence and directors must make informed decisions with the reasonable belief it is in the best interest of the corporation.[85] While directors may rely on information provided by experts employed by the corporation like lawyers and accountants, directors must make an effort to keep themselves informed and make decisions deliberately.

It is clear that the Disney directors were not adequately informed about the terms and conditions of Michael Ovitz's contract, how his performance would be evaluated, and under what conditions he might be terminated. In fact, Ovitz was at work for Disney for three months before the contract was finalized. Also contributing to the inadequacy of informed decision making by the board was a lack of expertise and knowledge of executive compensation, severance packages, stock option plans, and the legal terms of employment

contracts. Although directors can rely on experts, it is prudent to include board members on the compensation committee who have the requisite skills necessary to make sound decisions. In addition, a member of the compensation committee was paid to negotiate the Ovitz contract and was a part of the committee of directors that would approve it. This is not only an independence problem but also a conflict of interest issue.

Board independence encourages better monitoring and oversight of executive decisions and more critical questioning before the board takes action. The directors at Disney, however, did not raise questions as to why the corporate bylaws were violated when Ovitz was hired only as the president and not the chief operating officer. Questions should also have been asked about the wisdom of hiring someone who had never been a corporate officer, but who had been an agent more accustomed to being a corporate adversary.

Minutes were not kept of director meetings at which Michael Eisner was said to have kept members informed about the Ovitz matter and, if Stanley Gold's assessment of the situation is correct, four or five directors were ill-equipped to understand corporate strategy. The Board, therefore, did not have the business acumen required to do its job properly.

The shareholder suit was brought in Delaware, the state in which Disney, like other major American firms, is incorporated. While it is notorious for its liberal corporate laws, and even provides that a company's articles of incorporation may have a provision limiting the personal liability of directors for damages for breach of a duty, no corporate charter or bylaw can limit liability for any breach of duty or loyalty to the corporation or its shareholders for acts or omissions that violate good faith, or for intentional misconduct or for knowing violations of the law.[86]

CORPORATE GOVERNANCE: POST ENRON

As a result of recent corporate scandals involving financial reporting irregularities, there has been an increased focus on corporate governance with specific attention to board audit committee requirements. The Sarbanes-Oxley Act, passed by Congress in 2002 in response to the failure of corporate governance structures to protect shareholder interests, specifically calls for the independence of audit committee members. [87] Legislative and regulatory requirements related to board compensation committees, however, are less developed. There is a renewed focus on executive compensation issues and the function and accountability of the corporate compensation committee.[88] In fact, the California Public Employees Retirement System (CalPERS), the largest pension fund in the United States, has developed a plan to evaluate corporate board compensation committee practices in an effort to curb excessive executive pay and better align compensation and shareholder interests.[89] Aspects of the plan include:

> "pushing for improved disclosure of compensation with federal regulators, urging compensation consultants to devise packages that better align executives' interests with those of shareholders, targeting a series of companies in various sectors that have what it deems the most problematic compensation practices in hopes of starting a trend at reining in pay, and withholding votes for re-election of compensation committee members in the worst cases."[90]

The Internal Revenue Service has also indicated that it will be "undertaking extensive audits of executive compensation"[91] which may prompt closer board oversight of compensation

practices. The Delaware Court's willingness to hear the Disney case is further indication of a change in perception as to board accountability for excessive executive pay and severance packages. Board members, especially those on compensation committees, may be held to a higher standard in the post-Enron period.

CONCLUSION

The key question that Judge Chandler will answer in his decision is whether the shareholders have carried their burden of proof in showing that the Disney board was negligent in letting Michael Ovitz leave the company with a $140 million severance package. The directors' testimony revealed that most of them were heavily reliant on the word of Michael Eisner that there was no alternative but to let Ovitz depart with the severance.[92] The directors asked few questions when the decision to hire Ovitz was made and when the decision was made to fire him. Two directors, members of the compensation committee, confessed ignorance about the terms of Ovitz's departure. The evidence suggests that the Board's collective decision making with regard to Ovitz's compensation was not informed. However, there was a good deal of disparity in the level of involvement of the individual board members. Some were clearly left out of the loop. Although the evidence indicates that these members of the board failed to inform themselves, whether they acted with gross negligence and "consciously and intentionally disregarded their responsibilities"[93] is less clear. The testimony does indicate some negligence. The difficulty is that standards upon which we judge the behavior of board directors today may be different from the standards that may have applied in 1996. If the judge finds the directors negligent, their insurance should cover the damages.

The case is a path breaking one because never before has the Chancery Court permitted a suit which threatens directors with personal liability for decisions involving ordinary business matters.[94]

The second question is whether Ovitz did anything during his brief tenure at the company which would have merited a firing for just cause. At most, the plaintiffs merely proved that Ovitz was not a good fit for the job. While Ovitz committed some transgressions including giving gifts to people in excess of company limits, such a peccadillo would not have been sufficient to merit his being fired.

Regardless of the outcome of the case, the fact that the issue went to trial has been enough to ring bells in corporate boardrooms throughout the country. The Disney case has been closely scrutinized by those in the corporate world because of its implications for the standard of conduct expected of corporate boards of directors. Boards "have been virtually immune from liability for their actions except in cases of fraud."[95] In the post- Enron environment, however, there has been more scrutiny of the passivity of corporate boards in making decisions that adversely affect the company. Shareholder lawsuits and private securities litigation may extend beyond governance failures related to fraud to foster greater accountability with respect to due care and loyalty.[96]

The Disney case may have far reaching implications for board member conduct. The Delaware Court's decision as to whether the Disney board members acted in good faith and met their duty of care and loyalty, as well as their fiduciary responsibility to the shareholders, may raise the bar for many boards. Security Exchange Commission regulations, the mandates of the self-regulatory organizations (SRO's), such as the New York Stock Exchange and NASDAQ, and corporate

charters may dictate more stringent rules for independence and expectations with respect to board member conduct in order to avoid similar law suits. There may also be more critical scrutiny of all potential new board members, particularly with respect to competency and expertise, commitment, and independence. Further, directors themselves may decide that serving on boards is not worth the risk.

ENDNOTES

---

[1] Janet Shprintz, *Tale of 2 Mikes,* DAILY VARIETY GOTHAM, Oct 19, 2004 at 1. [hereinafter *Tale of 2 Mikes*].

[2] *Id.* at 13.

[3] As of 2004, Eisner was a lame duck CEO after serving at Disney since 1984. As a result of a shareholder rebellion in 2004, Eisner will step down as CEO in 2006. Eisner received a 45 % no confidence vote at the March 2004 shareholders' meeting. The Board of Directors took away Eisner's title of Chairman after the annual meeting. See Bruce Orwall, *In Court Case, a Vivid Portrayal of Eisner's Boardroom Tactics*, WALL STREET JOURNAL, Nov. 23, 2004 at A1. [hereinafter *In Court Case, a Vivid Portrayal of Eisner's Boardroom Tactics*].

[4] *Tale of 2 Mikes*, *supra* note 1, at 13.

[5] *Id.*

[6] *Id.* See also Jesse Hiestand, *Witness: Ovitz Firing Just*, THE HOLLYWOOD REPORTER, Oct. 22-24, 2004 at 82. [hereinafter *Witness: Ovitz Firing Just*]

[7] *Tale of 2 Mikes*, *supra* note 1, at 13.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Witness: Ovitz Firing Just*, *supra* note 6, at 3.

[19] *Id.*

[20] *Id* at 82.

[21] *Tale of 2 Mikes*, *supra* note 1, at 13.

[22] Peter Bart, *Mighty Mikes' Melee Takes Center Stage*, DAILY VARIETY GOTHAM, Oct 25, 2004, at 4.

[23] Jesse Hiestand, *Ovitz Pay 'Most Generous'*, THE HOLLYWOOD REPORTER, Oct. 26 – Nov 1, 2004, at 4.

[24] *Id.*

[25] *Id* at 96.

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] Jill Goldsmith, *Ovitz Felt the Pinch at Mouse*, DAILY VARIETY GOTHAM, Oct. 26, 2004, at 18.

[31] Jill Goldsmith, *Ovitz Blitz Hits Mouse*, DAILY VARIETY GOTHAM, Oct. 27, 2004, at 1.

[32] Janet Shprintz, *Panel Ok'd Ovitz After Hire*, DAILY VARIETY GOTHAM, Nov. 4, 2004, at 2.

[33] Jesse Hiestand, *Ovitz Negotiations Unusual*, THE HOLLYWOOD REPORTER, Nov. 8, 2004, at 3.

[34] *Id.*

[35] Jill Goldsmith, *Ovitz Exit Inevitable*. DAILY VARIETY GOTHAM. Dec. 10, 2004, at 69.

[36] Michael Learmonth, *Double Dipper Ok'd Ovitz*, DAILY VARIETY GOTHAM, Nov. 8, 2004, at 1. [hereinafter *Double Dipper Ok'd Ovitz*]

[37] *Id.*

[38] *Id* at 17.

[39] Jesse Hiestand, *Russell Defends Ovitz Hire Offer*, THE HOLLYWOOD REPORTER, Nov. 4, 2004, at 4.

[40] *Double Dipper Ok'd Ovitz*, *supra* note 36, at 17.

[41] Janet Shprintz, *Potier Playing Mouse Loyalist,* DAILY VARIETY GOTHAM, Dec. 8, 2004, at 8.

[42] Ann Donahue, *Ovitz Made $50 Bonus Pay*, DAILY VARIETY GOTHAM, Nov. 10, 2004, at 1.

[43] *Id.* at 11.

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *Id.* See also Bruce Orwall and Chad Bray, *Eisner defends Paper trail on Ovitz*, WALL STREET JOURNAL, Nov. 18, 2004, at A6.

