CASEBOOK

LAW AND SOCIAL ISSUES IN BUSINESS
ACCT 352; Section 052
Department of Accounting
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Table of Contents

I. Jurisdiction of the Courts

SIERRA CLUB V. MORTON, SECRETARY OF THE INTERIOR, ET AL.

U.S. Supreme Court

405 U.S. 727 (1972)

Decided April 19, 1972

STEWART, J., delivered the opinion of the Court, in which BURGER, C. J., and WHITE and MARSHALL, JJ., joined. DOUGLAS, J., BRENNAN, J., and BLACKMUN, J., filed dissenting opinions. POWELL and REHNQUIST, JJ., took no part in the consideration or decision of the case.

MR. JUSTICE STEWART delivered the opinion of the Court.

I

The Mineral King Valley is an area of great natural beauty nestled in the Sierra Nevada Mountains in Tulare County, California, adjacent to Sequoia National Park. . .

The United States Forest Service, which is entrusted with the maintenance and administration of national forests, began in the late 1940's to give consideration to Mineral King as a potential site for recreational development. Prodded by a rapidly increasing demand for skiing facilities, the Forest Service published a prospectus in 1965, inviting bids from private developers for the construction and operation of a ski resort that would also serve as a summer recreation area. The proposal of Walt Disney Enterprises, Inc., was chosen from those of six bidders . . .

The final Disney plan, approved by the Forest Service in January 1969, outlines a $35 million complex of motels, restaurants, swimming pools, parking lots, and other structures designed to accommodate 14,000 visitors daily. This complex is to be constructed on 80 acres of the valley floor under a 30-year use permit from the Forest Service. Other facilities, including ski lifts, ski trails, a cog-assisted railway, and utility installations, are to be constructed on the mountain slopes and in other parts of the valley under a revocable special-use permit. To provide access to the resort, the State of California proposes to construct a highway 20 miles in length. A section of this road would traverse Sequoia National Park, as would a proposed high-voltage power line needed to provide electricity for the resort. Both the highway and the power line require the approval of the Department of the Interior, which is entrusted with the preservation and maintenance of the national parks.

Representatives of the Sierra Club, who favor maintaining Mineral King largely in its present state, . . . unsuccessfully sought a public hearing on the proposed development in 1965 . . . In June 1969 the Club filed the present suit in the United States District Court for the Northern District of California, seeking a declaratory judgment that various aspects of the proposed development contravene federal laws and regulations governing the preservation of national parks, forests, and game refuges, and also seeking preliminary and permanent injunctions restraining the federal officials involved from granting their approval or issuing permits in connection with the Mineral King project. . . .

After two days of hearings, the District Court granted the requested preliminary injunction. It rejected the respondents' challenge to the Sierra Club's standing to sue, and determined that the hearing had raised questions "concerning possible excess of statutory authority, sufficiently substantial and serious to justify a preliminary injunction . . . ." The respondents appealed, and the Court of Appeals for the Ninth Circuit reversed. . . . The court thus vacated the injunction. The Sierra Club filed a petition for a writ of certiorari which we granted, to review the questions of federal law presented.

II

The first question presented is whether the Sierra Club has alleged facts that entitle it to obtain judicial review of the challenged action. Whether a party has a sufficient stake in an otherwise justiciable controversy to obtain judicial resolution of that controversy is what has traditionally been referred to as the question of standing to sue. . . . .

III

The injury alleged by the Sierra Club will be incurred entirely by reason of the change in the uses to which Mineral King will be put, and the attendant change in the aesthetics and ecology of the area. Thus, in referring to the road to be built through Sequoia National Park, the complaint alleged that the development "would destroy or otherwise adversely affect the scenery, natural and historic objects and wildlife of the park and would impair the enjoyment of the park for future generations." . . . .

The impact of the proposed changes in the environment of Mineral King will not fall indiscriminately upon every citizen. The alleged injury will be felt directly only by those who use Mineral King and Sequoia National Park, and for whom the aesthetic and recreational values of the area will be lessened by the highway and ski resort. The Sierra Club failed to allege that it or its members would be affected in any of their activities or pastimes by the Disney development. Nowhere in the pleadings or affidavits did the Club state that its members use Mineral King for any purpose, much less that they use it in any way that would be significantly affected by the proposed actions of the respondents.

The Club apparently regarded any allegations of individualized injury as superfluous, on the theory that this was a "public" action involving questions as to the use of natural resources, and that the Club's longstanding concern with and expertise in such matters were sufficient to give it standing as a "representative of the public". This theory reflects a misunderstanding of our cases . . . .

The Sierra Club is a large and long-established organization, with a historic commitment to the cause of protecting our Nation's natural heritage from man's depredations. But if a "special interest" in this subject were enough to entitle the Sierra Club to commence this litigation, there would appear to be no objective basis upon which to disallow a suit by any other bona fide "special interest" organization, however small or short-lived. And if any group with a bona fide "special interest" could initiate such litigation, it is difficult to perceive why any individual citizen with the same bona fide special interest would not also be entitled to do so.

The requirement that a party seeking review must allege facts showing that he is himself adversely affected does not insulate executive action from judicial review, nor does it prevent any public interests from being protected through the judicial process. It does serve as at least a rough attempt to put the decision as to whether review will be sought in the hands of those who have a direct stake in the outcome. That goal would be undermined were we to construe the APA to authorize judicial review at the behest of organizations or individuals who seek to do no more than vindicate their own value preferences through the judicial process. The principle that the Sierra Club would have us establish in this case would do just that.

As we conclude that the Court of Appeals was correct in its holding that the Sierra Club lacked standing to maintain this action, we do not reach any other questions presented in the petition, and we intimate no view on the merits of the complaint. The judgment is Affirmed.

MR. JUSTICE POWELL and MR. JUSTICE REHNQUIST took no part in the consideration . . . of this case.

(dissent on next page)

MR. JUSTICE DOUGLAS, dissenting.

I share the views of my Brother BLACKMUN and would reverse the judgment below.

The critical question of "standing" would be simplified and also put neatly in focus if we fashioned a federal rule that allowed environmental issues to be litigated before federal agencies or federal courts in the name of the inanimate object about to be despoiled, defaced, or invaded by roads and bulldozers and where injury is the subject of public outrage. Contemporary public concern for protecting nature's ecological equilibrium should lead to the conferral of standing upon environmental objects to sue for their own preservation. . . . This suit would therefore be more properly labeled as Mineral King v. Morton.

Inanimate objects are sometimes parties in litigation. A ship has a legal personality, a fiction found useful for maritime purposes. The corporation sole — a creature of ecclesiastical law — is an acceptable adversary and large fortunes ride on its cases. The ordinary corporation is a "person" for purposes of the adjudicatory processes, whether it represents proprietary, spiritual, aesthetic, or charitable causes.

So it should be as respects valleys, alpine meadows, rivers, lakes, estuaries, beaches, ridges, groves of trees, swampland, or even air that feels the destructive pressures of modern technology and modern life. The river, for example, is the living symbol of all the life it sustains or nourishes — fish, aquatic insects, water ouzels, otter, fisher, deer, elk, bear, and all other animals, including man, who are dependent on it or who enjoy it for its sight, its sound, or its life. The river as plaintiff speaks for the ecological unit of life that is part of it. Those people who have a meaningful relation to that body of water — whether it be a fisherman, a canoeist, a zoologist, or a logger — must be able to speak for the values which the river represents and which are threatened with destruction. . . .

The voice of the inanimate object, therefore, should not be stilled. That does not mean that the judiciary takes over the managerial functions from the federal agency. It merely means that before these priceless bits of Americana (such as a valley, an alpine meadow, a river, or a lake) are forever lost or are so transformed as to be reduced to the eventual rubble of our urban environment, the voice of the existing beneficiaries of these environmental wonders should be heard.

Perhaps they will not win. Perhaps the bulldozers of "progress" will plow under all the aesthetic wonders of this beautiful land. That is not the present question. The sole question is, who has standing to be heard?

. . . . Those who merely are caught up in environmental news or propaganda and flock to defend these waters or areas may be treated differently. That is why these environmental issues should be tendered by the inanimate object itself. Then there will be assurances that all of the forms of life which it represents will stand before the court — the pileated woodpecker as well as the coyote and bear, the lemmings as well as the trout in the streams. Those inarticulate members of the ecological group cannot speak. But those people who have so frequented the place as to know its values and wonders will be able to speak for the entire ecological community. . . .

That, as I see it, is the issue of "standing" in the present case and controversy.

WORLD-WIDE VOLKSWAGEN CORP. ET AL. v. WOODSON,
DISTRICT JUDGE OF CREEK COUNTY, OKLAHOMA, ET AL.

Supreme Court of the United States

444 U.S. 286

January 21, 1980, Decided

WHITE, J., delivered the opinion of the Court, in which BURGER, C. J., and STEWART, POWELL, REHNQUIST, and STEVENS, JJ., joined. BRENNAN, J., filed a dissenting opinion. MARSHALL, J., filed a dissenting opinion, in which BLACKMUN, J., joined. BLACKMUN, J., filed a dissenting opinion.

OPINION: MR. JUSTICE WHITE delivered the opinion of the Court.

The issue before us is whether, consistently with the Due Process Clause of the Fourteenth Amendment, an Oklahoma court may exercise in personam jurisdiction over a nonresident automobile retailer and its wholesale distributor in a products-liability action, when the defendants' only connection with Oklahoma is the fact that an automobile sold in New York to New York residents became involved in an accident in Oklahoma.

Respondents Harry and Kay Robinson purchased a new Audi automobile from petitioner Seaway Volkswagen, Inc. (Seaway), in Massena, N. Y., in 1976. The following year the Robinson family, who resided in New York, left that State for a new home in Arizona. As they passed through the State of Oklahoma, another car struck their Audi in the rear, causing a fire which severely burned Kay Robinson and her two children. The Robinsons subsequently brought a products-liability action in the District Court for Creek County, Okla., claiming that their injuries resulted from defective design and placement of the Audi's gas tank and fuel system. They joined as defendants the automobile's manufacturer, Audi NSU Auto Union Aktiengesellschaft (Audi); its importer, Volkswagen of America, Inc. (Volkswagen); its regional distributor, petitioner World-Wide Volkswagen Corp. (World-Wide); and its retail dealer, petitioner Seaway. Seaway and World-Wide entered special appearances, claiming that Oklahoma's exercise of jurisdiction over them would offend the limitations on the State's jurisdiction imposed by the Due Process Clause of the Fourteenth Amendment.

The facts presented to the District Court showed that World-Wide is incorporated and has its business office in New York. It distributes vehicles, parts, and accessories, under contract with Volkswagen, to retail dealers in New York, New Jersey, and Connecticut. Seaway, one of these retail dealers, is incorporated and has its place of business in New York. Insofar as the record reveals, Seaway and World-Wide are fully independent corporations whose relations with each other and with Volkswagen and Audi are contractual only. Respondents adduced no evidence that either World-Wide or Seaway does any business in Oklahoma, ships or sells any products to or in that State, has an agent to receive process there, or purchases advertisements in any media calculated to reach Oklahoma. In fact, as respondents' counsel conceded at oral argument, there was no showing that any automobile sold by World-Wide or Seaway has ever entered Oklahoma with the single exception of the vehicle involved in the present case.

Despite the apparent paucity of contacts between petitioners and Oklahoma, the District Court rejected their constitutional claim and reaffirmed that ruling in denying petitioners' motion for reconsideration. . . .

We granted certiorari to consider an important constitutional question with respect to state-court jurisdiction and to resolve a conflict between the Supreme Court of Oklahoma and the highest courts of at least four other States. We reverse.

II The Due Process Clause of the Fourteenth Amendment limits the power of a state court to render a valid personal judgment against a nonresident defendant. A judgment rendered in violation of due process is void in the rendering State and is not entitled to full faith and credit elsewhere. Due process requires that the defendant be given adequate notice of the suit and be subject to the personal jurisdiction of the court, *International Shoe Co. v. Washington, 326 U.S. 310 (1945)*. . . . In the present case, . . . the only question is whether these particular petitioners were subject to the jurisdiction of the Oklahoma courts. As has long been settled, and as we reaffirm today, a state court may exercise personal jurisdiction over a nonresident defendant only so long as there exist "minimum contacts" between the defendant and the forum State. *International Shoe Co. v. Washington, supra, at 316.* The concept of minimum contacts, in turn, can be seen to perform two related, but distinguishable, functions. It protects the defendant against the burdens of litigating in a distant or inconvenient forum. And it acts to ensure that the States, through their courts, do not reach out beyond the limits imposed on them by their status as coequal sovereigns in a federal system.

The protection against inconvenient litigation is typically described in terms of "reasonableness" or "fairness." We have said that the defendant's contacts with the forum State must be such that maintenance of the suit "does not offend 'traditional notions of fair play and substantial justice.'" The relationship between the defendant and the forum must be such that it is "reasonable . . . to require the corporation to defend the particular suit which is brought there." Implicit in this emphasis on reasonableness is the understanding that the burden on the defendant, while always a primary concern, will in an appropriate case be considered in light of other relevant factors, including the forum State's interest in adjudicating the dispute; the plaintiff's interest in obtaining convenient and effective relief; the interstate judicial system's interest in obtaining the most efficient resolution of controversies; and the shared interest of the several States in furthering fundamental substantive social policies.

The limits imposed on state jurisdiction by the Due Process Clause, in its role as a guarantor against inconvenient litigation, have been substantially relaxed over the years. . . .

Nevertheless, we have never accepted the proposition that state lines are irrelevant for jurisdictional purposes, nor could we, and remain faithful to the principles of interstate federalism embodied in the Constitution. The economic interdependence of the States was foreseen and desired by the Framers. In the Commerce Clause, they provided that the Nation was to be a common market, a "free trade unit" in which the States are debarred from acting as separable economic entities. But the Framers also intended that the States retain many essential attributes of sovereignty, including, in particular, the sovereign power to try causes in their courts. The sovereignty of each State, in turn, implied a limitation on the sovereignty of all of its sister States — a limitation express or implicit in both the original scheme of the Constitution and the Fourteenth Amendment.

Hence, even while abandoning the shibboleth that "[the] authority of every tribunal is necessarily restricted by the territorial limits of the State in which it is established," we emphasized that the reasonableness of asserting jurisdiction over the defendant must be assessed "in the context of our federal system of government," and stressed that the Due Process Clause ensures not only fairness, but also the "orderly administration of the laws." . . .

Even if the defendant would suffer minimal or no inconvenience from being forced to litigate before the tribunals of another State; even if the forum State has a strong interest in applying its law to the controversy; even if the forum State is the most convenient location for litigation, the Due Process Clause, acting as an instrument of interstate federalism, may sometimes act to divest the State of its power to render a valid judgment.

III Applying these principles to the case at hand, we find in the record before us a total absence of those affiliating circumstances that are a necessary predicate to any exercise of state-court jurisdiction. Petitioners carry on no activity whatsoever in Oklahoma. They close no sales and perform no services there. They avail themselves of none of the privileges and benefits of Oklahoma law. They solicit no business there either through salespersons or through advertising reasonably calculated to reach the State. Nor does the record show that they regularly sell cars at wholesale or retail to Oklahoma customers or residents or that they indirectly, through others, serve or seek to serve the Oklahoma market. In short, respondents seek to base jurisdiction on one, isolated occurrence and whatever inferences can be drawn therefrom: the fortuitous circumstance that a single Audi automobile, sold in New York to New York residents, happened to suffer an accident while passing through Oklahoma.

It is argued, however, that because an automobile is mobile by its very design and purpose it was "foreseeable" that the Robinsons' Audi would cause injury in Oklahoma. Yet "foreseeability" alone has never been a sufficient benchmark for personal jurisdiction under the Due Process Clause. . . . If foreseeability were the criterion, a local California tire retailer could be forced to defend in Pennsylvania when a blowout occurs there. . .

This is not to say, of course, that foreseeability is wholly irrelevant. But the foreseeability that is critical to due process analysis is not the mere likelihood that a product will find its way into the forum State. Rather, it is that the defendant's conduct and connection with the forum State are such that he should reasonably anticipate being haled into court there. The Due Process Clause, by ensuring the "orderly administration of the laws," gives a degree of predictability to the legal system that allows potential defendants to structure their primary conduct with some minimum assurance as to where that conduct will and will not render them liable to suit. When a corporation "purposefully avails itself of the privilege of conducting activities within the forum State," it has clear notice that it is subject to suit there, and can act to alleviate the risk of burdensome litigation by procuring insurance, passing the expected costs on to customers, or, if the risks are too great, severing its connection with the State. Hence if the sale of a product of a manufacturer or distributor such as Audi or Volkswagen is not simply an isolated occurrence, but arises from the efforts of the manufacturer or distributor to serve, directly or indirectly, the market for its product in other States, it is not unreasonable to subject it to suit in one of those States if its allegedly defective merchandise has there been the source of injury to its owner or to others. The forum State does not exceed its powers under the Due Process Clause if it asserts personal jurisdiction over a corporation that delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State. . . . But there is no such or similar basis for Oklahoma jurisdiction over World-Wide or Seaway in this case. Seaway's sales are made in Massena, N. Y. World-Wide's market, although substantially larger, is limited to dealers in New York, New Jersey, and Connecticut. There is no evidence of record that any automobiles distributed by World-Wide are sold to retail customers outside this tristate area. It is foreseeable that the purchasers of automobiles sold by World-Wide and Seaway may take them to Oklahoma. But the mere "unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State."