[48] Jesse Hiestand, *Hiring Committee Gave Ovitz Major Stock Option Deal*, THE HOLLYWOOD REPORTER, Nov. 9-15 2004, at 4. [hereinafter *Hiring Committee Gave Ovitz Major Stock Option Deal*]

[49] Ann Donahue, *Ovitz Gifts Cause Rift*, DAILY VARIETY GOTHAM, Nov. 9, 2004, at 17.

[50] *Id.* at 17.

[51] *Id.*

[52] *Id.*

[53] *Hiring Committee Gave Ovitz Major Stock Option Deal, supra* note 48, at 104.

[54] Jill Goldsmith, *A Tale of 2 Mikes*, DAILY VARIETY GOTHAM, Nov. 17, 2004, at 1.

[55] *Id.*

[56] *Id.* at 19

[57] Jill Goldsmith, *Mouse Eyed Powell, Diller as Big Cheese*, DAILY VARIETY GOTHAM, Nov. 18, 2004, at 24 [hereinafter *Mouse Eyed Powell*]

[58] *Disney chief Defends Paying $140m to Fired President*, BOSTON GLOBE, Nov. 18, 2004, at E4.

[59] *Mouse Eyed Powell, supra* note 57, at 24.

[60] *Id.*

[61] Rita K. Farrell, *Ovitz Fired for Management Style, Ex-Disney Director Testifies*, NEW YORK TIMES, Nov. 13, 2004, at C4.

[62] Jill Goldsmith, *Lawyers Fire at Mouse's Torpid Board*, DAILY VARIETY GOTHAM, Nov. 24, 2004, at 1.

[63] *Id.*

[64] *Id* at 8.

[65] Jesse Hiestand, *Mitchell: Ovitz Reassignment Was Unwise.* THE HOLLYWOOD REPORTER, Nov. 24, 2004, at 19. [hereinafter *Mitchell: Ovitz Reassignment Was Unwise*].

[66] *Id.*

[67] *Litvack: No Ovitz 'Malfeasance.* THE HOLLYWOOD REPORTER, Dec. 1, 2004, at 4, 22. [hereinafter *Litvack: No Ovitz 'Malfeasance*].

[68] *Id* at 22.

[69] Ann Donahue, *CFO: Ovitz Never Fit In*, DAILY VARIETY GOTHAM, Dec. 7, 2004, at 60.

[70] *Id.*

[71] Peter Bart, *Of Mouse and Men: Did Board Drop the Ball?* DAILY VARIETY GOTHAM, Nov. 22, 2004, at 4.

[72] *Mitchell: Ovitz Reassignment Was Unwise. supra* note 65, at 1, 19.

[73] Jill Goldsmith, *Ovitz Exit Inevitable.* DAILY VARIETY GOTHAM. Dec.10, 2004, at 69.

[74] Jesse Hiestand, *Dis Lost Faith In Ovitz Early,* THE HOLLYWOOD REPORTER. Nov. 23-29, at 4.

[75] *Id.* at 60.

[76] Jesse Hiestand, *Litvack Defends Gift Giving.* THE HOLLYWOOD REPORTER, Dec. 3-5, 2004, at 4.

[77] *Litvack: No Ovitz 'Malfeasance, supra* note 67, at 4, 22.

[78] Pamela McClintock, *Street Backed Ovitz Hire.* DAILY VARIETY GOTHAM, Dec. 9, 2004, at 4.

[79] *Id.* at 29.

[80] *Id.* at 29.

[81] Rita K. Farrell, *Defense Lawyers in Disney Trial Try to Discredit a Witness*, NEW YORK TIMES, Oct. 23, 2004, at C2.

[82] *Id.*

[83] Richard A. Mann and Barry S. Roberts, BUSINESS LAW AND THE REGULATION OF BUSINESS, 730, West, 1999.

[84] *Id.*

[85] *Id.*

[86] *Id* at 734-735.

[87] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Section 302 (3).

[88] Barry Reiter, *Compensation Concerns*, 78 CMA MANAGEMENT, 24, 24-28 (2004).

[89] *Markets; CalPERS to Urge Curbs in Execs' Pay; The Pension Fund's Board Agrees to Take Companies It Invests in to Task Over the Issue of Excessive Compensation*, LOS ANGELES TIMES, Nov. 16, 2004, at C4.

[90] Andrew Countryman, *California Public Employees' Pension Board Takes On 'Obscene' Executive Pay,* KNIGHT RIDDER TRIBUNE BUSINESS NEWS, Nov. 16, 2004, at 1.

[91] Anne E. Moran, *IRS Audits of Executive Compensation Suggest the Need to Review Executive Pay Practices and Procedures*, 30 EMPLOYEE RELATIONS LAW JOURNAL, 100, 100-115 (2004).

[92] See *Sides in Ovitz Trial Bicker Over Missions Documents*, THE HOLLYWOOD REPORTER, Jan. 14-16, 2005. An article in the New Yorker magazine reportedly has Eisner allaying Ovitz's fear about the

Disney board not approving his appointment by Eisner "ticking off the various ways that Board members were beholden to him and assuring Ovitz that they would do what he wanted," at 118. See also, James B. Stewart, Disney War, Simon and Shuster, 2005. Laura M. Holson and Lorne Manly, *Much Ado About What's in a Disney Book*, NEW YORK TIMES, Jan. 31, 2005 at C1 and C6.

[93] Ralph Ferrara and Jocelyn Bramble, *Good faith! Good luck! Two Recent Court Decisions Look to be Embracing a New Judicial Device for Finding Liability,* 28 DIRECTORS & BOARDS, 8-10 (2004).

[94] Bruce Orwall and Chad Bray, *Outcome of Ovitz Suit to Affect Liabilities of Corporate Boards,* WALL STREET JOURNAL, Dec. 15, 2004 at B3.

[95] *Tale of 2 Mikes*, *supra* note 1, at 13.

[96] Sherrie R. Savett, *The "Indispensable Tool" of Shareholder Suits: Private securities Litigation is as Important as Ever as a Remedy for Failed Governance*, 28 DIRECTORS AND BOARDS, 12 (2004).

CRIMINAL LIABILITY FOR AMUSEMENT PARK DEATH AND INJURIES

by

Gwen Seaquist*
Marlene Barken**

INTRODUCTION AND BACKGROUND

Recently, there have been significant developments in the legal landscape affecting the liability of amusement parks for injuries and deaths occurring on the premises.[1] Partially due to a perceived increase in the number of deaths and serious injuries, civil suits are in the forefront of the news. [2] Numerous suits have been filed alleging a wide variety of underlying causes of action and relying often on "creative" legal theories.[3] Nevertheless, few plaintiffs have been successful.

A 1981 amendment to the Consumer Product Safety Act explicitly excluded fixed site rides from the authority of the Consumer Product Safety Commission(CPSC). [4] Known as the "roller coaster loophole," permanent rides such as those found at Disney World and Six Flags are not covered by any federal regulation.[5] In contrast, nonpermanent traveling carnivals and rides are subject to the jurisdiction of the CPSC.

Since 1999, and most recently in May of 2003, Representative Edward Markey of Massachusetts has unsuccessfully introduced legislation in the House to restore

---

* Coordinator, Legal Studies Program, Ithaca College
** Associate Professor of Legal Studies, Ithaca College

federal oversight of all amusement park rides.[6] His proposed Amusement Park Ride Safety Act would give the CPSC authority to investigate accidents, develop and enforce action plans to correct defects, act as a national clearinghouse for accident and defect data, and provide an annual appropriation of $500,000 to carry out these goals.[7]

Both permanent and nonpermanent rides may be subject to state regulation, but such regulation is highly variable. Some states have no applicable laws; others barely go beyond licensing requirements; and many provide limited or no penalties for noncompliance.[8]Additionally, it is difficult to ascertain the degree of risk consumers face at amusement parks because there is no central reporting agency and no uniform requirements on what type of injuries must be reported. [9]

This paper will provide a brief background of recent civil lawsuits, and then discuss in greater detail the emerging use of criminal sanctions against places of amusement, both domestically and internationally. In light of this growing body of law, it seems appropriate to provide for uniform regulatory coverage of fixed and nonpermanent amusement rides and to include criminal sanctions for noncompliance.

Civil Suits: An Overview

Since consumers cannot rely on the government to regulate the safety of amusement rides, they have in effect been forced to seek redress through private civil actions. It is notable that suits against amusement parks based upon negligence often fail because the plaintiff cannot sustain the burden of proof. Contributory or comparative negligence and assumption of the risk may bar recovery, and often defendants argue that a lack of parental supervision caused the injury. Strict liability theories fail because the courts are reluctant to extend strict liability to a

service, as opposed to a good.[10] They have allowed the doctrine to apply when the patron proves that the ride is a bailment; but this is only true when the guest has control over the ride, or the amusement park relinquishes control over the ride.[11] Another creative theory is that an amusement park ride is equivalent to a common carrier.[12] Since a common carrier is held to a duty of "utmost care and diligence at common law"[13], then the ride in an amusement park is also subject to strict liability. This argument, understandably, has met with much skepticism by the courts.[14]

Criminal Liability

It is difficult to imagine a case more illustrative of criminal negligence than that of 15-year-old Leslie Lane. She died in 1998 while riding the Himalayan. Her lap bar broke and she was thrown against a wall at a Texas fair. Police investigators concluded that the ride was "poorly maintained"; that the ride operators and owners had been advised of safety problems before the incident; that the ride was being operated at "unsafe" speeds; that the restraint equipment was inadequate; and that the ride used cotter pins too small to hold the lap bars in place. Investigators determined that the lap bar had broken off from the car at all three points of attachment.[15]

Initially prosecutors charged the carnival owners, ride operators, maintenance workers, and safety inspectors with murder.[16] The indictments stated that all nine parties "knowingly and intentionally" caused the death of the victim. The grand jury concluded that the ride was operated faster than the specifications set forth by the ride's manufacturer, that the lap bar was not properly fastened to the car, that the safety latch was inadequate, that the ride had not been adequately inspected, and that the owners and operators of the ride allowed it to continue to operate even after they had been

notified that parts of the ride were broken.[17] Ultimately, the owner of the ride pled guilty to manslaughter in return for a 30-day jail sentence and six years of probation.[18] For the first time in the United States, a court imposed criminal liability for a death at an amusement park.[19]

Grand jurors who heard the evidence against the amusement ride owner were so appalled that they called for increased regulation of carnival rides after returning the manslaughter indictments. "Each carnival ride is transported, set up, and torn down by unskilled and poorly trained employees for each of these events," said jurors. "Testimony has indicated that our state has little or no control of this industry."[20]

The fact that the ride operators ignored warnings about the broken bars, as well as cries to stop the ride when the bars broke, may have been factors that prompted prosecutors to seek criminal charges.[21] Additionally, once the charges were published, the Travis County District Attorney's office learned of other problems with the same ride. For example, an accident on the Himalayan seriously injured two women at a fair in California in 1991 when one woman was thrown from the ride because of the same problems with the pins that attached the safety bar to the floor of the car.[22] At least two other accidents in which riders were thrown from their cars on Himalayas occurred in Florida and Missouri.[23] In light of this history, it is understandable why Travis County prosecutors deemed the case worthy of criminal prosecution.

Subsequently, the Texas State Senate proposed legislation that requires qualified, private ride inspectors to inspect rides every 180 days and to keep inspection logs for governmental review. In addition, the statute would impose criminal penalties.[24]

Note that the Texas case was prosecuted pursuant to the state criminal code. Likewise, in January of 2004, three workers in Ohio were charged with reckless homicide, involuntary manslaughter and dereliction of duty for the death of an 8 year old boy under an Ohio state statute.[25] The boy was waiting in line at the Ohio Lake County Fair to ride the bumper cars. He suffered an electrical shock from charges running through the floor and an electric cord nearby. The case marks the first time in Ohio that criminal charges have been filed as the result of an amusement ride fatality.[26]

To date, no other successful criminal prosecutions against amusement park operators exist. Prosecutors in Oklahoma considered, but then declined to prosecute for the death of a young boy on a roller coaster.[27] Prosecutors said at the time that Oklahoma's Amusement Ride Safety Act[28] was too vague to enforce, and the act lacks criminal sanctions. They also said that they could not mount successful second-degree manslaughter cases against either the operator or the amusement park itself, because their actions did not reach the necessary degree of negligence."[29] Nevertheless, the prosecutor's office did perform an extensive investigation when deciding not to bring criminal charges.[30]

Lacking statutory authority and/or any evidence of willful wrongdoing, district attorneys understandably hesitate to prosecute. A recent case in California is probably typical. Here, a 12 year old boy fell from a ride equipped with a contoured seat and an over-the-shoulder safety harness. No charges were filed and an investigation of the accident yielded no explanation of how the accident happened.[31]

Criminal Liability Outside the United States

While United States prosecutors may be reluctant to pursue criminal actions, this is not true outside the states. Foreign countries have successfully prosecuted both inspectors and ride assistants for criminal negligence.

Canada enacted legislation in 1990 entitled the "Amusement Devices Act." This statute sets standards for amusement parks in the province of Ontario that include the duty to inspect on a continual basis and maintain safety standards. For example, one part of the provision states that:

> Every attendant shall,
> (c.) ensure that persons move safely to or from the amusement device to which the attendant is assigned;
> (d.) ensure that persons using the amusement device to which the attendant is assigned are properly instructed with respect to the use of the area and components under the attendant's supervision.[32]

The failure to abide by the code can lead to charges and fines of up to $100,000 for each count for corporations and $25,000 for individuals.[33] The largest fine imposed to date was $148,000.00 in connection with the 1998 tragic accident at the Central Canadian Exhibition in Ottawa. A 21- year-old man plunged to his death when a bungee cable snapped. Anderson Ventures, a Delaware corporation, was convicted of three violations for illegally substituting a nylon extension strap that disengaged and killed the rider. According to newspaper reports, Doug Anderson, the president of the company, admitted at trial that, "the illegal and unsafe nylon strap was used hundreds of times prior to the incident." [34]

In 1999, Conklin & Garrett Ltd., the world's largest amusement-ride operator was criminally charged in connection with an accident at the Canadian National Exhibition that injured 18 people, most of them children. A lift system on the Wave Swinger ride failed, dropping 48 people strapped in their seats more than two meters. Most of their injuries were minor. As a result, Canada's Technical Standards and Safety Authority laid three charges against owners of the midway rides: replacing equipment with material not of the same strength and quality as that initially supplied by the manufacturer; failing to examine an amusement ride at regular intervals to ensure safe operation; and failing to replace worn, defective or broken components on a ride.[35]

The same company was fined $15,000.00 after pleading guilty to two violations of the Ontario Amusement Devices Act in connection with another accident.[36] This time, a girl was seriously injured by a flying piece of a midway ride. The girl was attending the 1995 Canadian National Exhibit, when a ride owned by Conklin injured her. In addition to the fines incurred, she received $775,000.00 in 2000 to settle her suit with Conklin and Garrett.[37]

According to newspaper reports, one of Australia's largest amusement park operators, Wittingslow Entertainment Services, was found guilty on 33 counts of failing to take adequate steps to avoid risk to members of the public; four counts of failing to protect the safety of employees; two counts of failing to comply with the maintenance recommendations of the ride's manufacturer; and one count of failing to ensure that the ride was maintained in a safe condition. One of its rides, the "Spin Dragon" collapsed injuring 37 people. Investigators found that 44 of the 48 bolts which held the ride's carriage to its two lifting arms had either failed, loosened, or had been undone completely. The bolts sheered off from the ride,

causing the passenger platform to break free from its mountings and crash to the ground. After finding the company guilty, they were ordered to pay $20,000.00 to each victim and fined $147,500.00. [38]

In another incident in Australia, an eleven-year-old girl died on an Octopus amusement ride, when one of the rides' arms broke off during a fair at the Ryletone fairgrounds near Mudgee, Australia. A ride operator was charged with manslaughter.[39]

The death of an Indian man who was killed in a fall from a swing ride resulted in charges against the operator of the ride and the ride attendant. Under India's Penal Code, the two will be charged with causing death due to a rash and negligent act, and causing the disappearance of evidence or giving false information.[40]

In Great Britain, a ride inspector was found guilty of manslaughter for the deaths of two people. They died from injuries they sustained when the car they were riding in, called a Super Trooper, flew through the air and crashed into a concession stand at a London fair. The ride inspector's guilt stemmed from his failure to notice cracks and rust on the 18 year old ride. [41]

In a recent British case, the owner of an amusement park was found guilty under Great Britain's Health and Safety at Work Act. The jury found that the park's operator, Dreamland Leisure, "failed to ensure so far as reasonably practicable that passengers were properly contained in the ride between August 15, 1999 and September 11, 1999." A girl fell out of one of the cars, struck her head and died a day later. The company was ordered to pay $40,000.00 in fines and restitution to the mother in the amount of $200,000.00.[42]

The above cases illustrate a variety of prosecutorial approaches, including actions pursuant to specific amusement park statutes, general health and safety laws, and penal code provisions. Note also in some cases, the relevant codes provide monetary relief for the injured parties.

CONCLUSION

The foregoing review of state regulatory attempts and the mixed patchwork of prosecutorial efforts reveal that no matter how diligent a particular state may be, the lack of federal oversight of the amusement park industry is a serious problem. Millions of consumers erroneously assume that safety standards must somehow be higher at pricey destination theme parks, yet these fixed site rides remain beyond the purview of the CPSC. As the rides get faster and the thrills get bigger, so too the fatality and injury rates have risen on fixed, unregulated rides. Plaintiffs typically have difficulty obtaining civil redress for such injuries, and few states provide adequate statutory guidance for prosecutors to take criminal action.

Congress should look closely at the approach taken in Canada, Great Britain, Australia, and India, where clear criminal liability is imposed for violation of health and safety laws applicable to amusement parks. The authors endorse Representative Markey's proposed legislation to close the roller coaster loophole and to restore CPSC jurisdiction over fixed site rides. Moreover, Congress should impose significant criminal penalties for owners, operators and inspectors of amusement park rides who fail to comply with safety standards.

ENDNOTES

---

1 J. Mc Dowell, Thrill Rides Headed For Slowdown? Several Lawsuits Wind Their Way Toward Greater Safety Regulations, TIME MAGAZINE, Dec. 15, 2003; Ruben, P., Scared to Death: Do Breakneck Speeds and High-g Turns Push Thrill Rides to a Lethal New Level, http://www.popularmechanics.com/science/medicine/2003/8/scared_to_death/ (Last visited April 29, 2004).

2 For example, the CPSC found that, in 1999, an estimated 7,260 people were injured on rides at amusement parks and required emergency room treatment. That number is up 12% from 1998 and 95% from 1996. The study also says that roller coasters are responsible for more deaths than any other type of ride; they accounted for 15 of the 49 amusement ride-related deaths over the last twelve years.ohttp://www.ivillagehealth.com/interests/healthy/articles/0,,242974_245239,00.html?arrivalSA=1&cobrandRef=0&arrival_freqCap=2.

3 See, e.g., Seaquist, G. and Barken, M., *Should Amusement Parks Be Federally Regulated*? Business Law Review, 35:111-123, Spring, 2002.

4 The amendments added provisions that the term "consumer product" includes any mechanical device which carries or conveys and which is not permanently fixed to a site and that such term does not include such a device which is permanently fixed to a site. 15 U.S.C. 2052 (I) (1981).

5 Statement of Representative Edward Markey introducing the National Amusement Park Ride Safety Act of 2003, May 22, 2003. Wood, Sean, Congressman To Press For Federal Regulation Of Amusement Park .centredaily.com/mld/centredaily/news/5261153.htm.