In a variant on the previous argument, it is contended that jurisdiction can be supported by the fact that petitioners earn substantial revenue from goods used in Oklahoma. The Oklahoma Supreme Court so found drawing the inference that because one automobile sold by petitioners had been used in Oklahoma, others might have been used there also. While this inference seems less than compelling on the facts of the instant case, we need not question the court's factual findings in order to reject its reasoning. This argument seems to make the point that the purchase of automobiles in New York, from which the petitioners earn substantial revenue, would not occur but for the fact that the automobiles are capable of use in distant States like Oklahoma. Respondents observe that the very purpose of an automobile is to travel, and that travel of automobiles sold by petitioners is facilitated by an extensive chain of Volkswagen service centers throughout the country, including some in Oklahoma. However, financial benefits accruing to the defendant from a collateral relation to the forum State will not support jurisdiction if they do not stem from a constitutionally cognizable contact with that State. In our view, whatever marginal revenues petitioners may receive by virtue of the fact that their products are capable of use in Oklahoma is far too attenuated a contact to justify that State's exercise of in personam jurisdiction over them.

Because we find that petitioners have no "contacts, ties, or relations" with the State of Oklahoma, *International Shoe Co. v. Washington, supra, at 319,* the judgment of the Supreme Court of Oklahoma is

Reversed.

CARNIVAL CRUISE LINES, INC. v. SHUTE

Supreme Court of the United States

499 U.S. 585

April 17, 1991, Decided

JUDGES: Blackmun, J., delivered the opinion of the Court, in which Rehnquist, C. J., and White, O'Connor, Scalia, Kennedy, and Souter, J., joined. Stevens, J., filed a dissenting opinion, in which Marshall, J., joined.

OPINION BY: BLACKMUN

In this admiralty case we primarily consider whether the United States Court of Appeals for the Ninth Circuit correctly refused to enforce a forum-selection clause contained in tickets issued by petitioner Carnival Cruise Lines, Inc., to respondents Eulala and Russel Shute.

I

The Shutes, through an Arlington, Wash., travel agent, purchased passage for a 7-day cruise on petitioner's ship, the *Tropicale*. Respondents paid the fare to the agent who forwarded the payment to petitioner's headquarters in Miami, Fla. Petitioner then prepared the tickets and sent them to respondents in the State of Washington. The face of each ticket, at its left-hand lower corner, contained this admonition:

"SUBJECT TO CONDITIONS OF CONTRACT ON LAST PAGES **IMPORTANT!** PLEASE READ CONTRACT "

The following appeared on "contract page 1" of each ticket:

"*TERMS AND CONDITIONS OF PASSAGE CONTRACT TICKET* . . . .

> "3. (a) The acceptance of this ticket by the person or persons named hereon as passengers shall be deemed to be an acceptance and agreement by each of them of all of the terms and conditions of this Passage Contract Ticket. . . . .
>
> "8. It is agreed by and between the passenger and the Carrier that all disputes and matters whatsoever arising under, in connection with or incident to this Contract shall be litigated, if at all, in and before a Court located in the State of Florida, U. S. A., to the exclusion of the Courts of any other state or country."

The last quoted paragraph is the forum-selection clause at issue.

II

Respondents boarded the *Tropicale* in Los Angeles, Cal. The ship sailed to Puerto Vallarta, Mexico, and then returned to Los Angeles. While the ship was in international waters off the Mexican coast, respondent Eulala Shute was injured when she slipped on a deck mat during a guided tour of the ship's galley. Respondents filed suit against petitioner in the United States District Court for the Western District of Washington, claiming that Mrs. Shute's injuries had been caused by the negligence of Carnival Cruise Lines and its employees.

Petitioner moved for summary judgment, contending that the forum clause in respondents' tickets required the Shutes to bring their suit against petitioner in a court in the State of Florida. Petitioner contended, alternatively, that the District Court lacked personal jurisdiction over petitioner because petitioner's contacts with the State of Washington were insubstantial. The District Court granted the motion, holding that petitioner's contacts with Washington were constitutionally insufficient to support the exercise of personal jurisdiction.

The Court of Appeals reversed. Reasoning that "but for" petitioner's solicitation of business in Washington, respondents would not have taken the cruise and Mrs. Shute would not have been injured, the court concluded that petitioner had sufficient contacts with Washington to justify the District Court's exercise of personal jurisdiction.

Turning to the forum-selection clause, the Court of Appeals acknowledged that a court concerned with the enforceability of such a clause must begin its analysis with *The Bremen* v. *Zapata Off-Shore Co.*, 407 U.S. 1 (1972), where this Court held that forum-selection clauses, although not "historically . . . favored," are "prima facie valid." The appellate court concluded that the forum clause should not be enforced because it "was not freely bargained for." As an "independent justification" for refusing to enforce the clause, the Court of Appeals noted that there was evidence in the record to indicate that "the Shutes are physically and financially incapable of pursuing this litigation in Florida" and that the enforcement of the clause would operate to deprive them of their day in court and thereby contravene this Court's holding in *The Bremen*.

We granted certiorari to address the question whether the Court of Appeals was correct in holding that the District Court should hear respondents' tort claim against petitioner. Because we find the forum-selection clause to be dispositive of this question, we need not consider petitioner's constitutional argument as to personal jurisdiction. . . .

III

We begin by noting the boundaries of our inquiry. First, . . . federal law governs the enforceability of the forum-selection clause we scrutinize. Second, we do not address the question whether respondents had sufficient notice of the forum clause before entering the contract for passage.

Within this context, respondents urge that the forum clause should not be enforced because . . . the clause was not the product of negotiation, and enforcement effectively would deprive respondents of their day in court. . .

IV

. . . . Respondents' passage contract was purely routine and doubtless nearly identical to every commercial passage contract issued by petitioner and most other cruise lines. In this context, it would be entirely unreasonable for us to assume that respondents — or any other cruise passenger — would negotiate with petitioner the terms of a forum-selection clause in an ordinary commercial cruise ticket. Common sense dictates that a ticket of this kind will be a form contract the terms of which are not subject to negotiation, and that an individual purchasing the ticket will not have bargaining parity with the cruise line. . . .

Including a reasonable forum clause in a form contract of this kind well may be permissible for several reasons: First, a cruise line has a special interest in limiting the fora in which it potentially could be subject to suit. Because a cruise ship typically carries passengers from many locales, it is not unlikely that a mishap on a cruise could subject the cruise line to litigation in several different fora. Additionally, a clause establishing *ex ante* the forum for dispute resolution has the salutary effect of dispelling any confusion about where suits arising from the contract must be brought and defended, sparing litigants the time and expense of pretrial motions to determine the correct forum and conserving judicial resources that otherwise would be devoted to deciding those motions. Finally, it stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued. . . .

It bears emphasis that forum-selection clauses contained in form passage contracts are subject to judicial scrutiny for fundamental fairness. In this case, there is no indication that petitioner set Florida as the forum in which disputes were to be resolved as a means of discouraging cruise passengers from pursuing legitimate claims. Any suggestion of such a bad-faith motive is belied by two facts: Petitioner has its principal place of business in Florida, and many of its cruises depart from and return to Florida ports. Similarly, there is no evidence that petitioner obtained respondents' accession to the forum clause by fraud or overreaching. Finally, respondents have conceded that they were given notice of the forum provision and, therefore, presumably retained the option of rejecting the contract with impunity. In the case before us, therefore, we conclude that the Court of Appeals erred in refusing to enforce the forum-selection clause.

. . . By its plain language, the forum-selection clause before us does not take away respondents' right to "a trial by [a] court of competent jurisdiction." Instead, the clause states specifically that actions arising out of the passage contract shall be brought "if at all," in a court "located in the State of Florida," which, plainly, is a "court of competent jurisdiction" within the meaning of the statute. . .

The clause before us allows for judicial resolution of claims against petitioner and does not purport to limit petitioner's liability for negligence . . .

V

The judgment of the Court of Appeals is reversed.

It is so ordered.

DISSENT BY: STEVENS; MARSHALL

Justice Stevens, with whom Justice Marshall joins, dissenting.

The Court prefaces its legal analysis with a factual statement that implies that a purchaser of a Carnival Cruise Lines passenger ticket is fully and fairly notified about the existence of the choice of forum clause in the fine print on the back of the ticket. Even if this implication were accurate, I would disagree with the Court's analysis. But, given the Court's preface, I begin my dissent by noting that only the most meticulous passenger is likely to become aware of the forum-selection provision. I have therefore appended to this opinion a facsimile of the relevant text, using the type size that actually appears in the ticket itself. A careful reader will find the forum-selection clause in the 8th of the 25 numbered paragraphs.

Of course, many passengers, like the respondents in this case, will not have an opportunity to read paragraph 8 until they have actually purchased their tickets. By this point, the passengers will already have accepted the condition set forth in paragraph 16(a), which provides that "the Carrier shall not be liable to make any refund to passengers in respect of . . . tickets wholly or partly not used by a passenger." Not knowing whether or not that provision is legally enforceable, I assume that the average passenger would accept the risk of having to file suit in Florida in the event of an injury, rather than canceling — without a refund — a planned vacation at the last minute. The fact that the cruise line can reduce its litigation costs, and therefore its liability insurance premiums, by forcing this choice on its passengers does not, in my opinion, suffice to render the provision reasonable. . . .

The stipulation in the ticket that Carnival Cruise sold to respondents certainly lessens or weakens their ability to recover for the slip and fall incident that occurred off the west coast of Mexico during the cruise that originated and terminated in Los Angeles, California. It is safe to assume that the witnesses — whether other passengers or members of the crew — can be assembled with less expense and inconvenience at a west coast forum than in a Florida court several thousand miles from the scene of the accident. . . .

I respectfully dissent.

ERIE RAILROAD CO. v. TOMPKINS,

U.S. Supreme Court

304 U.S. 64 (1938)

Decided April 25, 1938.

Mr. Justice BRANDEIS delivered the opinion of the Court.

The question for decision is whether the oft-challenged doctrine of Swift v. Tyson shall now be disapproved.

Tompkins, a citizen of Pennsylvania, was injured on a dark night by a passing freight train of the Erie Railroad Company while walking along its right of way at Hughestown in that state. He claimed that the accident occurred through negligence in the operation, or maintenance, of the train; that he was rightfully on the premises as licensee because on a commonly used beaten footpath which ran for a short distance alongside the tracks; and that he was struck by something which looked like a door projecting from one of the moving cars. To enforce that claim he brought an action in the federal court for Southern New York, which had jurisdiction because the company is a corporation of that state. It denied liability; and the case was tried by a jury. The Erie insisted that its duty to Tompkins was no greater than that owed to a trespasser. It contended, among other things, that its duty to Tompkins, and hence its liability, should be determined in accordance with the Pennsylvania law; that under the law of Pennsylvania, as declared by its highest court, persons who use pathways along the railroad right of way—that is, a longitudinal pathway as distinguished from a crossing—are to be deemed trespassers; and that the railroad is not liable for injuries to undiscovered trespassers resulting from its negligence, unless it be wanton or willful. Tompkins denied that any such rule had been established by the decisions of the Pennsylvania courts; and contended that, since there was no statute of the state on the subject, the railroad's duty and liability is to be determined in federal courts as a matter of general law.

The trial judge refused to rule that the applicable law precluded recovery. The jury brought in a verdict of $30,000; and the judgment entered thereon was affirmed by the Circuit Court of Appeals, which held . . . that it was unnecessary to consider whether the law of Pennsylvania was as contended, because the question was one not of local, but of general, law, and that 'upon questions of general law the federal courts are free, in absence of a local statute, to exercise their independent judgment as to what the law is; and it is well settled that the question of the responsibility of a railroad for injuries caused by its servants is one of general law. . . . Where the public has made open and notorious use of a railroad right of way for a long period of time and without objection, the company owes to persons on such permissive pathway a duty of care in the operation of its trains. . . . It is likewise generally recognized law that a jury may find that negligence exists toward a pedestrian using a permissive path on the railroad right of way if he is hit by some object projecting from the side of the train.' . . . .

Because of the importance of the question whether the federal court was free to disregard the alleged rule of the Pennsylvania common law, we granted certiorari. . . .

Swift v. Tyson [1842], held that federal courts exercising jurisdiction on the ground of diversity of citizenship need not, in matters of general jurisprudence, apply the unwritten law of the state as declared by its highest court; that they are free to exercise an independent judgment as to what the common law of the state is—or should be . . . Criticism of the doctrine became widespread . . . . The injustice and confusion incident to the doctrine of Swift v. Tyson have been repeatedly urged as reasons for abolishing or limiting diversity of citizenship jurisdiction. . . .

Except in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state. And whether the law of the state shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern. There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a state whether they be local in their nature or 'general,' be they commercial law or a part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts. . . .

The fallacy underlying the rule declared in Swift v. Tyson is made clear by Mr. Justice Holmes. The doctrine rests upon the assumption that there is 'a transcendental body of law outside of any particular State but obligatory within it unless and until changed by statute,' that federal courts have the power to use their judgment as to what the rules of common law are; and that in the federal courts 'the parties are entitled to an independent judgment on matters of general law'. . .

Thus the doctrine of Swift v. Tyson is, as Mr. Justice Holmes said, 'an unconstitutional assumption of powers by the Courts of the United States which no lapse of time or respectable array of opinion should make us hesitate to correct.' In disapproving that doctrine we . . . declare that in applying the doctrine this Court and the lower courts have invaded rights which in our opinion are reserved by the Constitution to the several states.

The defendant contended that by the common law of Pennsylvania as declared by its highest court . . . . the only duty owed to the plaintiff was to refrain from willful or wanton injury. The plaintiff denied that such is the Pennsylvania law. In support of their respective contentions the parties discussed and cited many decisions of the Supreme Court of the state. The Circuit Court of Appeals ruled that the question of liability is one of general law; and on that ground declined to decide the issue of state law. As we hold this was error, the judgment is reversed and the case remanded to it for further proceedings in conformity with our opinion.

REVERSED.

Mr. Justice CARDOZO took no part in the consideration or decision of this case.

Mr. Justice BUTLER (dissenting).

George WENDELKEN, Petitioner,
v.
Henry S. Sherrill, Respondent

Supreme Court of Arizona

137 Ariz. 455; 671 P.2d 896

September 26, 1983

JUDGES: In Banc. Gordon, Vice Chief Justice. Holohan, C.J., and Hays, Cameron and Feldman, JJ., concur.

OPINION BY: GORDON

George Wendelken, the plaintiff-petitioner, is a sixty-six year old widower and a member of an organization known as "Arizona Singles Who's Who." Wendelken is a resident of Scottsdale, Arizona. The defendant-respondent, Henry S. Sherrill, is also a member of "Arizona Singles Who's Who" and, in addition, belongs to a California organization, "International Singles Who's Who." Sherrill is a resident of Tucson, Arizona, with his home and business there. Sherrill also has a vacation home in Puerto Penasco (Rocky Point), Sonora, Mexico.

Sometime prior to October 12, 1979, the "Arizona Singles Who's Who" circulated an invitation from Sherrill to club members in Phoenix soliciting reservations for a Columbus Day weekend party to be held at Sherrill's Puerto Penasco property. A similar invitation was circulated by the "International Singles Who's Who." A personal letter from Sherrill detailing the planned weekend was also distributed.

With two friends, Wendelken arrived at Sherrill's Puerto Penasco home during the afternoon of October 12, 1979. Upon his arrival, he discovered that the Mexican government had shut off all electricity to the Sherrill property. It was still daylight, though, and Wendelken and his companions were able to move about the house and to walk down a path to the beach without difficulty. However, after dark, the house and grounds were illuminated only by candlelight. While walking along the path that led from Sherrill's house to the beach, Wendelken fell several feet over the edge of the path and sustained a broken hip. Other guests took Wendelken to a Mexican clinic for examination and then arranged with the Arizona Department of Public Safety for helicopter transportation to the Tucson Veteran's Administration Hospital. There, he underwent surgery and subsequent care.

Wendelken timely filed suit against Sherrill in Pima County, Arizona, seeking compensation for his injuries, his medical expenses, and his lost earnings. Trial on the matter was set for February 8, 1983. On January 5, 1983, the trial court, the Honorable Lillian S. Fisher presiding, entered a minute entry granting Sherrill's Motion for Partial Summary Judgment and ordering that Mexican law would apply to "the issues of negligence, damages, and standard of care, etc." Wendelken filed a Petition for Special Action with the Court of Appeals Division Two to vacate the trial court's order. Division Two dismissed that petition on March 10, 1983. This petition for review followed. Jurisdiction is found pursuant to the Arizona Constitution and the Arizona Rules of Civil Appellate Procedure. As we find that Arizona law should apply to all aspects of this case, we vacate the Court of Appeal's order dated March 10, 1983, as well as the trial court's ruling which granted Sherrill's Motion for Partial Summary Judgment, and remand the matter to the Superior Court for further proceedings consistent with this opinion.

This petition for review raises only one issue: whether the laws of the country of Mexico or the laws of the State of Arizona should apply to this action. To make this choice between laws, we must look to the conflicts laws of Arizona, the forum state.

In *Schwartz v. Schwartz, 103 Ariz. 562 (1968),* this Court adopted the rules embodied in the Restatement (Second) of Conflict of Laws as the rules for Arizona. In so doing, we discarded the doctrine of lex loci delicti. Had this case arisen while lex loci was still in effect, our response would have been automatic: since this incident occurred in Mexico, that country's law would be applied to all substantive issues. However, as this case arose after the demise of lex loci, our response is not at all automatic.

The Restatement (Second) § 145 sets forth the general principle by which tort choice of law questions are to be decided. Approved by this court in Schwartz, § 145 provides:

> "(1) The rights and liabilities of the parties with respect to an issue in tort are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the occurrence and the parties under the principles stated in § 6.
>
> "(2) Contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include:
>
> "(a) the place where the injury occurred,
> "(b) the place where the conduct causing the injury occurred,
> "(c) the domicil, residence, nationality, place of incorporation and place of business of the parties, and
> "(d) the place where the relationship, if any, between the parties is centered. "These contacts are to be evaluated according to their relative importance with respect to the particular issue."