6 Timeline: The National Amusement Park Ride Safety Act, http://www.saferparks.org/national-safety –act.htm.

7 Statement of Representative Edward Markey, supra.

8 Statutes Directly Relating to Amusement Parks. The following are state statutes relating directly to amusement parks that either explain regulations or state the penalty for failing to adhere to state law on amusement ride

regulation (states not listed have no applicable statute): Alaska Stat. § 05.20.010 (2004) ("An owner or operator of a device . . . shall construct, furnish, maintain, and provide safe and adequate facilities and equipment with which to safely and properly receive and carry all persons offered to and received by the owner or operator of the device."); Cal. Labor Code § 7930 (2004) ("If the division determines that any owner or operator of a permanent amusement ride . . . has willfully or intentionally violated this part or any rule or regulation promulgated under this part, and that violation results in a death or serious . . . the division shall impose on that owner or operator a civil penalty of not less than twenty-five thousand dollars ($25,000) and not more than seventy thousand dollars ($ 70,000)."); Fla. Stat. § 616.242(19) (2004) (establishing fines of up to $2500.00 per day for specified violations); 430 Ill. Comp. Stat. 85/2-15 (2004) ("Any person who operates an amusement ride or amusement attraction at a carnival or fair without having obtained a permit from the Director or who violates any order or rule issued by the Director or Board under this Act is guilty of a Class A misdemeanor. Each day shall constitute a separate and distinct offense."); Kansas: Insurance requirements only, local jurisdictions enforce. La. Rev. Stat. Ann. § 40:1484.7 (2004) (A violation of inspection and maintenance standards "shall constitute a misdemeanor offense punishable by a fine of not more than one thousand dollars and imprisonment for not more than thirty days or both."); Maine: Mechanical ride regulations were REPEALED. Michigan: Act 225 of 1966, 408.667, Sec. 17.(2): Violation of act is a misdemeanor. Each day is separate offense. No penalties specified. Minn. Stat. § 184B.06 (2004) ("A person that violates sections 184B.01 to 184B.05 is subject to a fine of up to $ 2,000 for each day the violation exists."); Mo. Rev. Stat. § 316.218 (2004) ("Any person who knowingly operates, causes to be operated or directs someone to operate an amusement ride in violation of sections 316.203 to 316.233 is guilty of a class A misdemeanor."); Neb. Rev. Stat. § 48-1816 (2004) ("Any person who knowingly operates or causes to be operated an amusement ride in violation of the Nebraska Amusement Ride Act shall be guilty of a Class II misdemeanor. Each day a violation continues shall constitute a separate offense."); Nev. Rev. Stat. 455B.020 (2004) ("An operator shall take all measures reasonably necessary to ensure the safety of the passengers in constructing, maintaining, operating and supervising an amusement ride."); N.H. Rev. Stat. Ann. § 321-A:9 (2003) ("Any person convicted of operating a carnival or amusement ride without having first registered it with the commissioner . . . or violating the rules adopted by the commissioner . . . shall be guilty of a violation if a natural person, or guilty of a misdemeanor if any other person. Any operator or owner who operates

after a suspension . . . shall be guilty of a violation for each day of illegal operation."); N.J. Stat. Ann. § 5:3-54 (2004) ("Any person who interferes in any manner with the implementation of or otherwise fails to comply with the provisions of this act [regulating amusement rides], shall be liable to a fine of not more than $ 5,000 per day for each violation to be adjudged . ."); N.Y. Labor Law § 870-j (2004): Civil penalties

1. Any person who knowingly and willfully operates an amusement device, viewing stand or tent without any of the following:

(a) the permit required by section eight hundred seventy-d of this article; or

(b) the inspections required by section eight hundred seventy-e of this article; or

(c) the insurance or other security required by section eight hundred seventy-f of this article shall be subject to a civil penalty not to exceed two thousand dollars for each day the violation continues.

2. Any person who operates an amusement device, viewing stand or tent without any of the following:

(a) the permit required by section eight hundred seventy-d of this article; or

(b) the inspections required by section eight hundred seventy-e of this article; or

(c) the insurance or other security required by section eight hundred seventy-f of this article shall be subject to a civil penalty not to exceed a total of two thousand dollars.

3. The commissioner, in assessing penalties under [fig 1] subdivision one of this section, shall give due consideration to the appropriateness of the penalty with respect to the size of the owner's or lessee's business, the good faith of the owner or lessee and his history of previous violation.

N.Y. Labor Law § 870-j (2004): Criminal penalties

1. (a) Any owner or lessee of an amusement device, viewing stand or tent who willfully violates any provision of this article or any rule, regulation, standard or order promulgated pursuant to this article, and that violation

causes . . . physical injury to any member of the public exposed to the violation, is guilty of a class A misdemeanor and upon conviction shall be sentenced in accordance with the provisions of the penal law.

(b) Any owner or lessee of an amusement device, viewing stand or tent who willfully violates any provision of this article or any rule, regulation, standard or order promulgated pursuant to this article, and that violation causes death or serious physical injury to any member of the public exposed to the violation, is guilty of a class E felony and upon conviction shall be sentenced in accordance with the provisions of the penal law.

(c) For the purposes of this subdivision, the term "physical injury" shall have the same meaning as that term is defined in subdivision nine of section 10.00 of the penal law and the term "serious physical injury" shall have the same meaning as that term is defined in subdivision ten of section 10.00 of the penal law.

2. A person who knowingly makes any false statement, representation, or certification in any application, record, report, plan or other document filed or required to be maintained pursuant to this article, is guilty of a misdemeanor and upon conviction is subject to a fine of not more than two thousand five hundred dollars or imprisonment for not more than six months, or both.

3. Nothing contained in this section shall be construed to limit or preclude a prosecution under any provision of the penal law.

N.D. Cent. Code § 53-05.1-05 (2004) ("A person who violates this chapter is guilty of a class A misdemeanor. The governing body of a city or county may seek an injunction against a person operating an amusement ride in violation of this chapter."); Ohio Rev. Code Ann. § 1711.56 (2004) (violation of statutes regulating amusement park rides punishable by up to $5000.00 fine); Or. Rev. Stat. § 460.320(1)(a) (2004) ("No person shall: Operate an amusement ride or device without a valid operation permit . . . or allow an amusement ride or device owned, leased, controlled or managed by the person to be so operated"); Or. Rev. Stat. § 460.990(2) (2004) ("Violation of [§ 460.320] is a Class B misdemeanor"); 4 Pa. Stat. Ann. §§ 401-415 (2004) (Amusement Ride Inspection Act) and 4 Pa. Stat. Ann. §§ 501-507 (2004) (Amusement Rider Safety and Liability Act); R.I. Gen. Laws § 23-34.1-15(a)-(b) (2004) ("Any violation of the provision of this chapter shall result in a revocation of the permit or certificate to operate, or

both until all violations are abated. (b) Any person who willfully violates the provision of this chapter, or any order or regulation made pursuant to the provisions thereof shall be fined not more than five thousand dollars ($5,000) or imprisoned not more than one (1) year or both."); S.C. Code Ann. § 41-18-10 (2003) (South Carolina Amusement Rides Safety Code); S.D. Codified Laws § 42-10-2 (2003) ("No person may own, operate or lease an amusement ride in this state unless the person purchases insurance in an amount not less than one million dollars against liability for injury or death to persons arising out of the use of the amusement ride. Any owner, operator or lessee of an amusement ride who fails to purchase liability insurance is guilty of a Class 1 misdemeanor."); Tenn. Code Ann. § 56-38-105 (2004)("Any person who operates an amusement ride or amusement attraction in violation of this chapter commits a Class C misdemeanor. Each day a violation occurs constitutes a separate offense."); Utah Code Ann. § 78-27-61(2) (2004) ("An amusement park shall inform riders in writing, where appropriate, of the nature of the ride, including factors which would assist riders in determining whether they should participate in the ride activity and the rules concerning conduct on each ride. Information concerning the rules of conduct may be given verbally at the beginning of each ride segment or posted in writing conspicuously at the entrance to each ride."); Vt. Stat. Ann. tit. 31, § 724 (2003) ("An operator or owner who violates any provision of this chapter shall be fined no more than $ 500.00 per day for each day the violation continues."); Va. Code Ann. § 36-98.3 (2004) (establishing regulation for certificates of inspection, maintenance, reporting, and certification, with authority given to local jurisdictions to enforce provisions of act and levy penalties.); Wash. Rev. Code § 67.42.070 (2004) ("Any person who operates an amusement ride or structure without complying with the requirements of this chapter is guilty of a gross misdemeanor."); W. Va. Code § 21-10-1 (2004) (Amusement Rides and Amusement Attractions Safety Act; violation is a civil penalty up to $5,000.).

9 Only thirty-seven states require public reporting of amusement park accidents and many of those states limit reporting to death and catastrophic injuries. For example, injuries such as broken bones and concussions are only reported in 24 of the 50 states. See International Association of Amusement Parks and Attractions Website http://www.iappa.org. For detailed information about amusement park accidents world wide, see RideAccident.com.

10 See *Siciliana v. Capitol City Shows, Inc.*, 475 A.2d 19 (N.H. 1984. Because the amusement ride company in this case was engaged in the service of selling rides, it provided a service and not a product; see also *Eves v. S.P. Parks, Inc.*, 1988 WL 109107, at *1 (E.D.Pa.1988)in which the court applied Pennsylvania law to dismiss a strict liability action brought by a plaintiff who had paid an admission fee to enter a water amusement park and later sustained injuries while riding a water slide. The court held that in the absence of a sale, lease, or bailment of the product, there was not a commercial transaction significant enough to involve Pennsylvania's adoption of section §402-A of the Restatement of Torts; *Rossetti v. Busch Entertainment Corporation,* 87 F.Supp.2d 415 (E.D. Pa. 2000) (where a plaintiff was injured on a water slide ride on which small groups of patrons descended in oversized rafts did not argue that the raft ride constituted a bailment, but rather that the amusement park was a "seller" of goods, which the court summarily rejected).