. . . . As § 145(1) makes clear, our task is to determine which state has the "most significant relationship" to the parties and the issues in question. Of the four contacts specified in § 145(2), two obviously attach to Mexico — the place of Wendelken's injury and the place of Sherrill's alleged negligence. However, the other two contacts attach to Arizona — both Wendelken and Sherrill are domiciled in Arizona, both are residents of Arizona, both are American nationals, Sherrill advertised this weekend party in Arizona via an Arizona organization of which both Sherrill and Wendelken are members, the solicitation reached Wendelken in Arizona, and the reservation was accepted in Arizona. Only the destination involved was Mexico. The "relationship between the parties" centered in Arizona. As we have made clear, "the determination of which state has the most significant contacts is primarily qualitative, not quantitative." *Schwartz, at 257.* Having established the numerical distribution of the important contacts, we now must evaluate those contacts to determine which law should apply. . . . .

Our choice of law in this matter should have little effect on the harmonious relationship or on the commercial interaction between Arizona and Mexico. This was a purely private relationship between two Arizona residents. Neither public accommodation nor public transportation facilities was utilized. Had this trip been sponsored by the Mexican government instead of by a private American citizen or had the accident occurred at a Mexican hotel instead of at a private home, Mexican tourism might have been affected. In either event, this element would take on a greater weight in the choice of law decision. Those facts, however, are not before us.

Arizona, in addition to being the forum state and the place of the trial, has considerable interest in this matter. Both parties are domiciliaries of Arizona giving this state a natural interest in each of them. One aspect of that interest is the appropriate compensation of Wendelken for his losses. Striving insofar as possible to make the injured party whole, Arizona allows unlimited recovery for actual damages, expenses for past and prospective medical care, past and prospective pain and suffering, lost earnings, and diminished earning capacity. This is in sharp contrast to the compensatory scheme of Mexico. The parties have supplied this Court with a translation of Article 1915 of the Civil Code of Mexico. According to that translation, not only are damages resulting from personal injury recoverable only to the extent allowed by a quota system included in the Mexican Federal Labor Law, but the maximum wage that can be taken into account in this determination is twenty-five pesos per day. [On the date of Wendelken's accident, twenty-five pesos equaled $1.0975. At current exchange rates, the value is only $0.1675.]

As both Wendelken and Sherrill are Arizona residents, there is little reason to apply Mexico's measure of damages and undercompensate Wendelken for his losses. . . . The measure of Wendelken's damage recovery for his injuries is of interest to this state not only because he is a domiciliary, but also because appropriate compensation helps guarantee payment to his Arizona medical providers and because, if other resources are not available, the burden for caring for his injuries will fall upon the State of Arizona.

Mexico also has an interest in the duties and the extent of the liability imposed upon Sherrill. This interest is based on Sherrill's possessory interest in Mexican land. The policy of limited liability just explained is apparently designed to shield Mexican citizens from large judgments and is undoubtedly linked to Mexico's socialized system of health care. As an injured Mexican's health care costs would be paid for, the Civil Code limits damages to reimbursement, by the above-mentioned quota system, of his lost wages. As neither Wendelken nor Sherrill is a Mexican citizen or a Mexican wage-earner, Mexico's interest does not overcome that of Arizona.

Respondent Sherrill seeks to distinguish this case from automobile accident cases involving forum state plaintiffs and forum state defendants but an out-of-state accident. In those cases, because mere fortuity determines the place of the injury, the forum state law is generally applied. Sherrill argues that this injury and the alleged negligence that caused it could only have occurred in Mexico and asserts that Mexico's interest in establishing duties and liabilities of possessors of Mexican land should be the decisive consideration in our choice of law determination. This would signal a return to the doctrine of lex loci delicti in those cases where the duties of owners and occupiers of land are at issue. We refuse to return to lex loci for these cases. . . .

As neither party anticipated a negligent act, it is likely that neither acted with any thought to the consequences of his conduct or to the law that might be applied to any dispute resolution. However, Sherrill can not claim that the imposition of Arizona negligence or damage standards is an unfair surprise. He has offered no indication that he relied in any way on the Mexican limited liability scheme. Rather, he concedes that he purchased liability insurance on his Puerto Penasco property through an Arizona insurance carrier in the amount of $300,000.00, and obviously relied on the expectation that this Arizona insurance would cover any liability resulting from his interest in the Mexican land. . . . . Finally, Mexican laws, though in Spanish, could certainly be presented by counsel to the finder of fact in such a way that its application would be no more difficult than the application of Arizona law.

Having fully considered the relevant factors and the interests of both states, we conclude that Arizona has the most significant relationship to this occurrence and to these parties. As this state borders the state of Sonora, Mexico, our citizens are frequent visitors there and this issue will undoubtedly arise again. Our decision does not affect the sovereignty of the State of Sonora nor the Country of Mexico, but does protect our own citizens. We therefore vacate the trial court's ruling which granted Sherrill's Motion for Partial Summary Judgment and ordered that Mexican law would apply to all substantive issues and remand to the Superior Court for further proceeding.

FRANK J. FERLITO and SUSAN FERLITO, Plaintiffs,
v.
JOHNSON & JOHNSON PRODUCTS, INC., a New Jersey corporation, Defendant

United States District Court for the Eastern District Of Michigan, Southern Division

771 F. Supp. 196
(August 22, 1991)

JUDGE: Paul V. Gadola, United States District Judge.

Plaintiffs Susan and Frank Ferlito, husband and wife, attended a Halloween party in 1984 dressed as Mary (Mrs. Ferlito) and her little lamb (Mr. Ferlito). Mrs. Ferlito had constructed a lamb costume for her husband by gluing cotton batting manufactured by defendant Johnson & Johnson Products ("JJP") to a suit of long underwear. She had also used defendant's product to fashion a headpiece, complete with ears. The costume covered Mr. Ferlito from his head to his ankles, except for his face and hands, which were blackened with Halloween paint. At the party Mr. Ferlito attempted to light his cigarette by using a butane lighter. The flame passed close to his left arm, and the cotton batting on his left sleeve ignited. Plaintiffs sued defendant for injuries they suffered from burns which covered approximately one-third of Mr. Ferlito's body.

Following a jury verdict entered for plaintiffs November 2, 1989, the Honorable Ralph M. Freeman entered a judgment for plaintiff Frank Ferlito in the amount of $555,000 and for plaintiff Susan Ferlito in the amount of $70,000. Judgment was entered November 7, 1989.

Subsequently, on November 16, 1989, defendant JJP filed a timely motion for judgment notwithstanding the verdict pursuant to Fed.R.Civ.P. 50(b) or, in the alternative, for new trial. Plaintiffs filed their response to defendant's motion December 18, 1989; and defendant filed a reply January 4, 1990. . . .

MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

Issuance of a judgment notwithstanding the verdict ("j.n.o.v.") is authorized by Rule 50(b) of the Federal Rules of Civil Procedure. . . .Rule 50(b) Fed.R.Civ.P.

Defendant JJP filed two motions for a directed verdict, the first on October 27, 1989, at the close of plaintiffs' proofs, and the second on October 30, 1989, at the close of defendant's proofs. Judge Freeman denied both motions without prejudice. Judgment for plaintiffs was entered November 7, 1989; and defendant's instant motion, filed November 16, 1989, was filed in a timely manner.

The standard for determining whether to grant a j.n.o.v. is identical to the standard for evaluating a motion for directed verdict:

> In determining whether the evidence is sufficient, the trial court may neither weigh the evidence, pass on the credibility of witnesses nor substitute its judgment for that of the jury. Rather, the evidence must be viewed in the light most favorable to the party against whom the motion is made, drawing from that evidence all reasonable inferences in his favor.

[cites omitted]. . . If after reviewing the evidence, however, the trial court is of the opinion that reasonable minds could not come to the result reached by the jury, then the motion for j.n.o.v. should be granted. . . . . [cites omitted] The trial court makes its determination as a matter of law. . . .

To recover in a "failure to warn" product liability action, a plaintiff must prove each of the following four elements of negligence: (1) that the defendant owed a duty to the plaintiff, (2) that the defendant violated that duty, (3) that the defendant's breach of that duty was a proximate cause of the damages suffered by the plaintiff, and (4) that the plaintiff suffered damages. . . . . [cites omitted]

To establish a prima facie case that a manufacturer's breach of its duty to warn was a proximate cause of an injury sustained, a plaintiff must present evidence that the product would have been used differently had the proffered warnings been given. . . . [cites omitted] In the absence of evidence that a warning would have prevented the harm complained of by altering the plaintiff's conduct, the failure to warn cannot be deemed a proximate cause of the plaintiff's injury as a matter of law.

Similarly, a failure to warn cannot be deemed a proximate cause of injury if the plaintiff knew of the danger about which he claims the defendant failed to warn. [cites omitted]

A manufacturer has a duty "to warn the purchasers or users of its product about dangers associated with intended use." [cites omitted] Conversely, a manufacturer has no duty to warn of a danger arising from an unforeseeable misuse of its product. [cites omitted] Thus, whether a manufacturer has a duty to warn depends on whether the use of the product and the injury sustained by it are foreseeable. [cites omitted] Whether a plaintiff's use of a product is foreseeable is a legal question to be resolved by the court. Trotter, supra. Whether the resulting injury is foreseeable is a question of fact for the jury. [cites omitted]

In the instant action no reasonable jury could find that JJP's failure to warn of the flammability of cotton batting was a proximate cause of plaintiffs' injuries because plaintiffs failed to offer any evidence to establish that a flammability warning on JJP's cotton batting would have dissuaded them from using the product in the manner that they did.

Plaintiffs repeatedly stated in their response brief that plaintiff Susan Ferlito testified that "she would never again use cotton batting to make a costume." Plaintiffs' Answer to Defendant JJP's Motion for J.N.O.V., pp. 1, 3, 4, 5. However, a review of the trial transcript reveals that plaintiff Susan Ferlito never testified that she would never again use cotton batting to make a costume. More importantly, the transcript contains no statement by plaintiff Susan Ferlito that a flammability warning on defendant JJP's product would have dissuaded her from using the cotton batting to construct the costume in the first place. At oral argument counsel for plaintiffs conceded that there was no testimony during the trial that either plaintiff Susan Ferlito or her husband, plaintiff Frank J. Ferlito, would have acted any different if there had been a flammability warning on the product's package. The absence of such testimony is fatal to plaintiffs' case; for without it, plaintiffs have failed to prove proximate cause, one of the essential elements of their negligence claim.

In addition, both plaintiffs testified that they knew that cotton batting burns when it is exposed to flame. Susan Ferlito testified that she knew at the time she purchased the cotton batting that it would burn if exposed to an open flame. Frank Ferlito testified that he knew at the time he appeared at the Halloween party that cotton batting would burn if exposed to an open flame. His additional testimony that he would not have intentionally put a flame to the cotton batting shows that he recognized the risk of injury of which he claims JJP should have warned. Because both plaintiffs were already aware of the danger, a warning by JJP would have been superfluous. Therefore, a reasonable jury could not have found that JJP's failure to provide a warning was a proximate cause of plaintiffs' injuries.

The evidence in this case clearly demonstrated that neither the use to which plaintiffs put JJP's product nor the injuries arising from that use were foreseeable. Susan Ferlito testified that the idea for the costume was hers alone. As described on the product's package, its intended uses are for cleansing, applying medications, and infant care. Plaintiffs' showing that the product may be use on occasion in classrooms for decorative purposes failed to demonstrate the foreseeability of an adult male encapsulating himself from head to toe in cotton batting and then lighting up a cigarette. . . .

NOW, THEREFORE, IT IS HEREBY ORDERED that defendant JJP's motion for judgment notwithstanding the verdict is GRANTED.

IT IS FURTHER ORDERED that the judgment entered November 2, 1989, is SET ASIDE.

IT IS FURTHER ORDERED that the clerk will enter a judgment in favor of the defendant JJP.

II. Constitutional Law

UNITED STATES v. DARBY

SUPREME COURT OF THE UNITED STATES

312 U.S. 100

February 3, 1941, Decided

JUDGES: Hughes, McReynolds, Stone, Roberts, Black, Reed, Frankfurter, Douglas, Murphy

OPINION: MR. JUSTICE STONE delivered the opinion of the Court.

The two principal questions raised by the record in this case are, first, whether Congress has constitutional power to prohibit the shipment in interstate commerce of lumber manufactured by employees whose wages are less than a prescribed minimum or whose weekly hours of labor at that wage are greater than a prescribed maximum, and, second, whether it has power to prohibit the employment of workmen in the production of goods "for interstate commerce" at other than prescribed wages and hours. . . .

The Fair Labor Standards Act set up a comprehensive legislative scheme for preventing the shipment in interstate commerce of certain products and commodities produced in the United States under labor conditions as respects wages and hours which fail to conform to standards set up by the Act. Its purpose . . . is to exclude from interstate commerce goods produced for the commerce and to prevent their production for interstate commerce, under conditions detrimental to the maintenance of the minimum standards of living necessary for health and general well-being; and to prevent the use of interstate commerce as the means of competition in the distribution of goods so produced, and as the means of spreading and perpetuating such substandard labor conditions among the workers of the several states. . . .

Section 15 (1) makes unlawful the shipment in interstate commerce of any goods "in the production of which any employee was employed in violation of section 6 or section 7," which provide, among other things, that during the first year of operation of the Act a minimum wage of 25 cents per hour shall be paid to employees "engaged in [interstate] commerce or the production of goods for [interstate] commerce," and that the maximum hours of employment for employees "engaged in commerce or the production of goods for commerce" without increased compensation for overtime, shall be forty-four hours a week. . . . .

The indictment charges that appellee is engaged, in the State of Georgia, in the business of acquiring raw materials, which he manufactures into finished lumber with the intent, when manufactured, to ship it in interstate commerce to customers outside the state, and that he does in fact so ship a large part of the lumber so produced. There are numerous counts charging appellee with the shipment in interstate commerce from Georgia to points outside the state of lumber in the production of which, for interstate commerce, appellee has employed workmen at less than the prescribed minimum wage or more than the prescribed maximum hours without payment to them of any wage for overtime. Other counts charge the employment by appellee of workmen in the production of lumber for interstate commerce at wages at less than 25 cents an hour or for more than the maximum hours per week without payment to them of the prescribed overtime wage. . . .

The district court quashed the indictment in its entirety upon the broad grounds that the Act, which it interpreted as a regulation of manufacture within the states, is unconstitutional. It declared that manufacture is not interstate commerce and that the regulation by the Fair Labor Standards Act of wages and hours of employment of those engaged in the manufacture of goods . . . is not within the congressional power to regulate interstate commerce.

The effect of the court's decision and judgment is thus to deny the power of Congress to prohibit shipment in interstate commerce of lumber produced for interstate commerce under the proscribed substandard labor conditions of wages and hours, its power to penalize the employer for his failure to conform to the wage and hour provisions in the case of employees engaged in the production of lumber which he intends thereafter to ship in interstate commerce in part or in whole according to the normal course of his business and its power to compel him to keep records of hours of employment as required by the statute and the regulations of the administrator. . . .

While manufacture is not of itself interstate commerce, the shipment of manufactured goods interstate is such commerce and the prohibition of such shipment by Congress is indubitably a regulation of the commerce. The power to regulate commerce is the power "to prescribe the rule by which commerce is governed." . . . It extends not only to those regulations which aid, foster and protect the commerce, but embraces those which prohibit it. . . .

But it is said that the present prohibition falls within the scope of none of these categories; that while the prohibition is nominally a regulation of the commerce its motive or purpose is regulation of wages and hours of persons engaged in manufacture, the control of which has been reserved to the states and upon which Georgia and some of the states of destination have placed no restriction; that the effect of the present statute is not to exclude the proscribed articles from interstate commerce in aid of state regulation. . . . but instead, under the guise of a regulation of interstate commerce, it undertakes to regulate wages and hours within the state contrary to the policy of the state which has elected to leave them unregulated. The power of Congress over interstate commerce "is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations other than are prescribed in the Constitution." *Gibbons v. Ogden, supra, 196.* . . . Congress, following its own conception of public policy concerning the restrictions which may appropriately be imposed on interstate commerce, is free to exclude from the commerce articles whose use in the states for which they are destined it may conceive to be injurious to the public health, morals or welfare, even though the state has not sought to regulate their use. Such regulation is not a forbidden invasion of state power merely because either its motive or its consequence is to restrict the use of articles of commerce within the states of destination; and is not prohibited unless by other Constitutional provisions. It is no objection to the assertion of the power to regulate interstate commerce that its exercise is attended by the same incidents which attend the exercise of the police power of the states. The motive and purpose of the present regulation are plainly to make effective the Congressional conception of public policy that interstate commerce should not be made the instrument of competition in the distribution of goods produced under substandard labor conditions, which competition is injurious to the commerce and to the states from and to which the commerce flows. . . . Whatever their motive and purpose, regulations of commerce which do not infringe some constitutional prohibition are within the plenary power conferred on Congress by the Commerce Clause. Subject only to that limitation, presently to be considered, we conclude that the prohibition of the shipment interstate of goods produced under the forbidden substandard labor conditions is within the constitutional authority of Congress.

In the more than a century which has elapsed since the decision of *Gibbons v. Ogden* (1824), these principles of constitutional interpretation have been so long and repeatedly recognized by this Court as applicable to the Commerce Clause, that there would be little occasion for repeating them now were it not for the decision of this Court twenty-two years ago in *Hammer v. Dagenhart, 247 U.S. 251.* In that case it was held by a bare majority of the Court over the powerful and now classic dissent of Mr. Justice Holmes setting forth the fundamental issues involved, that Congress was without power to exclude the products of child labor from interstate commerce. The reasoning and conclusion of the Court's opinion there cannot be reconciled with the conclusion which we have reached, that the power of Congress under the Commerce Clause is plenary to exclude any article from interstate commerce subject only to the specific prohibitions of the Constitution.

Hammer v. Dagenhart has not been followed. The distinction on which the decision was rested that Congressional power to prohibit interstate commerce is limited to articles which in themselves have some harmful or deleterious property — a distinction which was novel when made and unsupported by any provision of the Constitution — has long since been abandoned. The thesis of the opinion that the motive of the prohibition or its effect to control in some measure the use or production within the states of the article thus excluded from the commerce can operate to deprive the regulation of its constitutional authority has long since ceased to have force. And finally we have declared "The authority of the federal government over interstate commerce does not differ in extent or character from that retained by the states over intrastate commerce." [cites omitted]

The conclusion is inescapable that Hammer v. Dagenhart was a departure from the principles which have prevailed in the interpretation of the Commerce Clause both before and since the decision and that such vitality, as a precedent, as it then had has long since been exhausted. It should be and now is overruled.

. . . . As the Government seeks to apply the statute in the indictment, and as the court below construed the phrase "produced for interstate commerce," it embraces at least the case where an employer engaged, as is appellee, in the manufacture and shipment of goods in filling orders of extrastate customers, manufactures his product with the intent or expectation that according to the normal course of his business all or some part of it will be selected for shipment to those customers.

Without attempting to define the precise limits of the phrase, we think the acts alleged in the indictment are within the sweep of the statute. The obvious purpose of the Act was not only to prevent the interstate transportation of the proscribed product, but to stop the initial step toward transportation, production with the purpose of so transporting it. Congress was not unaware that most manufacturing businesses shipping their product in interstate commerce make it in their shops without reference to its ultimate destination and then after manufacture select some of it for shipment interstate and some intrastate according to the daily demands of their business, and that it would be practically impossible, without disrupting manufacturing businesses, to restrict the prohibited kind of production to the particular pieces of lumber, cloth, furniture or the like which later move in interstate rather than intrastate commerce. [cite omitted] . . .

There remains the question whether such restriction on the production of goods for commerce is a permissible exercise of the commerce power. The power of Congress over interstate commerce is not confined to the regulation of commerce among the states. It extends to those activities intrastate which so affect interstate commerce or the exercise of the power of Congress over it as to make regulation of them appropriate means to the attainment of a legitimate end, the exercise of the granted power of Congress to regulate interstate commerce

While this Court has many times found state regulation of interstate commerce, when uniformity of its regulation is of national concern, to be incompatible with the Commerce Clause even though Congress has not legislated on the subject, the Court has never implied such restraint on state control over matters intrastate not deemed to be regulations of interstate commerce or its instrumentalities even though they affect the commerce. In the absence of Congressional legislation on the subject state laws which are not regulations of the commerce itself or its instrumentalities are not forbidden even though they affect interstate commerce.

But it does not follow that Congress may not by appropriate legislation regulate intrastate activities where they have a substantial effect on interstate commerce. . . . . In such legislation Congress has sometimes left it to the courts to determine whether the intrastate activities have the prohibited effect on the commerce . . . It has sometimes left it to an administrative board or agency to determine whether the activities sought to be regulated or prohibited have such effect, or whether they come within the statutory definition of the prohibited Act. . . . And sometimes Congress itself has said that a particular activity affects the commerce, as it did in the present Act . . . . In passing on the validity of legislation of the class last mentioned the only function of courts is to determine whether the particular activity regulated or prohibited is within the of the federal power.

Congress, having by the present Act adopted the policy of excluding from interstate commerce all goods produced for the commerce which do not conform to the specified labor standards, it may choose the means reasonably adapted to the attainment of the permitted end, even though they involve control of intrastate activities. Such legislation has often been sustained with respect to powers, other than the commerce power granted to the national government, when the means chosen, although not themselves within the granted power, were nevertheless deemed appropriate aids to the accomplishment of some purpose within an admitted power of the national government. A familiar like exercise of power is the regulation of intrastate transactions which are so commingled with or related to interstate commerce that all must be regulated if the interstate commerce is to be effectively controlled. . . . .

. . . . As we have said the evils aimed at by the Act are the spread of substandard labor conditions through the use of the facilities of interstate commerce for competition by the goods so produced with those produced under the prescribed or better labor conditions; and the consequent dislocation of the commerce itself caused by the impairment or destruction of local businesses by competition made effective through interstate commerce. The Act is thus directed at the suppression of a method or kind of competition in interstate commerce which it has in effect condemned as "unfair" . . . The means adopted by §15(a)(2) for the protection of interstate commerce by the suppression of the production of the condemned goods for interstate commerce is so related to the commerce and so affects it as to be within the reach of the commerce power. . . .

Reverse

UNITED STATES, PETITIONER v. ALFONSO LOPEZ, JR.

U.S. Supreme Court

Argued November 8, 1994
Decided April 26, 1995

Facts: After respondent, a 12th-grade student, carried a concealed handgun into his high school, he was charged with violating the Gun-Free School Zones Act of 1990, which forbids "any individual knowingly to possess a firearm at a place that [he] knows is a school zone." The District Court denied his motion to dismiss the indictment, concluding that the Act is a constitutional exercise of Congress' power to regulate activities in and affecting commerce. In reversing, the Court of Appeals held that the Act is invalid as beyond Congress' power under the Commerce Clause.

Held: The Act exceeds Congress' Commerce Clause authority. First, although this Court has upheld a wide variety of congressional Acts regulating intrastate economic activity that substantially affected interstate commerce, the possession of a gun in a local school zone is in no sense an economic activity that might, through repetition elsewhere, have such a substantial effect on interstate commerce. The Act is a criminal statute that by its terms has nothing to do with "commerce" or any sort of economic enterprise, however broadly those terms are defined. Nor is it an essential part of a larger regulation of economic activity, in which the regulatory scheme could be undercut unless the intrastate activity were regulated. It cannot, therefore, be sustained under the Court's cases upholding regulations of activities that arise out of or are connected with a commercial transaction, which viewed in the aggregate, substantially affects interstate commerce.

REHNQUIST, C. J., delivered the opinion of the Court, in which O'CONNOR, SCALIA, KENNEDY, and THOMAS, JJ., joined. KENNEDY, J., filed a concurring opinion, in which O'CONNOR, J., joined. THOMAS, J., filed a concurring opinion. STEVENS, J., and SOUTER, J., filed dissenting opinions. BREYER, J., filed a dissenting opinion, in which STEVENS, SOUTER, and GINSBURG, JJ., joined.

OPINION: REHNQUIST, C. J.,

We start with first principles. The Constitution creates a Federal Government of enumerated powers. As James Madison wrote, "[t]he powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite." The Federalist No. 45. This constitutionally mandated division of authority "was adopted by the Framers to ensure protection of our fundamental liberties." . . .

The commerce power "is the power to regulate; that is, to prescribe the rule by which commerce is to be governed. This power, like all others vested in Congress, is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the constitution." The Gibbons Court, however, acknowledged that limitations on the commerce power are inherent in the very language of the Commerce Clause. . . .

For nearly a century thereafter, the Court's Commerce Clause decisions dealt but rarely with the extent of Congress' power, and almost entirely with the Commerce Clause as a limit on state legislation that discriminated against interstate commerce. . . . Under this line of precedent, the Court held that certain categories of activity such as "production," "manufacturing," and "mining" were within the province of state governments, and thus were beyond the power of Congress under the Commerce Clause. . .

In 1887, Congress enacted the Interstate Commerce Act, and in 1890, Congress enacted the Sherman Antitrust Act. These laws ushered in a new era of federal regulation under the commerce power. When cases involving these laws first reached this Court, we imported from our negative Commerce Clause cases the approach that Congress could not regulate activities such as "production," "manufacturing," and "mining." . . . Simultaneously, however, the Court held that, where the interstate and intrastate aspects of commerce were so mingled together that full regulation of interstate commerce required incidental regulation of intrastate commerce, the Commerce Clause authorized such regulation. . . . .

The Court held that intrastate activities that "have such a close and substantial relation to interstate commerce that their control is essential or appropriate to protect that commerce from burdens and obstructions" are within Congress' power to regulate.

In United States v. Darby, 312 U.S. 100 (1941), the Court upheld the Fair Labor Standards Act, stating: "The power of Congress over interstate commerce is not confined to the regulation of commerce among the states. It extends to those activities intrastate which so affect interstate commerce or the exercise of the power of Congress over it as to make regulation of them appropriate means to the attainment of a legitimate end, the exercise of the granted power of Congress to regulate interstate commerce."

. . . . Darby ushered in an era of Commerce Clause jurisprudence that greatly expanded the previously defined authority of Congress under that Clause. In part, this was a recognition of the great changes that had occurred in the way business was carried on in this country. Enterprises that had once been local or at most regional in nature had become national in scope. But the doctrinal change also reflected a view that earlier Commerce Clause cases artificially had constrained the authority of Congress to regulate interstate commerce.

But even these modern-era precedents which have expanded congressional power under the Commerce Clause confirm that this power is subject to outer limits. . . .

Consistent with this structure, we have identified three broad categories of activity that Congress may regulate under its commerce power. . . . . First, Congress may regulate the use of the channels of interstate commerce. See, e.g., Darby, 312 U.S. . . . Second, Congress is empowered to regulate and protect the instrumentalities of interstate commerce, or persons or things in interstate commerce, even though the threat may come only from intrastate activities. . . . Finally, Congress' commerce authority includes the power to regulate those activities having a substantial relation to interstate commerce, i.e., those activities that substantially affect interstate commerce. . . .

We now turn to consider the power of Congress, in the light of this framework. . . . .

First, we have upheld a wide variety of congressional Acts regulating intrastate economic activity where we have concluded that the activity substantially affected interstate commerce. . . . Where economic activity substantially affects interstate commerce, legislation regulating that activity will be sustained. . . . .

The Government argues that Congress has accumulated institutional expertise regarding the regulation of firearms through previous enactments. . . . The Government's essential contention, in fine, is that we may determine here that the Act is valid because possession of a firearm in a local school zone does indeed substantially affect interstate commerce. The Government argues that possession of a firearm in a school zone may result in violent crime and that violent crime can be expected to affect the functioning of the national economy in two ways. First, the costs of violent crime are substantial, and, through the mechanism of insurance, those costs are spread throughout the population. Second, violent crime reduces the willingness of individuals to travel to areas within the country that are perceived to be unsafe. . . . The Government also argues that the presence of guns in schools poses a substantial threat to the educational process by threatening the learning environment. . . . That, in turn, would have an adverse effect on the Nation's economic well-being. As a result, the Government argues that Congress could rationally have concluded that the Act substantially affects interstate commerce.

We pause to consider the implications of the Government's arguments. The Government admits, under its "costs of crime" reasoning, that Congress could regulate not only all violent crime, but all activities that might lead to violent crime, regardless of how tenuously they relate to interstate commerce. Similarly, under the Government's "national productivity" reasoning, Congress could regulate any activity that it found was related to the economic productivity of individual citizens: family law (including marriage, divorce, and child custody), for example. Under the theories that the Government presents in support of the Act, it is difficult to perceive any limitation on federal power, even in areas such as criminal law enforcement or education where States historically have been sovereign. Thus, if we were to accept the Government's arguments, we are hard-pressed to posit any activity by an individual that Congress is without power to regulate. . . .

Admittedly, a determination whether an intrastate activity is commercial or noncommercial may in some cases result in legal uncertainty. But, so long as Congress' authority is limited to those powers enumerated in the Constitution, and so long as those enumerated powers are interpreted as having judicially enforceable outer limits, congressional legislation under the Commerce Clause always will engender "legal uncertainty." . . . .

These are not precise formulations, and in the nature of things they cannot be. But we think they point the way to a correct decision of this case. The possession of a gun in a local school zone is in no sense an economic activity that might, through repetition elsewhere, substantially affect any sort of interstate commerce. Respondent was a local student at a local school; there is no indication that he had recently moved in interstate commerce, and there is no requirement that his possession of the firearm have any concrete tie to interstate commerce.

To uphold the Government's contentions here, we would have to pile inference upon inference in a manner that would bid fair to convert congressional authority under the Commerce Clause to a general police power of the sort retained by the States. Admittedly, some of our prior cases have taken long steps down that road, giving great deference to congressional action. The broad language in these opinions has suggested the possibility of additional expansion, but we decline here to proceed any further. To do so would require us to conclude that the Constitution's enumeration of powers does not presuppose something not enumerated, and that there never will be a distinction between what is truly national and what is truly local. This we are unwilling to do.

For the foregoing reasons the judgment of the Court of Appeals is Affirmed.

JUSTICE THOMAS, concurring.

The Court today properly concludes that the Commerce Clause does not grant Congress the authority to prohibit gun possession within 1,000 feet of a school, as it attempted to do in the Gun-Free School Zones Act of 1990.

At the time the original Constitution was ratified, "commerce" consisted of selling, buying, and bartering, as well as transporting for these purposes. . . . As one would expect, the term "commerce" was used in contradistinction to productive activities such as manufacturing and agriculture. . . . The Constitution not only uses the word "commerce" in a narrower sense than our case law might suggest, it also does not support the proposition that Congress has authority over all activities that "substantially affect" interstate commerce. . . . . Clearly, the Framers could have drafted a Constitution that contained a "substantially affects interstate commerce" clause had that been their objective.

This extended discussion of the original understanding and our first century and a half of case law does not necessarily require a wholesale abandonment of our more recent opinions. It simply reveals that our substantial effects test is far removed from both the Constitution and from our early case law and that the Court's opinion should not be viewed as "radical" or another "wrong turn" that must be corrected in the future. The analysis also suggests that we ought to temper our Commerce Clause jurisprudence. . . .

At an appropriate juncture, I think we must modify our Commerce Clause jurisprudence. Today, it is easy enough to say that the Clause certainly does not empower Congress to ban gun possession within 1,000 feet of a school.

JUSTICE BREYER, with whom JUSTICES STEVENS, SOUTER, and GINSBURG join, dissenting.

The issue in this case is whether the Commerce Clause authorizes Congress to enact a statute that makes it a crime to possess a gun in, or near, a school. In my view, the statute falls well within the scope of the commerce power as this Court has understood that power over the last half-century. . . .

In sum, to find this legislation within the scope of the Commerce Clause would permit "Congress . . . to act in terms of economic . . . realities." . . . . Upholding this legislation would do no more than simply recognize that Congress had a "rational basis" for finding a significant connection between guns in or near schools and (through their effect on education) the interstate and foreign commerce they threaten. For these reasons, I would reverse the judgment of the Court of Appeals. Respectfully, I dissent.

COHEN v. CALIFORNIA

SUPREME COURT OF THE UNITED STATES

403 U.S. 15

February 22, 1971, Argued
June 7, 1971, Decided

JUDGES: Harlan, J., delivered the opinion of the Court, in which Douglas, Brennan, Stewart, and Marshall, JJ., joined. Blackmun, J., filed a dissenting opinion, in which Burger, C. J., and Black, J., joined, and in which White, J., joined in part. MR. JUSTICE HARLAN delivered the opinion of the Court.

This case may seem at first blush too inconsequential to find its way into our books, but the issue it presents is of no small constitutional significance.

Appellant Paul Robert Cohen was convicted in the Los Angeles Municipal Court of violating that part of California Penal Code § 415 which prohibits "maliciously and willfully disturb[ing] the peace or quiet of any neighborhood or person . . . by . . . offensive conduct . . . ."[1] He was given 30 days' imprisonment. The facts upon which his conviction rests are detailed in the opinion of the Court of Appeal of California, Second Appellate District, as follows:

"On April 26, 1968, the defendant was observed in the Los Angeles County Courthouse in the corridor outside of division 20 of the municipal court wearing a jacket bearing the words 'Fuck the Draft' which were plainly visible. There were women and children present in the corridor. The defendant was arrested. The defendant testified that he wore the jacket knowing that the words were on the jacket as a means of informing the public of the depth of his feelings against the Vietnam War and the draft.

"The defendant did not engage in, nor threaten to engage in, nor did anyone as the result of his conduct in fact commit or threaten to commit any act of violence. The defendant did not make any loud or unusual noise, nor was there any evidence that he uttered any sound prior to his arrest."

In affirming the conviction the Court of Appeal held that "offensive conduct" means "behavior which has a tendency to provoke *others* to acts of violence or to in turn disturb the peace," and that the State had proved this element because, on the facts of this case, "it was certainly reasonably foreseeable that such conduct might cause others to rise up to commit a violent act against the person of the defendant or attempt to forcibly remove his jacket." The California Supreme Court declined review by a divided vote. We brought the case here, postponing the consideration of the question of our jurisdiction over this appeal to a hearing of the case on the merits. We now reverse.

The question of our jurisdiction need not detain us long. Throughout the proceedings below, Cohen consistently claimed that, as construed to apply to the facts of this case, the statute infringed his rights to freedom of expression guaranteed by the First and Fourteenth Amendments of the Federal Constitution. That contention has been rejected by the highest California state court in which review could be had. Accordingly, we are fully satisfied that Cohen has properly invoked our jurisdiction by this appeal.

I

In order to lay hands on the precise issue which this case involves, it is useful first to canvass various matters which this record does *not* present.