11 See *Sells v. Six Flags Over Texas*, 1997 WL 527320 C2(N.D.Tex.1997). Courts have distinguished between parks that maintain control over a ride from those that relinquish control and possession to their patrons. In the present case, it was undisputed that Six Flags retained possession and control. Hence, "this case is therefore distinguishable from those involving a bailment, where a patron has exclusive control over an amusement park ride". Id. at 8.

12 See *Gomez v. Superior Court*, 1 Cal.Rptr.3d 860 (Cal. App. 2003). While the court in *Gomez* initially held that places of amusement in California are common carriers, it was later reversed in *Gomez v. Superior Court* (Disney), 79 P.3d 539(Cal. 2003).

13 *Id.*

14 *Id.*

15 http://members.aol.com/rides911/1998.htm#texas7 1998 News Archive.

16 On November 20, 2000, the owner of B&B Amusements, Robert Merten, Sr., pleaded guilty to manslaughter charges which had been brought against him in connection with the death of Leslie Lane. Merten pleaded guilty on his own behalf, and on behalf of his company. On May 11, 2001, Bob G. Gill, the man who inspected the Himalaya ride, pled guilty to manslaughter on behalf of his company, Bob G. Gill & Associates. In

addition, Gill pleaded guilty to a misdemeanor charge on his own behalf. Bob G. Gill & Associates is no longer in business. B&B Amusements still operates amusement rides. For detailed information about this case, *see*: "Amusement Parks Accident Reports and News," http://members.aol.com/rides911/accidents.htm.

17 http://members.aol.com/rides911/1998.htm#texas7. *See also* the Texas Department of Insurance website, http://www.tdi.state.tx.us/commish/news/nr12309a.html.

18 See No Defense, The B & B Himalaya Tragedy, *http://members.aol.com/rides911/himalaya.htm. The owner of B&B Amusements has pleaded guilty to manslaughter charges in the case of the 1998 Texas Himalaya accident which left a 15-year-old girl dead. In addition to pleading guilty on his own behalf, Robert Merten, Sr. also pleaded guilty to manslaughter on behalf of his company. The guilty plea makes B&B Amusements the first carnival operator in American history to be held criminally responsible for the death of a patron which resulted from negligence. The manslaughter indictment said that the victim, 15-year-old Leslie Lane, was 'restrained by a lap bar with an inadequate latching mechanism and a lap bar attachment that was inadequate to secure the lap bar to the amusement ride.'*

19 Id.

20 "Amusement Parks Accident Reports and News,"http://members.aol.com/rides911/accidents.htm.

21 According to reports, In the affidavit, Detective Mark Gilchrest said that several riders had called him after the accident telling him that the Himalayan experienced safety problems during the day on Thursday, and that ride operators were not checking to make sure that restraining bar latches were secured before they operated the ride. He also said that some riders told him that the ride was being operated too fast, Gilchrest also noted his observation that the ride appeared to be "poorly maintained," and that he had reason to believe that the ride was being operated at an unsafe speed. *Id.*

22 http://members.aol.com/rides9ll/1998.htm#texas6.

23 *Id.*

24 For the proposed Texas legislation, *see*: TX S.B. 279 (SN), 2003, Texas Senate Bill No. 279, Texas 78th Legislature (Mar 06, 2003).

25 http://www.rideaccidents.com/2004.html#jan17b

26 *Id.*

27 http://members.aol.com/rides911/bells1.txt contains the executive summary reported by the Oklahoma Department of Labor investigating the incident. The report identifies possible violations of the Oklahoma Amusement Ride Safety Act, Title 40, O.S. 1991, 460.

28 *Id.*

29 *Id.*

30 http://members.aol.com/rides911/bells1.txt contains the executive summary reported by the Oklahoma Department of Labor investigating the incident.

31 http://members.aol.com/rides911/1999.htm.

32 The Amusement Devices Act, S.O. 1986, c.6 R.S.O. 1990.

33 *Id.*

34 http://members.aol.com/rides911/2000.htm#feb22.

35 http://members.aol.com/rides911/1999.htm#sep21.

36 http://members.aol.com/rides911/2000.htm.

37 *Id.*

38 http://members.aol.com/rides911/2003.htm#nov20.

39http://mombers.aol.com/rides911/accidents.htm.

40 http://members.aol.com/rides911/2003.htm#nov20.

41 http://members.aol.com/rides911/2002.htm#nov26.

42 http://members.aol.com/rides911/2003.htm#nov20.

CLASSROOM WARFARE – *AICPA and AACSB v. LEGAL STUDIES;* RESULT: THE NEW CPA EXAM

by

Peter M. Edelstein*

ABSTRACT

The American Institute of Certified Public Accountants ("AICPA") and the Association to Advance Collegiate Schools of Business ("AACSB") either intentionally or because of shortsightedness or ignorance have diminished the importance of the study of law. By choosing to ignore the news headlines and the illegal and unethical behavior of some executives, these organizations fail to realize the connection between a knowledge of the law and the quality of business leaders. The marginalization of legal studies ill serves our students. The new computerized CPA Exam is the latest manifestation of this trend.

I. INTRODUCTION

If ever there was a period in history in which one could say that a fundamental knowledge of law is a practical necessity, it is now. All variety of laws, rules and regulations are ubiquitous

---

* Professor of Law, Pace University Lubin School of Business, Pleasantville, New York

and intrusive in our daily life. Ask any small business owner who seeks a license or even any homeowner who wants to refinance.

A basic knowledge of the law is not a luxury, but a necessity, not only to successfully navigate the maze of a free economy, but to maintain an ethical and moral society; one in which the sanctity of rules is respected.

It is this author's opinion that Law 101, or its equivalent, should be a requirement for every college student.

II. THE DEATH OF THE STUDY OF BAILMENTS

The subject of bailments is an ancient area of the law and still represents one of the most common transactions. [1] Bailments is a wonderful subject. It is manageable in scope and rewarding to study.

- Bailments combine contract law and tort law, and serves to refresh the student in both areas, which is especially important if contracts and torts were studied in a previous or introductory law course. [2]

- Bailments serve as an excellent vehicle for explaining and illustrating the difference between real and personal property ("goods," under the UCC). [3] A difference that is meaningful in virtually all commercial law courses.

- Bailments introduce and distinguish the concepts of title and possession that is the foundation for learning

documents of title, transfer of title, risk of loss, personal property, insurance, real property and even trusts and estates. [4]

- Bailments raise the issue of ethics and pose an ethical dilemma. Is it fair that a person, separated from his or her property, and thus unaware of what may have happened to it, should have the burden of proving that the defendant was negligent? [5]

- Bailments explains and illustrates the function of a legal "presumption," that operates as a "plaintiff's helper," by shifting the burden of proof to the defendant to show the absence of negligence. [6]

- Bailments serve as the perfect and graceful link between Law 101 and its basic and introductory content and subsequent law courses with content that may focus on transactional concepts.

If the law of bailments did not exist, some clever professor would invent it. It offers a natural path from the familiar to the new with the bonus of a dose of ethics.

Under the new Uniform CPA Examination which became effective in April of this year, bailments, among other subjects, is no longer covered. The great loss is not that future CPAs will not know what a bailment is, but that they will be deprived of such a valuable learning exercise.

III. THE AICPA JUST DOESN'T GET IT

The AICPA, in justifying its changes to the substance of the CPA Exam stated its objective, in salient part:

> "To keep pace with the evolution of the accounting profession and the business world...and to provide ongoing protection of the public interest...[To] help insure that CPA candidates continue to demonstrate *the knowledge and skill needed to protect the public*"[7] (emphasis added).

Doesn't the AICPA read the newspapers? In as few words as possible, the author would merely suggest that the accounting profession review the following case studies, among many others: ENRON, WorldCom, Arthur Anderson, Adelphia, Xerox, Global Crossing, Merrill Lynch, Quest [8] and Martha Stewart. [9]

It would be presumptuous to assume that if the executives of the companies listed were familiar with the applicable laws, these respective scandals would not have occurred. But in view of the common theme of the oft-repeated defenses amounting to: "I didn't know," it seems that the marginalization of law by the accounting profession is misguided.

IV. THE AACSB DOESN'T GET IT EITHER

The AACSB[10] is an accrediting organization, recognition from which many business schools aspire. It was founded in 1916, and first set standards for business schools in 1919. [11]

It [12] publishes a document entitled "Eligibility Procedures and Standards for Business Accreditation" [13](hereinafter, the "Standards") that states in its Introduction:

> "...the Association to advance collegiate schools of business promotes continuous quality improvements in management education." [14]

Thereafter, the Standards include a section entitled "Standards for Business Accreditation" [15] that includes the heading "Assurance of Learning Standards, 15. Management of Curricula," which requires:

> "...an undergraduate degree program that includes learning experiences in such general knowledge and such areas as:
>
> - Communication abilities
> - Ethical understanding and reasoning abilities
> - Analytical skills
> - Use of information technology
> - Multicultural and diversity understanding
> - Reflective thinking skills." [16]

If ever there was a single area of study that nearly perfectly satisfied the AACSB accreditation standards, it is the study of law. Addressing their requirements in sequence:

- ***Communication Abilities.*** The study of law includes writing briefs, use of the Socratic method of discourse in the classroom, exams with essay questions, homework problems requiring written answers.

- ***Ethical Understanding and Reasoning Abilities.*** The study of the law is the study of social values, morals and ethics. From the basic query: is it fair that a promise made without consideration not be enforced, to the philosophical: should an agreement, in all other respects enforceable, not be enforced because it is unconscionable?

- ***Analytical Skills.*** Who has not heard the old pronouncement in law school: "The study of law teaches you how to think?" The process of briefing a case is a standard and consistent methodology used to analyze the facts, determine the issues to be decided, apply the applicable law, and arrive at a logical conclusion. The study of law is in great measure learning the ability to analyze, including thinking critically, to apply the rules, and make a decision.