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[1] The statute provides in full: "Every person who maliciously and willfully disturbs the peace or quiet of any neighborhood or person, by loud or unusual noise, or by tumultuous or offensive conduct, or threatening, traducing, quarreling, challenging to fight, or fighting, or who, on the public streets of any unincorporated town, or upon the public highways in such unincorporated town, run any horse race, either for a wager or for amusement, or fire any gun or pistol in such unincorporated town, or use any vulgar, profane, or indecent language within the presence or hearing of women or children, in a loud and boisterous manner, is guilty of a misdemeanor, and upon conviction by any Court of competent jurisdiction shall be punished by fine not exceeding two hundred dollars, or by imprisonment in the County Jail for not more than ninety days, or by both fine and imprisonment, or either, at the discretion of the Court."

The conviction quite clearly rests upon the asserted offensiveness of the *words* Cohen used to convey his message to the public. The only "conduct" which the State sought to punish is the fact of communication. Thus, we deal here with a conviction resting solely upon "speech," not upon any separately identifiable conduct which allegedly was intended by Cohen to be perceived by others as expressive of particular views but which, on its face, does not necessarily convey any message and hence arguably could be regulated without effectively repressing Cohen's ability to express himself. Further, the State certainly lacks power to punish Cohen for the underlying content of the message the inscription conveyed. At least so long as there is no showing of an intent to incite disobedience to or disruption of the draft, Cohen could not, consistently with the First and Fourteenth Amendments, be punished for asserting the evident position on the inutility or immorality of the draft his jacket reflected.

Appellant's conviction, then, rests squarely upon his exercise of the "freedom of speech" protected from arbitrary governmental interference by the Constitution and can be justified, if at all, only as a valid regulation of the manner in which he exercised that freedom, not as a permissible prohibition on the substantive message it conveys. This does not end the inquiry, of course, for the First and Fourteenth Amendments have never been thought to give absolute protection to every individual to speak whenever or wherever he pleases, or to use any form of address in any circumstances that he chooses. In this vein, too, however, we think it important to note that several issues typically associated with such problems are not presented here.

In the first place, Cohen was tried under a statute applicable throughout the entire State. Any attempt to support this conviction on the ground that the statute seeks to preserve an appropriately decorous atmosphere in the courthouse where Cohen was arrested must fail in the absence of any language in the statute that would have put appellant on notice that certain kinds of otherwise permissible speech or conduct would nevertheless, under California law, not be tolerated in certain places. No fair reading of the phrase "offensive conduct" can be said sufficiently to inform the ordinary person that distinctions between certain locations are thereby created.[2]

In the second place, as it comes to us, this case cannot be said to fall within those relatively few categories of instances where prior decisions have established the power of government to deal more comprehensively with certain forms of individual expression simply upon a showing that such a form was employed. This is not, for example, an obscenity case. Whatever else may be necessary to give rise to the States' broader power to prohibit obscene expression, such expression must be, in some significant way, erotic. It cannot plausibly be maintained that this vulgar allusion to the Selective Service System would conjure up such psychic stimulation in anyone likely to be confronted with Cohen's crudely defaced jacket.

This Court has also held that the States are free to ban the simple use, without a demonstration of additional justifying circumstances, of so-called "fighting words," those personally abusive epithets which, when addressed to the ordinary citizen, are, as a matter of common knowledge, inherently likely to provoke violent reaction. While the four-letter word displayed by Cohen in relation to the draft is not uncommonly employed in a personally provocative fashion, in this instance it was clearly not "directed to the person of the hearer. " No individual actually or likely to be present could reasonably have regarded the words on appellant's jacket as a direct personal insult. Nor do we have here an instance of the exercise of the State's police power to prevent a speaker from intentionally provoking a given group to hostile reaction. There is, as noted above, no showing that anyone who saw Cohen was in fact violently aroused or that appellant intended such a result.

Finally, in arguments before this Court much has been made of the claim that Cohen's distasteful mode of expression was thrust upon unwilling or unsuspecting viewers, and that the State might therefore legitimately act as it did in order to protect the sensitive from otherwise unavoidable exposure to appellant's crude form of protest. Of course, the mere presumed presence of unwitting listeners or viewers does not serve automatically to justify curtailing all speech capable of giving offense. While this Court has recognized that government may properly act in many situations to prohibit intrusion into the privacy of the home of unwelcome views and ideas which cannot be totally banned from the public dialogue, we have at the same time consistently stressed that "we are often 'captives' outside the sanctuary of the home and subject to objectionable speech." The ability of government, consonant with the Constitution, to shut off discourse solely to protect others from hearing it is, in other words, dependent upon a showing that substantial privacy interests are being invaded in an essentially intolerable manner. Any broader view of this authority would effectively empower a majority to silence dissidents simply as a matter of personal predilections.

[2] It is illuminating to note what transpired when Cohen entered a courtroom in the building. He removed his jacket and stood with it folded over his arm. Meanwhile, a policeman sent the presiding judge a note suggesting that Cohen be held in contempt of court. The judge declined to do so and Cohen was arrested by the officer only after he emerged from the courtroom.

In this regard, persons confronted with Cohen's jacket were in a quite different posture than, say, those subjected to the raucous emissions of sound trucks blaring outside their residences. Those in the Los Angeles courthouse could effectively avoid further bombardment of their sensibilities simply by averting their eyes. And, while it may be that one has a more substantial claim to a recognizable privacy interest when walking through a courthouse corridor than, for example, strolling through Central Park, surely it is nothing like the interest in being free from unwanted expression in the confines of one's own home. Given the subtlety and complexity of the factors involved, if Cohen's "speech" was otherwise entitled to constitutional protection, we do not think the fact that some unwilling "listeners" in a public building may have been briefly exposed to it can serve to justify this breach of the peace conviction where, as here, there was no evidence that persons powerless to avoid appellant's conduct did in fact object to it, and where that portion of the statute upon which Cohen's conviction rests evinces no concern, either on its face or as construed by the California courts, with the special plight of the captive auditor, but, instead, indiscriminately sweeps within its prohibitions all "offensive conduct" that disturbs "any neighborhood or person."

II

Against this background, the issue flushed by this case stands out in bold relief. It is whether California can excise, as "offensive conduct," one particular scurrilous epithet from the public discourse, either upon the theory of the court below that its use is inherently likely to cause violent reaction or upon a more general assertion that the States, acting as guardians of public morality, may properly remove this offensive word from the public vocabulary.

The rationale of the California court is plainly untenable. At most it reflects an "undifferentiated fear or apprehension of disturbance [which] is not enough to overcome the right to freedom of expression." We have been shown no evidence that substantial numbers of citizens are standing ready to strike out physically at whoever may assault their sensibilities with execrations like that uttered by Cohen. There may be some persons about with such lawless and violent proclivities, but that is an insufficient base upon which to erect, consistently with constitutional values, a governmental power to force persons who wish to ventilate their dissident views into avoiding particular forms of expression. The argument amounts to little more than the self-defeating proposition that to avoid physical censorship of one who has not sought to provoke such a response by a hypothetical coterie of the violent and lawless, the States may more appropriately effectuate that censorship themselves.

Admittedly, it is not so obvious that the First and Fourteenth Amendments must be taken to disable the States from punishing public utterance of this unseemly expletive in order to maintain what they regard as a suitable level of discourse within the body politic. We think, however, that examination and reflection will reveal the shortcomings of a contrary viewpoint.

At the outset, we cannot overemphasize that, in our judgment, most situations where the State has a justifiable interest in regulating speech will fall within one or more of the various established exceptions, discussed above but not applicable here, to the usual rule that governmental bodies may not prescribe the form or content of individual expression. Equally important to our conclusion is the constitutional backdrop against which our decision must be made. The constitutional right of free expression is powerful medicine in a society as diverse and populous as ours. It is designed and intended to remove governmental restraints from the arena of public discussion, putting the decision as to what views shall be voiced largely into the hands of each of us, in the hope that use of such freedom will ultimately produce a more capable citizenry and more perfect polity and in the belief that no other approach would comport with the premise of individual dignity and choice upon which our political system rests.

To many, the immediate consequence of this freedom may often appear to be only verbal tumult, discord, and even offensive utterance. These are, however, within established limits, in truth necessary side effects of the broader enduring values which the process of open debate permits us to achieve. That the air may at times seem filled with verbal cacophony is, in this sense not a sign of weakness but of strength. We cannot lose sight of the fact that, in what otherwise might seem a trifling and annoying instance of individual distasteful abuse of a privilege, these fundamental societal values are truly implicated. That is why "wholly neutral futilities . . . come under the protection of free speech as fully as do Keats' poems or Donne's sermons," and why "so long as the means are peaceful, the communication need not meet standards of acceptability."

Against this perception of the constitutional policies involved, we discern certain more particularized considerations that peculiarly call for reversal of this conviction. First, the principle contended for by the State seems inherently boundless. How is one to distinguish this from any other offensive word? Surely the State has no right to cleanse public debate to the point where it is grammatically palatable to the most squeamish among us. Yet no readily ascertainable general principle exists for stopping short of that result were we to affirm the judgment below. For, while the particular four-letter word being litigated here is perhaps more distasteful than most others of its genre, it is nevertheless often true that one man's vulgarity is another's lyric. Indeed, we think it is largely because governmental officials cannot make principled distinctions in this area that the Constitution leaves matters of taste and style so largely to the individual.

Additionally, we cannot overlook the fact, because it is well illustrated by the episode involved here, that much linguistic expression serves a dual communicative function: it conveys not only ideas capable of relatively precise, detached explication, but otherwise inexpressible emotions as well. In fact, words are often chosen as much for their emotive as their cognitive force. We cannot sanction the view that the Constitution, while solicitous of the cognitive content of individual speech, has little or no regard for that emotive function which, practically speaking, may often be the more important element of the overall message sought to be communicated. . . . .

Finally, and in the same vein, we cannot indulge the facile assumption that one can forbid particular words without also running a substantial risk of suppressing ideas in the process. Indeed, governments might soon seize upon the censorship of particular words as a convenient guise for banning the expression of unpopular views. We have been able, as noted above, to discern little social benefit that might result from running the risk of opening the door to such grave results.

It is, in sum, our judgment that, absent a more particularized and compelling reason for its actions, the State may not, consistently with the First and Fourteenth Amendments, make the simple public display here involved of this single four-letter expletive a criminal offense. Because that is the only arguably sustainable rationale for the conviction here at issue, the judgment below must be

Reversed.

DISSENT

MR. JUSTICE BLACKMUN, with whom THE CHIEF JUSTICE and MR. JUSTICE BLACK join.

I dissent, and I do so for two reasons:

1. Cohen's absurd and immature antic, in my view, was mainly conduct and little speech. . . . The California Court of Appeal appears so to have described it, and I cannot characterize it otherwise. Further, the case appears to me to be well within the sphere of *Chaplinsky* v. *New Hampshire*, 315 U.S. 568 (1942), where Mr. Justice Murphy, a known champion of First Amendment freedoms, wrote for a unanimous bench. As a consequence, this Court's agonizing over First Amendment values seems misplaced and unnecessary.

2. [omitted]

III. Intentional Torts

BETTY L. PERNA AND THOMAS R. PERNA, JR., PLAINTIFFS-APPELLANTS, v. MICHAEL J. PIROZZI, M.D., ANTHONY DEL GAIZO, M.D., AND PATRICK N. CICCONE, M.D., DEFENDANTS-RESPONDENTS, AND MANSOOR KARAMOOZ, M.D., DEFENDANT

Supreme Court of New Jersey

92 N.J. 446; 457 A.2d 431; 1983

March 2, 1983, Decided

The opinion of the Court was delivered by Pollock, J.

OPINION:

I

On the advice of his family physician, Thomas Perna entered St. Joseph's Hospital on May 8, 1977 for tests and a urological consultation. Mr. Perna consulted Dr. Pirozzi, a specialist in urology, who examined Mr. Perna and recommended that he undergo surgery for the removal of kidney stones.

Dr. Pirozzi was associated with a medical group that also included Drs. Del Gaizo and Ciccone. The doctors testified at trial that their medical group customarily shared patients; no doctor had individual patients, and each doctor was familiar with all cases under care of the group. Further, it was not the practice of the group to inform patients which member would operate; the physicians operated as a "team," and their regular practice was to decide just prior to the operation who was to operate. If, however, a patient requested a specific member of the group as his surgeon, that surgeon would perform the operation. Nothing indicated that Mr. Perna was aware of the group's custom of sharing patients or of their methods for assigning surgical duties.

Although Mr. Perna had never consulted with Dr. Del Gaizo or Dr. Ciccone, he had been treated by Dr. Pirozzi previously in conjunction with a bladder infection. According to Mr. Perna, he specifically requested Dr. Pirozzi to perform the operation. None of the defendants directly contradicted Mr. Perna's testimony. However, Dr. Ciccone testified that he met with Mr. Perna on May 16 and, without discussing who would operate, explained that two members of the medical group would be present during the operation. The following day, in the presence of a urological resident, Mr. Perna executed a consent form that named Dr. Pirozzi as the operating surgeon and authorized him, with the aid of unnamed "assistants," to perform the surgery. n1 In this context, the term "assistants" refers to medical personnel, not necessarily doctors, who aid the operating surgeon. The operation was performed on May 18 by Dr. Del Gaizo, assisted by Dr. Ciccone. Dr. Pirozzi was not present during the operation; in fact, he was not on duty that day. At the time of surgery, Dr. Del Gaizo and Dr. Ciccone were unaware that only Dr. Pirozzi's name appeared on the consent form.

Mr. Perna first learned of the identities of the operating surgeons when he was readmitted to the hospital on June 11 because of post-surgical complications. Subsequently, Mr. and Mrs. Perna filed suit for malpractice against all three doctors, alleging four deviations from standard medical procedure concerning the diagnosis, treatment and surgery performed by the defendants. They further alleged that there was a failure to obtain Mr. Perna's informed consent to the operation performed by Dr. Del Gaizo. That is, plaintiffs claimed that Mr. Perna's consent to the operation was conditioned upon his belief that Dr. Pirozzi would be the surgeon.

Pursuant to [New Jersey law], the matter proceeded to a mandatory hearing before a medical malpractice panel. The physician member of the panel, Dr. Litzky, had indicated in response to a questionnaire that he knew Dr. Pirozzi from attending professional meetings. Plaintiffs' counsel did not object to Dr. Litzky serving on the panel, which unanimously found no basis for the claims pertaining to the diagnosis, treatment and operation performed by defendants. . . . .

[the court then discusses objections to the panel hearing]

IV

We now address the nature of the claim resulting from the performance of the operation by a physician other than the one named in the consent form, so-called "ghost surgery." If the claim is characterized as a failure to obtain informed consent, the operation may constitute an act of medical malpractice; if, however, it is viewed as a failure to obtain any consent, it is better classified as a battery.

Informed consent is a negligence concept predicated on the duty of a physician to disclose to a patient information that will enable him to "evaluate knowledgeably the options available and the risks attendant upon each" before subjecting that patient to a course of treatment. Under the doctrine, the patient who consents to an operation is given the opportunity to show that the surgeon withheld information concerning "the inherent and potential hazards of the proposed treatment, the alternatives to that treatment, if any, and the results likely if the patient remains untreated." If the patient succeeds in proving that the surgeon did not comply with the applicable standard for disclosure, the consent is vitiated.

In an action predicated upon a battery, a patient need not prove initially that the physician has deviated from a professional standard of care. Under a battery theory, proof of an unauthorized invasion of the plaintiff's person, even if harmless, entitles him to nominal damages. The plaintiff may further recover for all injuries proximately caused by the mere performance of the operation, whether the result of negligence or not. If an operation is properly performed, albeit by a surgeon operating without the consent of the patient, and the patient suffers no injuries except those which foreseeably follow from the operation, then a jury could find that the substitution of surgeons did not cause any compensable injury. Even there, however, a jury could award damages for mental anguish resulting from the belated knowledge that the operation was performed by a doctor to whom the patient had not given consent. Furthermore, because battery connotes an intentional invasion of another's rights, punitive damages may be assessed in an appropriate case.

The plaintiffs here do not challenge the adequacy of the disclosure of information relating to risks inherent in the operation performed. Nor do they contend that Mr. Perna would have decided not to undergo the operation if additional facts had been provided to him. In short, they concede Perna consented to an operation by Dr. Pirozzi. However, plaintiffs contend that two other surgeons operated on him without his consent. If that contention is correct, the operating surgeons violated the patient's right to control his own body.

Any non-consensual touching is a battery. Even more private than the decision who may touch one's body is the decision who may cut it open and invade it with hands and instruments. Absent an emergency, patients have the right to determine not only whether surgery is to be performed on them, but who shall perform it. A surgeon who operates without the patient's consent engages in the unauthorized touching of another and, thus, commits a battery. A nonconsensual operation remains a battery even if performed skillfully and to the benefit of the patient. The medical profession itself recognizes that it is unethical to mislead a patient as to the identity of the doctor who performs the operation. Participation in such a deception is a recognized cause for discipline by the medical profession. . . .

A different theory applies to the claim against Dr. Pirozzi. As to him, the action follows from the alleged breach of his agreement to operate and the fiduciary duty he owed his patient. With respect to that allegation, the Judicial Council of the American Medical Association has decried the substitution of one surgeon for another without the consent of the patient, describing that practice as a "deceit." A patient has the right to choose the surgeon who will operate on him and to refuse to accept a substitute. Correlative to that right is the duty of the doctor to provide his or her personal services in accordance with the agreement with the patient.

Few decisions bespeak greater trust and confidence than the decision of a patient to proceed with surgery. Implicit in that decision is a willingness of the patient to put his or her life in the hands of a known and trusted medical doctor. Sometimes circumstances will arise in which, because of an emergency, the limited capacity of the patient, or some other valid reason, the doctor cannot obtain the express consent of the patient to a surrogate surgeon. Other times, doctors who practice in a medical group may explain to a patient that any one of them may perform a medical procedure. In that situation, the patient may accept any or all the members of the group as his surgeon. In still other instances, the patient may consent to an operation performed by a resident under the supervision of the attending physician. The point is that a patient has the right to know who will operate and the consent form should reflect the patient's decision. Where a competent patient consents to surgery by a specific surgeon of his choice, the patient has every right to expect that surgeon, not another, to operate.

The failure of a surgeon to perform a medical procedure after soliciting a patient's consent, like the failure to operate on the appropriate part of a patient's body, is a deviation from standard medical care. It is malpractice whether the right surgeon operates on the wrong part or the wrong surgeon operates on the right part of the patient. In each instance, the surgeon has breached his duty to care for the patient. Where damages are the proximate result of a deviation from standard medical care, a patient has a cause of action for malpractice. Although an alternative cause of action could be framed as a breach of the contract between the surgeon and the patient, generally the more appropriate characterization of the cause will be for breach of the duty of care owed by the doctor to the patient. The absence of damages may render any action deficient, but the doctor who, without the consent of the patient, permits another surgeon to operate violates not only a fundamental tenet of the medical profession, but also a legal obligation.

The judgment below is reversed and the matter remanded for trial consistent with our opinion. On remand, the court shall conduct a new pretrial conference at which all parties should have the opportunity to amend their pleadings to conform to this opinion.

HUSTLER MAGAZINE AND LARRY C. FLYNT v. FALWELL

U.S. Supreme Court

485 U.S. 46 (1988)

Argued December 2, 1987
Decided February 24, 1988

REHNQUIST, C. J., delivered the opinion of the Court, in which BRENNAN, MARSHALL, BLACKMUN, STEVENS, O'CONNOR, and SCALIA, JJ., joined. WHITE, J., filed an opinion concurring in the judgment. KENNEDY, J., took no part in the consideration or decision of the case.

CHIEF JUSTICE REHNQUIST delivered the opinion of the Court.

Petitioner Hustler Magazine, Inc., is a magazine of nationwide circulation. Respondent Jerry Falwell, a nationally known minister who has been active as a commentator on politics and public affairs, sued petitioner and its publisher, petitioner Larry Flynt, to recover damages for invasion of privacy, libel, and intentional infliction of emotional distress. The District Court directed a verdict against respondent on the privacy claim, and submitted the other two claims to a jury. The jury found for petitioners on the defamation claim, but found for respondent on the claim for intentional infliction of emotional distress and awarded damages. We now consider whether this award is consistent with the First and Fourteenth Amendments of the United States Constitution.

The inside front cover of the November 1983 issue of Hustler Magazine featured a "parody" of an advertisement for Campari Liqueur that contained the name and picture of respondent and was entitled "Jerry Falwell talks about his first time." This parody was modeled after actual Campari ads that included interviews with various celebrities about their "first times." Although it was apparent by the end of each interview that this meant the first time they sampled Campari, the ads clearly played on the sexual double entendre of the general subject of "first times." Copying the form and layout of these Campari ads, Hustler's editors chose respondent as the featured celebrity and drafted an alleged "interview" with him in which he states that his "first time" was during a drunken incestuous rendezvous with his mother in an outhouse. The Hustler parody portrays respondent and his mother as drunk and immoral, and suggests that respondent is a hypocrite who preaches only when he is drunk. In small print at the bottom of the page, the ad contains the disclaimer, "ad parody - not to be taken seriously." The magazine's table of contents also lists the ad as "Fiction; Ad and Personality Parody."

Soon after the November issue of Hustler became available to the public, respondent brought this diversity action in the United States District Court for the Western District of Virginia against Hustler Magazine, Inc., Larry C. Flynt, and Flynt Distributing Co., Inc. Respondent stated in his complaint that publication of the ad parody in Hustler entitled him to recover damages for libel, invasion of privacy, and intentional infliction of emotional distress. The case proceeded to trial. At the close of the evidence, the District Court granted a directed verdict for petitioners on the invasion of privacy claim. The jury then found against respondent on the libel claim, specifically finding that the ad parody could not "reasonably be understood as describing actual facts about [respondent] or actual events in which [he] participated." The jury ruled for respondent on the intentional infliction of emotional distress claim, however, and stated that he should be awarded $100,000 in compensatory damages, as well as $50,000 each in punitive damages from petitioners. Petitioners' motion for judgment notwithstanding the verdict was denied.

On appeal, the United States Court of Appeals for the Fourth Circuit affirmed the judgment against petitioners. The court rejected petitioners' argument that the "actual malice" standard of New York Times Co. v. Sullivan, must be met before respondent can recover for emotional distress. The court agreed that because respondent is concededly a public figure, petitioners are "entitled to the same level of first amendment protection in the claim for intentional infliction of emotional distress that they received in [respondent's] claim for libel." But this does not mean that a literal application of the actual malice rule is appropriate in the context of an emotional distress claim. In the court's view, the New York Times decision emphasized the constitutional importance not of the falsity of the statement or the defendant's disregard for the truth, but of the heightened level of culpability embodied in the requirement of "knowing . . . or reckless" conduct. Here, the New York Times standard is satisfied by the state-law requirement, and the jury's finding, that the defendants have acted intentionally or recklessly. fn3 The Court of Appeals then went on to reject the contention that because the jury found that the ad parody did not describe actual facts about respondent, the ad was an opinion that is protected by the First Amendment. As the court put it, this was "irrelevant," as the issue is "whether [the ad's] publication was sufficiently outrageous to constitute intentional infliction of emotional distress." Petitioners then filed a petition for rehearing en banc, but this was denied by a divided court. Given the importance of the constitutional issues involved, we granted certiorari.

This case presents us with a novel question involving First Amendment limitations upon a State's authority to protect its citizens from the intentional infliction of emotional distress. We must decide whether a public figure may recover damages for emotional harm caused by the publication of an ad parody offensive to him, and doubtless gross and repugnant in the eyes of most. Respondent would have us find that a State's interest in protecting public figures from emotional distress is sufficient to deny First Amendment protection to speech that is patently offensive and is intended to inflict emotional injury, even when that speech could not reasonably have been interpreted as stating actual facts about the public figure involved. This we decline to do.

At the heart of the First Amendment is the recognition of the fundamental importance of the free flow of ideas and opinions on matters of public interest and concern. . . . . We have therefore been particularly vigilant to ensure that individual expressions of ideas remain free from governmentally imposed sanctions. . . . .

The sort of robust political debate encouraged by the First Amendment is bound to produce speech that is critical of those who hold public office or those public figures who are "intimately involved in the resolution of important public questions or, by reason of their fame, shape events in areas of concern to society at large." . . . . Justice Frankfurter put it succinctly in Baumgartner v. United States, when he said that "[o]ne of the prerogatives of American citizenship is the right to criticize public men and measures." Such criticism, inevitably, will not always be reasoned or moderate; public figures as well as public officials will be subject to "vehement, caustic, and sometimes unpleasantly sharp attacks," New York Times, supra, at 270. . . .

Of course, this does not mean that any speech about a public figure is immune from sanction in the form of damages. Since New York Times Co. v. Sullivan, we have consistently ruled that a public figure may hold a speaker liable for the damage to reputation caused by publication of a defamatory falsehood, but only if the statement was made "with knowledge that it was false or with reckless disregard of whether it was false or not." Id., at 279-280. False statements of fact are particularly valueless; they interfere with the truth-seeking function of the marketplace of ideas, and they cause damage to an individual's reputation that cannot easily be repaired by counterspeech, however persuasive or effective. . . . But even though falsehoods have little value in and of themselves, they are "nevertheless inevitable in free debate," id., at 340, and a rule that would impose strict liability on a publisher for false factual assertions would have an undoubted "chilling" effect on speech relating to public figures that does have constitutional value. "Freedoms of expression require "`breathing space.'" . . . This breathing space is provided by a constitutional rule that allows public figures to recover for libel or defamation only when they can prove both that the statement was false and that the statement was made with the requisite level of culpability.

Respondent argues, however, that a different standard should apply in this case because here the State seeks to prevent not reputational damage, but the severe emotional distress suffered by the person who is the subject of an offensive publication. . . . . In respondent's view, and in the view of the Court of Appeals, so long as the utterance was intended to inflict emotional distress, was outrageous, and did in fact inflict serious emotional distress, it is of no constitutional import whether the statement was a fact or an opinion, or whether it was true or false. It is the intent to cause injury that is the gravamen of the tort, and the State's interest in preventing emotional harm simply outweighs whatever interest a speaker may have in speech of this type.

Generally speaking the law does not regard the intent to inflict emotional distress as one which should receive much solicitude, and it is quite understandable that most if not all jurisdictions have chosen to make it civilly culpable where the conduct in question is sufficiently "outrageous." But in the world of debate about public affairs, many things done with motives that are less than admirable are protected by the First Amendment. . . .

Respondent contends, however, that the caricature in question here was so "outrageous" as to distinguish it from more traditional political cartoons. There is no doubt that the caricature of respondent and his mother published in Hustler is at best a distant cousin of the political cartoons described above, and a rather poor relation at that. If it were possible by laying down a principled standard to separate the one from the other, public discourse would probably suffer little or no harm. But we doubt that there is any such standard, and we are quite sure that the pejorative description "outrageous" does not supply one. "Outrageousness" in the area of political and social discourse has an inherent subjectiveness about it which would allow a jury to impose liability on the basis of the jurors' tastes or views, or perhaps on the basis of their dislike of a particular expression. An "outrageousness" standard thus runs afoul of our longstanding refusal to allow damages to be awarded because the speech in question may have an adverse emotional impact on the audience. . . . "[T]he fact that society may find speech offensive is not a sufficient reason for suppressing it. Indeed, if it is the speaker's opinion that gives offense, that consequence is a reason for according it constitutional protection. For it is a central tenet of the First Amendment that the government must remain neutral in the marketplace of ideas." . . . . .

We conclude that public figures and public officials may not recover for the tort of intentional infliction of emotional distress by reason of publications such as the one here at issue without showing in addition that the publication contains a false statement of fact which was made with "actual malice," i. e., with knowledge that the statement was false or with reckless disregard as to whether or not it was true. . . .

Here it is clear that respondent Falwell is a "public figure" for purposes of First Amendment law. fn5 The jury found against respondent on his libel claim when it decided that the Hustler ad parody could not "reasonably be understood as describing actual facts about [respondent] or actual events in which [he] participated.". . . The Court of Appeals interpreted the jury's finding to be that the ad parody "was not reasonably believable," and in accordance with our custom we accept this finding. Respondent is thus relegated to his claim for damages awarded by the jury for the intentional infliction of emotional distress by "outrageous" conduct. But for reasons heretofore stated this claim cannot, consistently with the First Amendment, form a basis for the award of damages when the conduct in question is the publication of a caricature such as the ad parody involved here. The judgment of the Court of Appeals is accordingly Reversed.

JUSTICE KENNEDY took no part in the consideration or decision of this case.

Footnotes

Footnote 3 Under Virginia law, in an action for intentional infliction of emotional distress a plaintiff must show that the defendant's conduct (1) is intentional or reckless; (2) offends generally accepted standards of decency or morality; (3) is causally connected with the plaintiff's emotional distress; and (4) caused emotional distress that was severe.

Footnote 5 Neither party disputes this conclusion. Respondent is the host of a nationally syndicated television show and was the founder and president of a political organization formerly known as the Moral Majority. He is also the founder of Liberty University in Lynchburg, Virginia, and is the author of several books and publications.

Jeff Roach et al., Appellants, v. Howard Stern et al., Respondents.

Supreme Court of New York, Appellate Division

252 A.D.2d 488; 675 N.Y.S.2d 133

January 9, 1998, Argued
July 6, 1998, Decided

PRIOR HISTORY: In an action, *inter alia,* to recover damages for the intentional infliction of emotional distress, the plaintiffs appeal from an order of the Supreme Court, Kings County (Huttner, J.), dated January 13, 1997, which granted the motion by the defendants Howard Stern and Infinity Broadcasting, Inc. to dismiss the complaint.

JUDGES: O'Brien, J. P., Santucci and Florio, JJ., concur.

OPINION:

Ordered that the order is reversed, with costs, the motion is denied, and the complaint is reinstated.

This lawsuit concerns events that occurred during a radio show hosted by the defendant Howard Stern, which was videotaped and later aired on a cable television station. The participants in the program handled and made crude remarks about the cremated remains of the plaintiffs' sister, Deborah Roach. We conclude that the plaintiffs have sufficiently pleaded a cause of action to recover damages for the intentional infliction of emotional distress and therefore the Supreme Court erred in dismissing their complaint.

The deceased, Deborah Roach, who used the name Debbie Tay, was described in a newspaper article following her death as a topless dancer, cable-access TV host, and perennial guest on Howard Stern's radio show. Stern gave her the label "Space Lesbian" based on her stories of encounters with aliens. After Tay's death in April 1995 her sister, the plaintiff Melissa Roach Driscol, had the body cremated and gave a portion of the remains to the defendant Chaunce Hayden, Tay's close friend. Driscol asserted that she did so with the understanding that Hayden would "preserve and honor said remains in an appropriate and private manner".

According to the complaint, sometime in July 1995 Hayden engaged in certain "on air" conversations with Stern during his radio show about Tay's death and the disposition of her remains. Upon learning that Stern had encouraged Hayden to appear on the radio show and to bring Tay's remains with him, her brother, the plaintiff Jeff Roach, telephoned the producer of the show and the manager of the radio station to demand that such conversations cease. Nevertheless, on July 18, 1995, Hayden brought a box containing Tay's cremated remains to the radio station. Thereafter Stern, Hayden, and other participants in the broadcast made comments about the remains while handling various bone fragments. The radio show was videotaped and later broadcast on a national cable television station.

The transcript and videotape of the show, which were made available to the court, corroborate the allegations in the complaint that Stern at one point donned rubber gloves and held up certain bone fragments while he guessed whether they came from Tay's skull or ribs. The on-air discussion included the following:

"VOICE: What's in the bottom?

"C. HAYDEN: They look like clam shells.

"ROBIN QUIVERS: Boy, that's wild.

"VOICE: Dig down. That's not normal, is it?

"H. STERN: Chew on it, Chaunce.

"R. QUIVERS: There you go.

"VOICE: What's it taste like?

"VOICE: It tastes like Cracker Jacks, maybe there's a prize in the bottom.

"R. QUIVERS: Boy oh boy, yeah, you're not kidding Chaunce.

"H. STERN: Look at the hunks.

"R. QUIVERS: Woooooh!

"H. STERN: Come here, I'll glue her together, give me that, Robin. Let me see that.

"R. QUIVERS: I'm shaking her bones.

"C. HAYDEN: Shake, rattle and roll.

"VOICE: Want me to get some Krazy Glue?

"H. STERN: Let me see this.

"(H. STERN PICKS UP A PIECE)

"VOICE: It's easy ... the leg bone's connected to the ...

"H. STERN: Look at the size of this! That looks like a piece of her head.

"R. QUIVERS: I don't know, I've never seen an actual skull bone, that looks awfully thick.

"VOICE: Looks like a potato or something ...

"C. HAYDEN: It's not normal ...

"H. STERN: Heh! Heh! Heh! Heh!, Chaunce, watch your language, huh dude!? Rob, here you want to hold Debbie? C'mon man, you like her.

"VOICE: Oh man!

"R. QUIVERS: What's wrong with you, Ralph?

"VOICE: Ralph made this so Chaunce could wear it around his neck.

"H. STERN: A big bag.

"R. QUIVERS: Bag.

"H. STERN: Hey Chaunce, why don't you wear that plastic bag around your neck? You can carry Debbie with you. It would be a big necklace, look at that. There she is, what do you think that is though? Let me see if I can piece it together.

"VOICE: Its gotta be a piece of skull, doesn't it Robin?

"R. QUIVERS: I've never seen how thick the skull is.

"H. STERN: Alright, hold it, hold ... Ralph hold up this picture of Debbie so I can ...

"R. QUIVERS: It's awfully thick.

"H. STERN: Alright, let's see, this matches ...

"C. HAYDEN: Well, she was very thickboned.

"VOICE: That's gotta be her teeth.

"VOICE: That's her head, that's a piece of her teeth.

"VOICE: Here's a temple.

"R. QUIVERS: But it's not rounded, why would you say that ...

"H. STERN: She had a square jaw. This looks like the breast, oh wait, here's her tooth.

"R. QUIVERS: Why don't you think there are any teeth?

"H. STERN: What do you think this is, this looks like her ribs. What do you think this is, Chaunce?

"voice: I say it's a rib. It's a rib. Yeah, it's a rib.

"R. QUIVERS: Yeah, look at that curve.

"H. STERN: That's a rib? Oh yeah, wow, she was a piece of ash. Alright, very good. Alright, there you go, very good.

"R. QUIVERS: Man.

"VOICE: Are there any bigger pieces on the bottom?"

The plaintiffs commenced this action against Stern, Infinity Broadcasting, Inc. (hereinafter Infinity), the owner of the radio station, and Hayden, in which they alleged, *inter alia*, that the defendants' conduct caused them severe emotional distress. Stern and Infinity moved to dismiss the complaint pursuant. . . on the ground that the allegations failed to state a cause of action. The Supreme Court granted the motion and dismissed the complaint.

We agree with the Supreme Court that the allegations in the complaint fail to state a cause of action against the moving defendants to recover damages for interference with or mishandling of a corpse. In general, such a cause of action requires a showing of interference with the right of the next-of-kin to dispose of the body. . . . The moving defendants did not interfere with the plaintiffs' decision to cremate the body and divide the ashes with Hayden.