- ***Use of Information Technology.*** Many readers of this paper may be too young to remember going to the law library in law school, searching for a case, hoping the volume sought was in the stacks, praying that some overly eager and competitive classmate had not ripped the case from the book; finding it, searching for nickels for the copy machine, and crossing your fingers that the copy machine was working. Today, our students have

access to those miracles of technology, LexisNexis [17] and the Internet. In a fraction of a second, cases, statutes, public information and news items can be in our student's hands. The study of law has adapted to information technology like it was designed for it.

- ***Multicultural and Diversity Understanding.*** *Brown v. Board of Education,* [18] *Rowe v. Wade* [19] and thousands of other cases represent real people, actual emotions, decisions that shaped the world as we know it today. What other business subject can offer such a passionate insight into how we have evolved as a society?

- ***Reflective Thinking Skills.*** What is the study of law if not a medium for reflective thinking? Is a case decision good law? Is the result fair and equitable? Can the law ever be unethical? Can an unethical act ever be legal? Briefing cases justifies and defends a decision. Studying the brief explains the legal reasoning. Comparing briefs distinguishes cases.

It is submitted that the study of the law is a necessary part of the education of every CPA and every manager, but that legal studies absolutely should be embraced by the AACSB as the ideal subject area. Yet, the AACSB doesn't seem to recognize this.

Professor Fran Zollers in her excellent article in the Spring 2004 issue of the ALSB Newsletter [20] reports on the latest AACSB fiasco. One must really question the rationality or motivation of those that lead that organization. While it may not be a cosmic change, the J.D. degree has been relegated (as of

this writing) to a separate category at the bottom of the list of "academically qualified faculty possessing a doctoral degree in the area in which the individual teaches..."

This issue arises just after the near death, but successful struggle to retain law and ethics in the AACSB standards. [21] While the J.D. issue is still not resolved (as of this writing), the recurrent problems are continuing evidence of their total lack of appreciation of and respect for the study of law.

V. THE NEW COMPUTER-BASED UNIFORM CPA EXAMINATION

The historic paper-based exam that extended over fifteen hours and contained parts covering business law and professional responsibilities; accounting and reporting; auditing; and financial accounting and reporting. Business Law has now been eliminated as a separate section.

The AICPA, [22] the National Association of State Boards of Accounting (NASBA)[23] and a private company, Prometric, [24] collaborated to design and administer the new exam. The changes were the result of a 2002 AICPA "practice analysis" survey to which hundreds of CPA's responded by identifying the most important requirements for the future CPA's. [25]

The new exam will still have four sections: Auditing & Attestation (4.5 hours), Financial Accounting & Reporting (4 hours), Regulations (3 hours), and Business Environment & Concepts (2.5 hours). [26]

The new test will be offered year-round at Prometric facilities and State Board testing facilities [27] in a format that will consist of multiple choice questions and case-studies ("simulations"). The simulations will require the student to do computer-based research. [28] The test will be available up to six days a week in two of every three months, instead of only twice a year. [29]

The new form and schedule will probably appeal to those CPA candidates who are computer literate or wish to break the testing process into smaller parts. They can now take the exam up to four times a year and can take each part separately. [30]

It is, however, the content of the revised exam, rather than the form, that further relegates the law to stepchild status. A new section, entitled "Business Environment & Concepts" includes coverage of business structures (17-34%) [31], economics, financial management, information technology and planning and measurement. [32] In addition to the new section, law teachers must now focus on another section of the exam that also tests law subjects: the *Regulation* part. According to the AICPA, the *Regulation* section will examine among other topics, professional and legal responsibility, business law, and the skills needed to apply that knowledge. [33] The general breakdown is Ethics and Professional Responsibilities (15-20%), and Business Law (20-25%). [34]

The AICPA describes the *Regulation* section as follows:

> "The [section] tests candidates' knowledge of federal taxation, ethics, professional and legal responsibilities, and *business law* and the skills necessary to apply that knowledge." [35]

In the *Business Law* section compromising 20-25 percent of the exam, the following topics are tested:

A. Agency

1. Formation and termination
2. Duties and authority of agents and principals
3. Liabilities and authority of agents and principals

B. Contracts

1. Formation
2. Performance
3. Third-party assignments
4. Discharge, breach, and remedies

C. Debtor-creditor relationships

1. Rights, duties, and liabilities of debtors, creditors, and guarantors
2. Bankruptcy

D. Government Regulation of Business

1. Federal Securities Act
2. Other government regulations such as antitrust, pension and retirement plans, union and employee relations, and legal liability for payroll and social security taxes.

E. Uniform Commercial Code

1. Negotiable instruments and letters of credit
2. Sales
3. Secured transactions
4. Documents of title and title transfer

F. Real property, including insurance[36]

The new *Business Environment & Concepts* section is described as follows:

> "...[the] section tests knowledge of general business environment and business concepts that candidates need to know in order to understand the underlying business reasons for and accounting implications of transactions, and the skills needed to apply that knowledge in performing financial statement audit and attestation engagements and other functions normally performed by CPAs that affect the public interest. Content covered in this section includes knowledge of business structure; economic concepts essential to obtaining an understanding of an entity's operations, business and industry; financial management; information technology; and planning and measurement."[37]

The law specific topics covered include:

Business Structures (17%-23%)

A. Advantages, implications, and constraints of legal structures for business

1. Sole proprietorships and general limited partnerships
2. Limited liability companies (LLC), limited liability partnerships (LLP), and joint ventures
3. Subchapter C and subchapter S corporations

B. Formation, operation and termination

C. Financial structure, capitalization, profit and loss allocation, and distributions

D. Rights, duties, legal obligations, and authority of owners and management (directors, officers, stockholders, partners and other owners). [38]

The AICPA has published a more detailed "Content Specification" for the new Business and Environment Concepts section. [39] A copy is attached hereto as Appendix "A."

VI. WHAT TO TEACH?

If among our students are CPA candidates, professors have a responsibility to teach, address, or at least warn about the CPA exam content coverage. To those in class who are not CPA candidates, the CPA Exam required subjects may be somewhat esoteric but not out of the realm of useful knowledge.

For those with a CPA-centric focus, the changes now require coverage of:

- Letters of Credit
- Pension and Retirement Plans
- Social Security Taxes

No longer is coverage required of:

- Personal property
- Bailments *
- Computer technology rights
- Estates and trusts
- Environmental regulation

VII. CONCLUSION: WHY DO WE TEACH LAW?

This author retains the romantic notion that teaching law helps make our students better people. Our teaching involves more than creating automatons that can parrot rules. We should seek to create a passion for what is right, fair and ethical.

It is respectfully submitted that we should:

- Teach that law is the means by which members of society live in harmony.
- Teach the meaning of right and wrong in a society that has seemingly embraced a relativist viewpoint.
- Teach that legal decisions must not be viewed independently from ethical considerations.
- Teach respect for all people.
- Teach respect for other peoples' property.
- Teach the rules of law.

We live in a world in which every college student, whether in business school or not, should be taught and should learn the fundamentals of law. We should teach more law, not less.

* *a tragic loss*

ENDNOTES

[1]Smith and Roberson's Business Law, Twelfth Edition, Richard A. Mann and Barry S. Roberts, Thompson 200, at 969.

[2] *Id.* at pp. 970-971.

[3] *Id.* at p. 970.

[4] *Id.* at p. 973.

[5] *Id.*; See pp 13-21.

[6] *Id.* at p. 971.

[7] Gregory Johnson, The Journal of Accountancy, September 2003. http://www.findarticles.com/cf_dls/m6280/3_196/`08600254/print.jhtml

[8] See: Wall Street Scandals at a Glance, BBC News http://bbc.co.uk/1/hi/business/2066962.stm, 26 June 2002 and Wall Street Scandals at a Glance, BBC News http://bbc.co.uk/1/hi/business/2158557.stm, 12 February 2003

[9] See any media outlet July 16, 2004.

[10] The Association to Advance Collegiate Schools of Business

[11] See: Eligibility Procedures and Standards for Business Accreditation, Adopted: April 25, 2003, Revised: January 01, 2004.

[12] *Id.* at p. 3.

[13] *Id.*

[14] *Id.* at p. 3.

[15] *Id.* at p. 16.

[16] *Id.* at p. 18.

[17] LexisNexis is a trademark of Reed Elsevier plc.

[18] *Brown v. Board of Education*, 347U.S. 483, 74S.CT.686, 98L.ED.873 (1954)

[19] *Rowe v. Wade*, 410 U.S.113, 93S.CT.705, 358L.ED.2d147 (1973)

[20] ALSB Newsletter The Publication of the American Business Law Association, Inc.

[21] *Id.*

[22] AICPA, the American Institute of Certified Public Accountants, is the national, professional organization of the CPAs, with more than 330,000 members. It sets U.S. Auditing standards and professional ethical standards, and with the Financial Accounting Standard Board, U.S. Accounting standards. See: Business Wire, Inc., Computerized CPA Exam Tutorial available: covers form and functions, May 12, 2003

[23] The National Association of State Boards of Accounting serves as a forum for 54 member boards in the U.S., Puerto Rico, Guam, Virgin Islands, and Washington, D.C. See: Press Release, Thomson Prometric, http://www.prometric.com.PressRoom/cpaexams.htm.

[24] Prometric, a part of Thomson Corp. (NYSE: TOC, TSX: TOC)

[25] See: Adam Snyder, Journal of Accounting, October 2003, http://www.findarticles.com/cf_dls/m6250/4_196/10889621/p1/article...

[26] See: Gregory Johnson, Journal of Accounting, September 2003; http://www.findarticles.com/cf_dls/m6280/3_196/108600254/print.jhtml

[27] *Id.*

[28] *Id.*

[29] See: Adam Snyder, Journal of Accounting, October 2003; http://www.findarticles.com/cf_dls/m6280/4_196/108839621/p1/article...