The Supreme Court further determined that, while the conduct complained of in the complaint was "vulgar and disrespectful", it did not rise to the level of outrageousness necessary to maintain a cause of action to recover damages for the intentional infliction of emotional distress. In order to impose liability for this intentional tort, the conduct complained of must be " 'so outrageous in character, and so extreme in degree, as to go beyond all possible bounds of decency, and to be regarded as atrocious, and utterly intolerable in a civilized community' ". The element of outrageous conduct is " 'rigorous, and difficult to satisfy' ", and its purpose is to filter out trivial complaints and assure that the claim of severe emotional distress is genuine. A court may determine, as a matter of law, that the alleged behavior is not sufficiently outrageous to warrant the imposition of liability.

Upon our review of the allegations in the case at bar, we conclude that the Supreme Court erred in determining that the element of outrageous conduct was not satisfied as a matter of law. Although the defendants contend that the conduct at issue was not particularly shocking, in light of Stern's reputation for vulgar humor and Tay's actions during her guest appearances on his program, a jury might reasonably conclude that the manner in which Tay's remains were handled, for entertainment purposes and against the express wishes of her family, went beyond the bounds of decent behavior.

We further conclude that the remaining elements necessary to establish a cause of action to recover damages for the intentional infliction of emotional distress were also sufficiently pleaded in the complaint.

Accordingly, the appellants' motion to dismiss the complaint is denied.

O'Brien, J. P., Santucci and Florio, JJ., concur.

DISSENT BY: KRAUSMAN

Krausman, J., Dissents and votes to affirm the order appealed from, with the following memorandum:

The majority decision amply demonstrates that Howard Stern and his cohorts behaved in a manner that some would find inappropriate when Chaunce Hayden came on the show with the decedent's remains. Certainly, many would consider their remarks and conduct in handling the decedent's remains tasteless, offensive, and insensitive to the feelings of the plaintiffs, who lost their sister to a drug overdose at the age of 27. However, I disagree with the majority's view that Stern's actions give rise to a cognizable legal right to recover damages for emotional distress.

At common law, emotional injury was not recognized as an independent basis for the recovery of damages, primarily because of the ease with which emotional injury could be "feigned without detection". While modern tort law now permits recovery for emotional distress, the historical reluctance to allow damages for purely psychic injury is reflected in the formulation of the tort, which demands a showing that the defendant has engaged in " 'extreme and outrageous conduct' ", with the "intent to cause, or disregard of a substantial possibility of causing, severe emotional distress". . . .

In practice, courts have tended to focus on the outrageousness element, the one most susceptible to determination as a matter of law". Since the requirements of the rule are " 'rigorous, and difficult to satisfy' ", the Court of Appeals noted that every one of the emotional distress claims it had considered had failed because "the alleged conduct was not sufficiently outrageous." Indeed, " '[l]iability has been found only where the conduct has been so outrageous in character, and so extreme in degree, as to go beyond all possible bounds of decency, and to be regarded as atrocious, and utterly intolerable in a civilized community'. "

The issue of whether the decedent's brother and sister may recover tort damages cannot be considered in a vacuum, with total disregard for who Debbie Tay was. Debbie Tay rose to fame by spinning outrageous tales of sexual encounters with female aliens on the Howard Stern show, and used the notoriety she had achieved to launch her own cable access show. While the plaintiffs now claim that Stern's conduct following their sister's untimely death caused them extreme emotional distress, the defendants note that on one occasion, the decedent's own mother appeared on the show, describing her daughter as an unusual young woman who was "a lot of fun".

The record also reflects the fact that the plaintiff Melissa Roach Driscol voluntarily gave a portion of her sister's remains to the decedent's close friend, the defendant Chaunce Hayden. Hayden brought the decedent's remains on the air as a memorial to her because "the only happiness Debbie had was the Howard Stern show". Once on the air, Hayden encouraged cast members to examine the remains, believing that since the decedent had so enjoyed Stern's irreverant brand of humor during her lifetime, she "would love this". Although the plaintiffs allege that the show's producer ignored their request to cease discussing the disposition of the remains, there is no indication that Stern or Infinity acted out of a desire to cause the plaintiffs distress. Indeed, at the end of the show, Stern advised Hayden that he should have the decedent's remains properly buried or turned into ashes, telling him to "remember her in your mind". Closing credits announced that the show was "dedicated in loving memory of Debbie Tay". Considering these circumstances, I would find, as a matter of law, that the conduct of Stern and Infinity was not so extreme and outrageous in nature as to be "utterly intolerable in a civilized community."

III. Unintentional Torts

Helen Palsgraf, Respondent, v. The Long Island Railroad Company, Appellant

Court of Appeals of New York

248 N.Y. 339; 162 N.E. 99; 1928

May 29, 1928, Decided

JUDGES: Cardozo, Ch. J. Pound, Lehman and Kellogg, JJ., concur with Cardozo, Ch. J.; Andrews, J., dissents in opinion in which Crane and O'Brien, JJ., concur.

OPINION BY: CARDOZO

Plaintiff was standing on a platform of defendant's railroad after buying a ticket to go to Rockaway Beach. A train stopped at the station, bound for another place. Two men ran forward to catch it. One of the men reached the platform of the car without mishap, though the train was already moving. The other man, carrying a package, jumped aboard the car, but seemed unsteady as if about to fall. A guard on the car, who had held the door open, reached forward to help him in, and another guard on the platform pushed him from behind. In this act, the package was dislodged, and fell upon the rails. It was a package of small size, about fifteen inches long, and was covered by a newspaper. In fact it contained fireworks, but there was nothing in its appearance to give notice of its contents. The fireworks when they fell exploded. The shock of the explosion threw down some scales at the other end of the platform, many feet away. The scales struck the plaintiff, causing injuries for which she sues.

The conduct of the defendant's guard, if a wrong in its relation to the holder of the package, was not a wrong in its relation to the plaintiff, standing far away. Relatively to her it was not negligence at all. Nothing in the situation gave notice that the falling package had in it the potency of peril to persons thus removed. Negligence is not actionable unless it involves the invasion of a legally protected interest, the violation of a right. "Proof of negligence in the air, so to speak, will not do" (Pollock, Torts [11th ed.], p. 455. The plaintiff as she stood upon the platform of the station might claim to be protected against intentional invasion of her bodily security. Such invasion is not charged. She might claim to be protected against unintentional invasion by conduct involving in the thought of reasonable men an unreasonable hazard that such invasion would ensue. These, from the point of view of the law, were the bounds of her immunity, with perhaps some rare exceptions, survivals for the most part of ancient forms of liability, where conduct is held to be at the peril of the actor. If no hazard was apparent to the eye of ordinary vigilance, an act innocent and harmless, at least to outward seeming, with reference to her, did not take to itself the quality of a tort because it happened to be a wrong, though apparently not one involving the risk of bodily insecurity, with reference to some one else. "In every instance, before negligence can be predicated of a given act, back of the act must be sought and found a duty to the individual complaining, the observance of which would have averted or avoided the injury." The plaintiff sues in her own right for a wrong personal to her, and not as the vicarious beneficiary of a breach of duty to another.

A different conclusion will involve us, and swiftly too, in a maze of contradictions. A guard stumbles over a package which has been left upon a platform. It seems to be a bundle of newspapers. It turns out to be a can of dynamite. To the eye of ordinary vigilance, the bundle is abandoned waste, which may be kicked or trod on with impunity. Is a passenger at the other end of the platform protected by the law against the unsuspected hazard concealed beneath the waste? If not, is the result to be any different, so far as the distant passenger is concerned, when the guard stumbles over a valise which a truckman or a porter has left upon the walk? The passenger far away, if the victim of a wrong at all, has a cause of action, not derivative, but original and primary. His claim to be protected against invasion of his bodily security is neither greater nor less because the act resulting in the invasion is a wrong to another far removed. In this case, the rights that are said to have been violated, the interests said to have been invaded, are not even of the same order. The man was not injured in his person nor even put in danger. The purpose of the act, as well as its effect, was to make his person safe. If there was a wrong to him at all, which may very well be doubted, it was a wrong to a property interest only, the safety of his package. Out of this wrong to property, which threatened injury to nothing else, there has passed, we are told, to the plaintiff by derivation or succession a right of action for the invasion of an interest of another order, the right to bodily security. The diversity of interests emphasizes the futility of the effort to build the plaintiff's right upon the basis of a wrong to some one else. The gain is one of emphasis, for a like result would follow if the interests were the same. Even then, the orbit of the danger as disclosed to the eye of reasonable vigilance would be the orbit of the duty. One who jostles one's neighbor in a crowd does not invade the rights of others standing at the outer fringe when the unintended contact casts a bomb upon the ground. The wrongdoer as to them is the man who carries the bomb, not the one who explodes it without suspicion of the danger. Life will have to be made over, and human nature transformed, before prevision so extravagant can be accepted as the norm of conduct, the customary standard to which behavior must conform.

The argument for the plaintiff is built upon the shifting meanings of such words as "wrong" and "wrongful," and shares their instability. What the plaintiff must show is "a wrong" to herself, i. e., a violation of her own right, and not merely a wrong to some one else, nor conduct "wrongful" because unsocial, but not "a wrong" to any one. We are told that one who drives at reckless speed through a crowded city street is guilty of a negligent act and, therefore, of a wrongful one irrespective of the consequences. Negligent the act is, and wrongful in the sense that it is unsocial, but wrongful and unsocial in relation to other travelers, only because the eye of vigilance perceives the risk of damage. If the same act were to be committed on a speedway or a race course, it would lose its wrongful quality. The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension. This does not mean, of course, that one who launches a destructive force is always relieved of liability if the force, though known to be destructive, pursues an unexpected path. "It was not necessary that the defendant should have had notice of the particular method in which an accident would occur, if the possibility of an accident was clear to the ordinarily prudent eye." Some acts, such as shooting, are so imminently dangerous to any one who may come within reach of the missile, however unexpectedly, as to impose a duty of prevision not far from that of an insurer. Even today, and much oftener in earlier stages of the law, one acts sometimes at one's peril. Under this head, it may be, fall certain cases of what is known as transferred intent, an act willfully dangerous to A resulting by misadventure in injury to B. These cases aside, wrong is defined in terms of the natural or probable, at least when unintentional. The range of reasonable apprehension is at times a question for the court, and at times, if varying inferences are possible, a question for the jury. Here, by concession, there was nothing in the situation to suggest to the most cautious mind that the parcel wrapped in newspaper would spread wreckage through the station. If the guard had thrown it down knowingly and willfully, he would not have threatened the plaintiff's safety, so far as appearances could warn him. His conduct would not have involved, even then, an unreasonable probability of invasion of her bodily security. Liability can be no greater where the act is inadvertent.

Negligence, like risk, is thus a term of relation. Negligence in the abstract, apart from things related, is surely not a tort, if indeed it is understandable at all. Negligence is not a tort unless it results in the commission of a wrong, and the commission of a wrong imports the violation of a right, in this case, we are told, the right to be protected against interference with one's bodily security. But bodily security is protected, not against all forms of interference or aggression, but only against some. One who seeks redress at law does not make out a cause of action by showing without more that there has been damage to his person. If the harm was not willful, he must show that the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended. Affront to personality is still the keynote of the wrong. Confirmation of this view will be found in the history and development of the action on the case. Negligence as a basis of civil liability was unknown to mediaeval law. For damage to the person, the sole remedy was trespass, and trespass did not lie in the absence of aggression, and that direct and personal. Liability for other damage, as where a servant without orders from the master does or omits something to the damage of another, is a plant of later growth. When it emerged out of the legal soil, it was thought of as a variant of trespass, an offshoot of the parent stock. This appears in the form of action, which was known as trespass on the case. The victim does not sue derivatively, or by right of subrogation, to vindicate an interest invaded in the person of another. Thus to view his cause of action is to ignore the fundamental difference between tort and crime. He sues for breach of a duty owing to himself.

The law of causation, remote or proximate, is thus foreign to the case before us. The question of liability is always anterior to the question of the measure of the consequences that go with liability. If there is no tort to be redressed, there is no occasion to consider what damage might be recovered if there were a finding of a tort. We may assume, without deciding, that negligence, not at large or in the abstract, but in relation to the plaintiff, would entail liability for any and all consequences, however novel or extraordinary. There is room for argument that a distinction is to be drawn according to the diversity of interests invaded by the act, as where conduct negligent in that it threatens an insignificant invasion of an interest in property results in an unforseeable invasion of an interest of another order, as, e. g., one of bodily security. Perhaps other distinctions may be necessary. We do not go into the question now. The consequences to be followed must first be rooted in a wrong.

The judgment of the Appellate Division and that of the Trial Term should be reversed, and the complaint dismissed, with costs in all courts.

DISSENT: Andrews, J. (dissenting). Assisting a passenger to board a train, the defendant's servant negligently knocked a package from his arms. It fell between the platform and the cars. Of its contents the servant knew and could know nothing. A violent explosion followed. The concussion broke some scales standing a considerable distance away. In falling they injured the plaintiff, an intending passenger.

Upon these facts may she recover the damages she has suffered in an action brought against the master? The result we shall reach depends upon our theory as to the nature of negligence. Is it a relative concept -- the breach of some duty owing to a particular person or to particular persons? Or where there is an act which unreasonably threatens the safety of others, is the doer liable for all its proximate consequences, even where they result in injury to one who would generally be thought to be outside the radius of danger? This is not a mere dispute as to words. We might not believe that to the average mind the dropping of the bundle would seem to involve the probability of harm to the plaintiff standing many feet away whatever might be the case as to the owner or to one so near as to be likely to be struck by its fall. If, however, we adopt the second hypothesis we have to inquire only as to the relation between cause and effect. We deal in terms of proximate cause, not of negligence. . . .

The proposition is this. Every one owes to the world at large the duty of refraining from those acts that may unreasonably threaten the safety of others. Such an act occurs. Not only is he wronged to whom harm might reasonably be expected to result, but he also who is in fact injured, even if he be outside what would generally be thought the danger zone. There needs be duty due the one complaining but this is not a duty to a particular individual because as to him harm might be expected. Harm to some one being the natural result of the act, not only that one alone, but all those in fact injured may complain. We have never, I think, held otherwise. . . .

What we do mean by the word "proximate" is, that because of convenience, of public policy, of a rough sense of justice, the law arbitrarily declines to trace a series of events beyond a certain point. This is not logic. It is practical politics. . . .

The proximate cause, involved as it may be with many other causes, must be, at the least, something without which the event would not happen. The court must ask itself whether there was a natural and continuous sequence between cause and effect. Was the one a substantial factor in producing the other? Was there a direct connection between them, without too many intervening causes? Is the effect of cause on result not too attentuated? Is the cause likely, in the usual judgment of mankind, to produce the result? Or by the exercise of prudent foresight could the result be foreseen? Is the result too remote from the cause, and here we consider remoteness in time and space. . . . There was no remoteness in time, little in space. And surely, given such an explosion as here it needed no great foresight to predict that the natural result would be to injure one on the platform at no greater distance from its scene than was the plaintiff. Just how no one might be able to predict. Whether by flying fragments, by broken glass, by wreckage of machines or structures no one could say. But injury in some form was most probable.

Under these circumstances I cannot say as a matter of law that the plaintiff's injuries were not the proximate result of the negligence. That is all we have before us. The court refused to so charge. No request was made to submit the matter to the jury as a question of fact, even would that have been proper upon the record before us.

The judgment appealed from should be affirmed, with costs.

Robert J. Fischer; Terri Fischer, Appellees, v. Red Lion Inns Operating L.P., A Delaware Limited Partnership, and Pepsi Cola Bottling Company of Omaha, Inc., A Nebraska Corporation, Appellant

United States Court of Appeals for The Eighth Circuit

972 F.2d 906

August 13, 1992, Decided

JUDGES: BEAM, Circuit Judge, HEANEY, Senior Circuit Judge, and LOKEN, Circuit Judge.

OPINION BY: BEAM, Circuit Judge.

Pepsi Cola Bottling Company of Omaha (Pepsi) appeals from a jury verdict finding it liable for injuries suffered by Fischer due to an electric shock he received while operating one of Pepsi's vending machines. . . . We affirm the district court.

I. BACKGROUND

On March 4, 1987, Fischer was in Omaha, Nebraska attending a seminar, and was a guest at the Red Lion Inn. At the end of the seminar's first day, Fischer returned to the hotel for a swim. Following his swim, Fischer visited the eleventh floor of the Red Lion to purchase a pop from the vending machine. Fischer was still wearing his wet swimming trunks and was barefoot. As he inserted his money into the vending machine, an electrical current passed through the trunk of his body. Fischer returned to his hotel room and reported the incident to the service desk. Later that evening Fischer experienced a burning sensation while urinating.

Upon his return home, Fischer began experiencing pain . . . This led to problems with his sexual relationship with his wife. When his condition persisted, he sought medical treatment.

Responding to a call by Red Lion, James Renner, a service technician employed by Pepsi, inspected the vending machine on March 9, but found nothing wrong. At the time he performed his inspection, Renner was wearing tennis shoes with rubber soles. Renner then called John Gruebel, Pepsi's service foreman, and asked him to check the machine to see if he, Renner, had missed anything.

On March 11, Gruebel inspected the machine and received an electrical shock when he inserted his key to open it. Gruebel unplugged the machine, followed the power cord from the electrical socket to the rear of the machine, and found that the cord was resting underneath the machine's metal cabinet. He noticed that the power cord's metal conducting wires were exposed and came into contact with the machine's cabinet. Gruebel replaced the power cord and threw away the damaged cord.