[30] See: Adam Snyder, Journal of Accounting, December 2003; http://www.findarticles.com/cf_dls/m6280/6_196/111533005/print.jhtml

[31] See: Diane Babuin, Journal of Accounting, November 2003; http://www.findarticles.com/cf_dls/m6280/5_196/110461832/print.jhtml

[32] See: Board of Examiners of the AICPA, Uniform CPA Examination Content Specifications, June 14, 2002.

[33] *Id.* at p. 11.

[34] *Id.*

[35] *Id.*

[36] *Id.* at p. 12.

[37] *Id.* at p. 15.

[38] *Id.*

[39] See: AICPA Business Environment and Concepts. Additional Detail Corresponding to Content Specification Outline, dated June 14, 2002. Board of Examiners of the AICPA, October 10, 2003.

APPENDIX A

Business Environment and Concepts

II – Detail for Content Specification Outline

Area I - Business Structures (17%-23%)

Group A – Advantages, implications, and constraints of legal structures for business

A CPA examination candidate should be able to:

- Identify the general characteristics of various business forms such as sole proprietorship, partnership (general, limited, limited liability), joint venture, limited liability company, and corporation (Subchapter C, Subchapter S).

- Identify the advantages and disadvantages of various business forms such as sole proprietorship, partnership (general, limited, limited liability), joint venture, limited liability company, and corporation (Subchapter C, Subchapter S).

Group B – Formation, operation, termination of businesses

The candidate should be able to:

- Determine the recommended business form based on given facts and circumstances.
- Identify circumstances indicating when a business should be terminated.
- List the factors supporting a fiscal rather than a calendar year end for both financial reporting and federal taxation purposes.

Group C – Financial structure, capitalization, profit and loss allocation, and distributions

The candidate should be able to:

- Determine income available for distribution.
- Allocate profits and losses for distribution to owners.
- Identify the characteristics, rights and implications of various capitalization options.

Group D – Rights, duties, legal obligations, and authority of owners and management

The candidate should be able to:

- Differentiate between the rights, duties, legal obligations, and authority of owners (shareholders and partners) and management (directors, officers, and management)
  - in general terms; and
  - based on business form.

KEY PHRASES AND SUMMARY STATEMENTS FOR MORE EFFECTIVE (AND SLIGHTLY HUMOROUS?) TEACHING OF AGENCY LAW

by

Arthur M. Magaldi*
Saul S. Le Vine*

As an instructor, one always seems to be striving for succinct ways to introduce or sum up important areas of discussion. Similarly, it is the dream of every student to be able to turn to or recall a key phrase or summary statement which will trigger recollection or understanding of a particular topic. During our combined sixty or so years of full time teaching of legal subjects, we have attempted to develop interesting and succinct statements to introduce topics and crystallize or summarize legal concepts. These attempts are the source of much of the material to follow. Designed as teaching aids, the key phrases and summary statements discussed below help students understand legal principles. At their best, these statements and the accompanying discussion may also inject a bit of levity into classroom discussions.

As faculty engaged and interested in the craft of teaching, the authors strongly believe that faculty can learn from each other. When the authors observe a colleague presenting a lesson or leading a discussion, they generally take from that presentation some teaching insight or pedagogical technique which they later find applicable in their own teaching. Regrettably, however, like most faculty the authors find that they do not have many opportunities to observe the teaching of

*Professor of Law, Pace University

colleagues. Similarly, although there are at present more presentations at conferences dealing with teaching and pedagogical issues, due to constraints imposed by the conference format many of these presentations do not deal in specifics.

In a spirit of collegial sharing of ideas, the following key words and summary statements in the area of agency law are offered for consideration. The substantive material discussed herein will be known to those teaching legal subjects, but the hope is that the material may be helpful for those looking for pedagogical insights. The statements have been developed over time and have been found to be helpful to students. Inasmuch as faculty are familiar with the legal principles involved, extensive background into the substantive legal principles is not provided. The emphasis of the material is the pedagogical value of the phrases and statements which is respectfully submitted in the hope that it may prove to be of value to colleagues.

YOU'RE TALKING TO ME, BUT I'M BUSY MAKING CONTRACTS.

This statement is frequently helpful in introducing the concept of agency. It emphasizes two of the basic concepts, i.e., that agents can make binding contracts for their principals and the fact that the principal does not have to be present or personally involved in the transaction.

As a teaching device, it works well to introduce the concept of agency by interrupting a matter that is under discussion and asking the question, "Do you realize that while I'm talking to you, I can also be busy making contracts?" Generally the students will be momentarily taken aback by the abruptness of the question only to understand the point rather easily when the

matter is further explored. The point, of course, is that the instructor (and anyone else) can literally be doing one thing and simultaneously be making contracts through the use of agents. Indeed, the instructor can be teaching the class and simultaneously be making contracts literally all over the world through the actions of agents. Since the principal does not have to be present or consent anew to the contract for it to be binding, the instructor may wish to remind students that it is likely that they will be agents and also employ agents at various times in their business careers.

If the instructor is in a playful mood, the instructor may make reference to the famous scene in the movie "Taxi Driver" in which the deranged title character asks that question in an enraged way, adding that perhaps he was concentrating too hard on contracts being made in his name.

YOU SAY HE'S MY AGENT, SO PROVE IT.

This statement is helpful as a reminder to students that the party who claims the benefit of agency has the burden of proving the assertion. For example, if Jones claims that he made a binding contract with Smith through Smith's agent, Rodriguez, and Smith denies that Rodriguez is an authorized agent of Smith, Jones generally has the burden of proving both that Rodriguez is Smith's agent and that Jones and Rodriguez made the contract. This is an agency application of a broader fundamental concept of procedural law which is commonly called "proving the affirmative."

The instructor may remind students that we are not generally concerned with procedural points of law. However, the point is so basic to an understanding of legal procedure and so simple to understand that it should not be overlooked. The point is simply that the party who claims something has the

burden of establishing that point. For example, if the plaintiff claims something to be true, the plaintiff has the burden of proving that point, i.e., proving the affirmative.

Accordingly, it is a good idea to remind students that parties who deal with agents in situations where a reasonable person would have grounds to doubt the authority of the agent to make the contract or warranties involved, the appropriate course of action is to verify the agent's authority with the principal. Failure to do so may result in a situation in which the principal disavows the action taken by the agent placing the other side in the untenable position of trying to prove the affirmative, i.e., that the agent was authorized.

DELEGATED AUTHORITY CANNOT BE RE-DELEGATED.

In an agency relationship, the principal gives over or delegates contract-making authority to an agent. Inherent in the relationship is the principal's trust of the agent. Theoretically, the principal has evaluated the qualities of the agent before placing the agent in a position of trust. The quoted statement is helpful to students in that it impliedly recognizes the important role of the agent and reminds the student that the agent may not pass along to a sub-agent the authority granted by the principal without the principal's permission.

Those instructors who are interested in a fuller discussion of this point may wish to discuss exceptions to this general rule, e.g., when an emergency arises and the principal cannot be contacted.

SORRY, BUT WE DON'T REIMBURSE CRIMINALS.

This statement serves as a reminder that although agents are generally entitled to be reimbursed and indemnified for expenses incurred in the performance of their duties, an agent is not entitled to reimbursement for expenses incurred by an agent who commits a serious breach of law. An agent, for example, who violates the Foreign Corrupt Practices Act by bribing a foreign official to obtain business for the principal is not entitled to reimbursement for the amount of the bribe. Less dramatically, an agent who incurs a fine for speeding while en route to contract signing is similarly not entitled to be reimbursed.

It is advisable for the instructor to remind students that many of them will be agents at various times in their business careers, they should be aware of this limitation.

AGENTS ARE LIKE BASEBALL MANAGERS; THEY CAN ALWAYS BE FIRED.

This statement makes the point that agents can be fired or removed despite the fact that the agents have employment contracts extending into the future and are performing their jobs well. The students are generally interested in hearing the mildly amusing (and somewhat sad) illustration of the former New York Yankees manager Billy Martin who was hired and fired five times by the demanding team owner George Steinbrenner. In each case, Billy had a contract extending into the future. Putting the matter in more general terms, the students are asked to ponder the situation of an agent who is performing his/her contract, but the principal nevertheless wishes to terminate, i.e., fire the agents. The question to the students: "What are the legal remedies the unjustly fired agent is entitled to?" A number of students may suggest that an

agent who has been properly performing the agency contract should be reinstated, but the discussion will then develop the point that there is generally no remedy of specific performance in contracts involving personal services. The agent is entitled to damages but not to reinstatement to the position.

If the instructor enjoys esoteric topics (or if the students are concerned about passing the CPA exam where this point is covered), the instructor may wish to mention the agent coupled with an interest. This unusual agent cannot be fired or terminated by the principal because the agent has supplied to the principal some special consideration to be appointed as the agent. For example, a bank lends money to a developer to construct a shopping center and part of the consideration is that the bank will act as the rental agent for the development until the debt is paid. The bank as agent coupled with an interest is not subject to termination as in the case of an ordinary agent. Admittedly, this is a fine point, but a fun phrase to conclude with is: "Who do these agents coupled with an interest think they are, tenured college professors?"

NAME ALL AGENTS "FIDO" AND TELL THEM TO MEMORIZE THE BOY/GIRL SCOUT OATH.

Students are generally amused to learn that "Fido" was a popular name for dogs years ago. The instructor may ask the students what that name means and why they think the name was popular. Guided by the instructor, the students will be led to the understanding that the name comes from the Latin word "fidelis," meaning "faithful." Dogs are well known to be faithful to their owners, hence the popularity of the name.

Again, the students may be asked what duties or terms are associated with the Boy or Girl Scout oaths. Invariably, the students will mention loyalty, trustworthiness, honesty, and

similar qualities. Similarly with regard to agents, the agent must always represent the principal faithfully, honestly, and loyally, putting the principal's interests above those of the agent. Once it is established that the agent owes a high degree of loyalty and faithfulness to the principal, practical questions are more understandable. For example, an agent may not receive secret payments, kickbacks or rebates from third parties, the agent may not sell to, or buy from, the principal without informing the principal, and the agent may not represent both sides to a transaction without the permission of both. Besides these somewhat obvious situations, students may encounter more subtle questions involving the duties of agents. In these more difficult cases, it is well to remind the students that the matter should be considered with this reflection, "How would someone following the Boy or Girl Scout Oath view the matter?"

The instructor may wish to extend on this theme and explore the concept of fiduciary duty reminding students that an agency owes a fiduciary duty to the principal. Once again drawing on the idea of faithfulness, the discussion readily flows to the idea that an agent by his/her undertaking must act under the highest standards of good faith in acting for the benefit of the principal. The point may be made that often the issue of fiduciary faithfulness will not be an obvious one and students will need to carefully consider their actions when placed in an agency role. The following story may be helpful in illustrating this point: When the instructor was a young and somewhat struggling attorney with a small private practice, a real estate broker with whom the instructor was familiar approached the instructor and offered to give him one-half of any real estate commissions earned by the broker on business referred by the instructor. At that time, the standard real estate commission was 6% and there was virtually no negotiation of the commission. So, the instructor felt this would be an

acceptable way to earn money, since the broker was a highly capable individual. Accordingly, when a client asked the instructor which broker he would recommend for the sale of the client's home, the instructor had no hesitation in recommending the broker in question. After the brokerage contract between client and broker was executed and a buyer for the property found, it suddenly dawned on the instructor that he had had an obligation to inform the client of his side deal and prospective profit on the transaction. Embarrassed, the instructor advised the client and informed that the responsibility to inform the client in advance had somehow simply not been in the instructor's consciousness. The instructor offered to relinquish the referral fee and apologized. Fortunately and generously, the client viewed the matter as an honest oversight and all turned out well. Although the lapse of judgment on the part of the instructor was unintentional, it was nonetheless very serious.

ON JUDGMENT DAY, THE SINS OF THE UNDISCLOSED PRINCIPAL WILL BE PUNISHED

This statement draws on the popular image of a Last Judgment where God or some higher being judges the actions and intentions of human beings. Whether the students believe in such a judgment is not important inasmuch as the concept is well known.

Where the principal has authorized an agent to enter into a transaction on behalf of the principal but without revealing that the principal is the true party in interest, the principal can be held responsible if the contract is breached. The statement is a play on the phrase "Judgment Day." The likely scenario is that the third party will sue the agent in the event the principal does not honor the contract, since the third party will not initially be aware of the interest of the undisclosed principal.

Theoretically, the third party will learn the identity of the principal at the trial or when judgment is entered against the agent. In actuality, the identity of the principal will generally be revealed long before a judgment is entered against the agent, as the agent will want to avoid responsibility for the breach by revealing that he/she was acting on behalf of the principal. But the Judgment Day image is a good one because it makes clear that the principal cannot avoid responsibility for acts the principal has authorized.

Those instructors who have the time may wish to emphasize the evolving or developmental aspect of the law by indicating that traditionally upon learning of the principal's existence and authorization of the contract, the third party had to elect whether to sue the agent who had acted for the undisclosed principal or the principal. The more modern cases do not stress the need to make this election and simply hold the undisclosed principal liable for authorized contracts.

It is generally well to remind students that the agent may also be held liable for the breach since the agent contracted in his/her own name. For example, in a situation where the principal declares bankruptcy, the agent would still be held responsible for the breach.

MAYBE THE FASHION CONSCIOUS ARE RIGHT AND APPEARANCE IS EVERYTHING

A principal generally has the responsibility of controlling agents and not allowing them to appear to be authorized to do that which they are not authorized to do. Where the principal creates or allows the appearance that an agent is authorized to take action which the agent is not authorized to take, the principal may be liable to a third party who relies in good faith on the appearances created or allowed by the principal. In a

typical case, an agent will make a contract in an amount or of a type that the principal has forbidden the agent to make. The students readily understand this type of liability based on apparent authority.

Many of the more interesting apparent authority cases involve situations where a party acts as an agent for a principal but the purported agent completely lacked authority to act as an agent. These cases generally are based on an unauthorized person coming on the premises of the principal and pretending to be an agent, taking a deposit, making a "contract, "and absconding with the deposit. The theory of apparent authority was traditionally based on the principal "holding out" the agent to third parties as authorized to act, i.e., the principal made the agent appear to be authorized to make the contract and the third party relied in good faith on the appearances created by the principal. The more modern cases, however, take the traditional liability to another level and provide that the principal may be liable under the apparent authority theory where the principal fails to keep the business premises secure and allows outsiders, e.g., those who do not work for the principal in any way, to come on the premises and "make contracts." In such cases, the principal has not affirmatively held out the unauthorized interloper to be an agent, but by failing to maintain the premises free of such individuals, the principal runs the risk of liability by apparent authority. Referring to our summary statement, the students are reminded that "appearance is everything."

EVERY AGENT WHO IS FIRED MAKES ONE MORE DEAL.

Continuing the theme of apparent authority, this summary statement is a good reminder to students of the requirement to give notice of termination of an agent, actual notice to those

who dealt with the agent and constructive notice to those who did not deal with agent but were aware of the fact that the agent represented the principal. Where appropriate notice has not been given, the former agent will appear to continue to represent the principal and will therefore be able to bind the principal by virtue of apparent authority. It also helps lead to a discussion of those situations, e.g., where the termination of agency authority occurs by operation of law, in which notice to third parties is not required.

The source of the summary statement derives from the fact that there are numerous cases where the principal has terminated an agent and failed to give notice of termination. Invariably, it seems, the agent makes one more contract in the principal's name and absconds with the deposit or down payment. Similarly, the concept is extremely popular on the CPA exam and with textbook writers as a source of questions.

FRAUD AND FIGHTING IN FURTHERANCE, THO FORBIDDEN, MAY BE IN THE SCOPE.

Students generally have little problem understanding the basic concept of *respondeat superior*. They readily accept the idea that torts committed by the agent in the scope of the work are imputed to the principal thereby making the principal responsible for the tort. For example, they accept that an agent selling for a principal who negligently runs down a pedestrian while driving to an assignment commits a tort for which the principal is responsible.

Students have more difficulty understanding the principal's responsibility when the agent has acted against the rules of the principal or is involved in doing something the principal clearly would not sanction, for example, a stock broker selling securities by virtue of false representations in violation of the

securities firm's regulations. The students frequently find it difficult to justify punishing the principal when the agent engages in conduct that the principal has expressly forbidden. The key to liability in the cases of this type seems to be whether the actions were in furtherance of the principal's business, i.e., in this case, selling securities. Where the conduct is in furtherance of the principal's business, the principal is held liable.

There have been numerous cases where agents engage in aggressive, violent conduct while vying for parking spaces to make deliveries or to reclaim goods of the principal. Accordingly, the key phrase makes the point that fraud and fighting in furtherance of the principal's business may be considered to be in the scope of the work despite the fact that such conduct was forbidden by the principal.

The following story may be instructive for students as a means of establishing boundaries for imputation of liability to the principal. Back in what seems now to be almost the Dark Ages, the legal drinking age in New York was eighteen. The instructor, then eighteen, went to a bar with a group of friends. Coincidentally, another friend, John, was working as a bartender that night. John leaned over the bar and asked the instructor whether he recognized a patron down at the end of the bar. When told that the instructor had no recollection of the patron, John said that he was a student at their former high school who had embarrassed John several times in front of his then girlfriend. John indicated that when the patron ordered a drink, John would pretend he was stealing money off the bar and that he would lean over the bar and "break his jaw." After a great deal of arguing, John was dissuaded from this course of action, but the question to the students is whether the proposed tort of John could have been imputed to the employer. The point is that intentional torts brought about by personal

animosity, hatred, etc. will not be imputed to the principal where the tort does not in any way further the principal's business.

RATIFICATION RETROACTIVELY RECOGNIZES REPRESENTATION

One of the interesting agency concepts is that the principal can ratify or say "yes" to otherwise unauthorized acts or contracts and therefore become bound by those contracts. It is helpful to remind students that ratification questions will always derive from two possible scenarios. The first is that an authorized agent oversteps the authority granted by the principal and makes an unauthorized contract in the principal's name, e.g., the president of Pace University without authorization from the Board of Trustees signs a contract to sell the Pace parking lot. The second possibility is that one who is not an agent undertakes to act as an agent. In this regard, a student who is aware that the professor's favorite car is a 1967 Mustang sees one for sale, and signs a contract in the professor's name to purchase it.

After discussing the elements of ratification, the four r's of ratification, i.e., ratification retroactively recognizes representation, reminds students that once the contract has been ratified, the principal is bound and can no longer disavow the contract. It is worthwhile to stress that the contract can be ratified expressly or by conduct showing acceptance of the originally unauthorized contract, and that once it is ratified the contract is fully binding on the principal. Finally, since ratification is possible only where the contract has been made in the principal's name, undisclosed principal cannot ratify contracts.

CONCLUSION

The scholarship demonstrated at the annual conventions of the Academy of Legal Studies in Business and its regionals is always impressive and of high quality. The overwhelming majority of these scholarly presentations develops and clarifies fine points of substantive law. A relatively few papers deal with the craft of teaching. Generally, the best that is available on pedagogy is non-specific general comments on ways to approach broad topics. While general comments and pedagogical insights are helpful, the author strongly believes that more could be gained by learning the specific approaches that faculty use to develop points in their teaching. In that vein, the material of this paper has been offered in the hope that it may be helpful to colleagues teaching business law/legal environment.