II. DISCUSSION

A. Directed Verdict and Sufficiency of the Evidence

. . . . In addition to the testimony outlined above, Pepsi's service foreman, Gruebel, testified that he saw damaged power cords on Pepsi's vending machines about nine or ten times a year, and that the service department received complaints that a vending machine was causing electrical shocks about once or twice a month. Gruebel also testified that on the day Fischer was electrically shocked, Pepsi had no policy for periodically inspecting the electrical parts of vending machines. Given this testimony, the jury could reasonably conclude that Pepsi was aware that its machines could cause injury, and that Pepsi was negligent in not inspecting its machines. . . .

Pepsi next argues that even if they had a duty to inspect, their failure to do so was not the proximate cause of Fischer's injuries. Proximate cause "is that cause which in the natural and continuous sequence, unbroken by an efficient intervening cause, produces the injury and without which the injury would not have occurred." . . . The basic requirements in establishing proximate cause are that the plaintiff establish but for causation, that the injury be the natural and probable result of the negligence, and that there be no efficient intervening cause. . . . The testimony outlined above concerning the defective power cord demonstrates that but for causation existed. The second element of proximate cause is satisfied because an electrical shock is the natural and probable result of coming into contact with a metal structure, such as the cabinet of a vending machine, that is sitting on a frayed power cord. According to the expert testimony Fischer produced, his impotence resulted from the electrical shock he received. Although Pepsi argued that the cord may have been damaged by someone moving or shaking the machine and causing it to land on the power cord--an efficient intervening cause— there was testimony that an empty vending machine weighs five-hundred pounds and a fully stocked one weighs six-hundred pounds. Based on the above facts and testimony, the jury was free to find that Pepsi's negligence was the proximate cause of Fischer's injury. . . . .

Here, Pepsi owned, maintained, and stocked the vending machine located in the Red Lion hotel. This machine was part of a group of approximately 10,000 machines Pepsi operated. Pepsi made a profit with this vending machine through the sale of pop, and, consequently, installed the machine for its own business interest. . . . . Nebraska law imposed a duty of inspection on Pepsi. . . .

III. Conclusion

For the reasons stated above, we affirm the judgment of the district court.

JEFFREY SCHICK, Plaintiff-Respondent, v. JOHN FEROLITO, Defendant-Appellant.

Supreme Court Of New Jersey
167 N.J. 7; 767 A.2d 962

Decided March 12, 2001

The opinion of the Court was delivered by LaVECCHIA, J.

On July 27, 1994, two pairs of golfers reached the tenth hole of East Orange Golf Course and agreed there to play the rest of the course as a foursome. Plaintiff Jeffrey Schick and his father, Wolfgang Schick, played the ensuing holes with defendant John Ferolito and Tom Ganella. At the tee-box on the sixteenth hole, a par four straightaway approximately 300 yards in length, an errant ball hit off the tee by defendant struck plaintiff in the right eye causing personal injuries. According to plaintiff, defendant hit an unannounced and unexpected second tee shot, or "mulligan," after all members of the foursome had teed off. Defendant moved for summary judgment, claiming that the heightened standard of care established by Crawn v. Campo, (1994), should apply to participants in the game of golf. That duty of care is "to avoid the infliction of injury caused by reckless or intentional conduct."

The trial court agreed that a recklessness standard applied and dismissed the action. The Appellate Division reversed, holding that the case was distinguishable from Crawn and that the negligence standard of care was applicable. . . . The panel reasoned that the recklessness standard was appropriate in "rough and tumble" sports, where "'anticipated risks . . . are an inherent or integral part of the game.'" As for golf, the court stated that the heightened standard would be appropriate only for anticipated risks of the game, such as errant or shanked balls, but not for unanticipated risks, such as an "unexpected Mulligan" as occurred here. Because Crawn may have left open the question of whether the recklessness standard should apply generally to conduct in recreational sporting contexts, including golf, we granted certification.

I.

According to plaintiff, he and his father met defendant and Ganella at the tenth tee and the four decided to play as a group, which would speed up play. It was dusk, and there were nine holes remaining to play. They played without incident until the sixteenth hole. There, plaintiff and his father teed off first. He and his father then left the tee-box area, returned to their golf cart, placed their clubs in their golf bags, and proceeded to sit down in the cart. Plaintiff described his cart as located ahead of the tee-box area at a forty-five-degree angle to the left.

Seated in the driver's position, plaintiff looked back over his right shoulder toward the teeing area and observed defendant about to strike a ball off the tee. Plaintiff claims that defendant and Ganella already had hit their tee shots and that defendant was hitting an unannounced second drive off the tee. Plaintiff stated that defendant's first ball had sliced, or angled sharply, off to the right, toward a series of trees situated along the right side of the fairway, but in an area where no out-of-bounds markers were located. Thus, while it might have presented a poor location for his next shot, defendant's first ball was still "in-play."

Although he saw defendant in a tee-off stance, plaintiff said he did not have time to move out of the way. He had only a few seconds to think about what was happening when defendant commenced his swing and hit his second tee shot. The ball struck plaintiff in the right eye socket, rendering him temporarily unconscious.

Defendant gives a different version of what transpired. He did not recall if it was his first or second shot off the tee. Defendant claims that he and plaintiff made eye contact before defendant teed off and that he gave a hand warning, described as a "wave," to plaintiff to move aside. According to defendant, plaintiff's cart was approximately thirty feet ahead, at a forty- five-degree angle, of where he was taking his stance to drive the ball onto the fairway. Defendant states he was trying to hit the ball straight down the middle of the fairway, and plaintiff similarly testified that defendant was not trying to hit in plaintiff's direction. Nevertheless, defendant explained that he waved plaintiff to move aside because defendant believed plaintiff "was in the line of fire."

II.

In Crawn, the Court considered the nature of a sports participant's duty to avoid inflicting physical injury on another player. . . In that case, a catcher suffered an injury when a base runner slid into home plate during an informal softball game. Our holding in Crawn was stated broadly. “[T]he duty of care applicable to participants in informal recreational sports is to avoid the infliction of injury caused by reckless or intentional conduct.” Two important considerations supported the decision to apply a standard of care that exceeded negligence: the promotion of vigorous participation in athletic activities, and the avoidance of a flood of litigation generated by participation in recreational games and sports. The Court determined that those policies outweighed concerns that raising the standard of care implicitly immunized conduct that otherwise would be considered tortious and actionable.

In applying the recklessness standard, the Court sought to avoid the complexities inherent in applying a negligence standard to conduct in recreational sports. The Court reasoned that in that context, “a legal duty of care based on the standard of what, objectively, an average reasonable person would do under the circumstances is illusory, and is not susceptible to sound and consistent application on a case-by-case basis.” Ascertaining whether a participant acted so as to create a risk of harm that was not a normal or ordinary part of the game is a difficult task. The Court explained further: Our conclusion that a recklessness standard is the appropriate one to apply in the sports context is founded on more than a concern for a court's ability to discern adequately what constitutes reasonable conduct under the highly varied circumstances of informal sports activity. The heightened standard will more likely result in affixing liability for conduct that is clearly unreasonable and unacceptable from the perspective of those engaged in the sport yet leaving free from the supervision of the law the risk-laden conduct that is inherent in sports and more often than not assumed to be “part of the game.”

One might well conclude that something is terribly wrong with a society in which the most commonly-accepted aspects of play—a traditional source of a community's conviviality and cohesion—spurs litigation. The heightened recklessness standard recognizes a commonsense distinction between excessively harmful conduct and the more routine rough-and-tumble of sports that should occur freely on the playing fields . . .

The Court's holding in Crawn placed New Jersey among the majority of jurisdictions that apply the recklessness standard of care to determine the duty that recreational players owe to one another. See, e.g., Knight v. Jewett, 843 P. 696 (Cal. 1992) (applying recklessness standard to injury in touch football); . . .

California also applies the recklessness standard of care to golf. In Dilger v. Moyles, 63 Cal. Rptr.2d 591 (Cal. Ct. App. 1997), the California Court of Appeals held that a participant in golf owes no duty to co-participants unless he or she intentionally injures another player or engages in reckless conduct that is totally outside the range of the ordinary activity involved in the sport. The court reasoned that participants assume those risks of injury inherent in the sport. Even a rule violation, in and of itself, is not sufficient to meet that heightened standard, as the court stated: [E]ven when a participant's conduct violates a rule of the game and may subject the violator to internal sanctions prescribed by the sport itself, imposition of *legal liability* for such conduct might well alter fundamentally the nature of the sport by deterring participants from vigorously engaging in activity that falls close to, but on the permissible side of, a prescribed rule. The court reasoned that a lower standard of care could deter people from participating in golf and cause them to forego the benefits of the sport, such as exercise and socialization.

. . . . The policies of promotion of vigorous participation in recreational sports and the avoidance of a flood of litigation over sports accidents are furthered by the application of the heightened standard of care to all recreational sports. We perceive no persuasive reason to apply an artificial distinction between “contact” and “noncontact” sports. . . . The risk arises in myriad forms and for many reasons. It may arise from the physical nature of the athletic endeavor creating the possibility, or likelihood, of direct physical contact with another player or with a ball thrown or hit among players. Risk of injury also is as real when it arises from an instrumentality used in a game, such as a golf club a golfer swings or the small hard ball the club propels at a very high rate of speed. Even for an experienced golfer of some proficiency, the course a golf ball takes is often unpredictable through no conscious fault of the golfer. . . . Is golf a contact sport? Obviously a golfer accepts the risks of coming in contact with wayward golf shots on the links, so golf is more dangerous than table tennis, for instance, but certainly not as dangerous as kickboxing.

The applicability of the heightened standard of care for causes of action for personal injuries occurring in recreational sports should not depend on which sport is involved and whether it is commonly perceived as a “contact” or “noncontact” sport. The recklessness or intentional conduct standard of care articulated in Crawn was not meant to be applied in a crabbed fashion. That standard represented the enunciation of a more modern approach to our common law in actions for personal injuries that generally occur during recreational sporting activities. It is the pertinent standard for assessing the duty of one sports participant to another concerning conduct on golf courses and tennis courts, as well as conduct on basketball courts and ice rinks.

III.

Application of a recklessness or intentional conduct standard to a cause of action involving a golfing injury should not convert a golf course into a free-fire zone. But application of a recklessness standard in a golf setting will affect the analysis of the probability of harm and the defendant's indifference to that harm. The question presented here is whether plaintiff's case can survive a summary judgment motion under a recklessness standard. . . . The Restatement (Second) of Torts articulates the standard as follows, contrasting negligence and recklessness: The actor's conduct is in reckless disregard of the safety of another if he does an act or intentionally fails to do an act which it is his duty to the other to do, knowing or having reason to know of facts which would lead a reasonable man to realize, not only that his conduct creates an unreasonable risk of physical harm to another, but also that such risk is substantially greater than that which is necessary to make his conduct negligent. [Restatement (Second) of Torts § 500 at 587 (1965).]

Recklessness, unlike negligence, requires a conscious choice of a course of action, with knowledge or a reason to know that it will create serious danger to others. Negligence may consist of an intentional act done with knowledge that it creates a risk of danger to others, but recklessness requires a substantially higher risk. The quantum of risk is the important factor.

Application of that standard to this matter requires an analysis of whether a finding of recklessness would be open to the jury. If so, summary judgment rightfully was denied defendant and the matter should proceed to trial. As was the case in Allen, we find that this case presents a question of recklessness that is properly for a jury to determine.

The facts are in conflict, but they are open to an interpretation that defendant did hit a second shot off the tee without telling the others in his playing group that he was about to do so. That version of the facts explains the so-called “mulligan” reference by the Appellate Division. Defendant's conduct in that respect is certainly relevant, but of itself is not determinative of the quality of his act. Although the formal rules of golf do not recognize the term “mulligan,” informal custom may permit that familiar “do-over.” And the formal rules of the game allow for the taking of a second, or “provisional shot,” if certain conditions are met. . . . As a practical matter, technical compliance with the rules at times may be lax on the course, but that should not compel a determination of recklessness. It is but one factor in the totality of circumstances to be examined in the context of a defendant's motion for summary judgment under a recklessness standard of care in a recreational sports context.

What does bear emphasis in this matter is defendant's own testimony that he perceived plaintiff to be in the “line of fire” and that he waved plaintiff off in an effort to induce plaintiff to move from his location. Plaintiff did not move, or defendant did not wait for him to move, and defendant hit anyway. That scenario presents a set of facts that a jury could find constitutes reckless conduct because it may reflect a conscious choice of a course of action with knowledge or reason to know that the action will create serious danger to others.

. . . . We conclude that plaintiff's case, even analyzed under a recklessness standard of care, survives defendant's motion for summary judgment and should proceed to trial. In conclusion, we hold that the recklessness or intentional conduct standard of care applies generally to conduct in recreational sporting contexts, including golf. Notwithstanding that holding, this matter must proceed to trial. Properly instructed on the heightened standard of care, a jury must resolve the disputed facts that encompass allegations of reckless conduct by defendant.

IV.

The judgment of the Appellate Division is affirmed, as modified. The matter is remanded to the Law Division for trial.

CHIEF JUSTICE PORITZ and JUSTICES STEIN, COLEMAN, LONG and ZAZZALI join in JUSTICE LaVECCHIA's opinion. JUSTICE VERNIERO filed a separate opinion concurring in part and dissenting in part.

VERNIERO, J., concurring in part, dissenting in part.

I concur in that part of the Court's opinion adopting the recklessness standard in recreational sporting contexts, including golf. The Court's analysis in that regard is persuasive. I respectfully dissent, however, from the majority's determination that there are disputed material facts warranting a trial in this case. Only the most egregious acts of golfers should give rise to liability in this setting. Because that standard has not been satisfied here, I would reverse the judgment of the Appellate Division and reinstate the trial court's summary disposition in favor of defendant.

. . . . In sum, the judiciary should refrain from interposing any set of rules that would discourage the spirited pursuit of sporting games, unless those rules are clearly necessary to protect the public interest. Unfortunately, injuries do occur on the playing field, even in a non-contact sport like golf. On balance, the public is best served by having players assume the risks of those injuries absent egregious conduct on the part of their fellow participants. By my reading of the record, defendant's only “offense” is that he hit an errant ball. He intended no injury to plaintiff. Accordingly, the public is not harmed by sustaining the grant of summary judgment in favor of the amateur athlete in this case.

. . . . Mere negligence, no matter how gross, will not suffice as a basis for punitive damages. . . . Here, the Court's disposition exposes this and similarly- situated defendants to the possibility of punitive damages. That possibility reinforces my view that the unintended consequence of the majority's holding is that it may foster more sports-related lawsuits and potentially punish well-intended athletes engaged in a variety of sports. Although it erred in applying the negligence standard, the Appellate Division below correctly concluded that “[u]nder plaintiff's version of the facts, defendant's conduct cannot be considered 'wantonly reckless' so punitive damages are not awardable.” I would rely on that conclusion as additional support to dismiss plaintiff's complaint as a matter of law.

. . . For the reasons stated, the Court should reverse the judgment of the Appellate Division and reinstate the trial court's grant of summary judgment.

IV. Product Liability

ALISON NOWAK, a Minor, by and through her Parent and Natural Guardian, LEO NOWAK; Individually, Plaintiffs v. FABERGE U.S.A., INC.; and PRECISION VALVE CORPORATION, Defendants

United States District Court for the Middle District of Pennsylvania

812 F. Supp. 492 (1992)

November 13, 1992, Decided
November 13, 1992, Filed

DISPOSITION: IT IS HEREBY ORDERED that the motions for judgment n.o.v. and/or a new trial are denied.

OPINION BY: WILLIAM J. NEALON

On April 7, 1992, a jury verdict was returned against defendant Faberge in this products liability case for serious burn injuries sustained by the minor plaintiff when she punctured can of Aqua Net hair spray resulting in the ignition of the spray when it came into contact with the flame from a gas stove. The jury found that the valve system in the hair spray can was defective when it was distributed for sale by Faberge because it failed to operate properly and was also defective because it did not contain adequate warnings. On the separate theory of design defect in the hair spray formulation, the jury found for the defendant. The jury found that those defects were the proximate cause of Alison's injuries and awarded her $ 1,500,000.00. Defendant Faberge filed post-trial motions for judgment notwithstanding the verdict. The plaintiff has filed both a reply and a brief in opposition to the defendant's motions. Oral argument was held on August 5, 1992, and the motions are now ripe for disposition. For reasons which follow, the defendant's motions for judgment notwithstanding the verdict, or, in the alternative, for a new trial, will be denied.

I. MOTION FOR JUDGMENT N.O.V.

[deleted]

A. FACTUAL BACKGROUND

Faberge manufactures the product "Aqua Net Hair Spray" by assembling component parts, inserting the liquid solvent under pressure and applying the labeling language on the can. The valve assembly component involved here was purchased from Precision Valve Company, one of three suppliers. The main ingredient in the solvent is alcohol and a liquified propellant to activate the spray is mixed into and dissolved in the solvent. A rosin is also inserted in order to hold the hair in place upon application. . . At one time, a non-flammable fluorocarbon propellant was utilized but had to be discontinued because it caused environmental problems in the ozone layer. In fact, a fluorocarbon propellant spray was not only non-flammable, but could actually put out a fire. As a result, hydrocarbons, butane and propane, were substituted as propellants for the non-flammable fluorocarbon. Butane and propane are extremely flammable, more so than gasoline, and are considered to be dangerous.

After the fluorocarbons were discontinued in favor of hydrocarbons, Faberge concluded that it would be to its advantage for marketing purposes if consumers would not perceive any change in the product. The marketing department at Faberge had the final word as to the warning to be placed on the product, and it was decided that "everything must be made to appear the same" even after being made aware that a more hazardous material was now involved. This decision was made notwithstanding the fact that reports Faberge received from the Consumer Products Safety Commission, as well as consumer complaints directly to the company, disclosed incidents of consumers being injured while puncturing aerosol cans near an open flame.

On April 2, 1989, plaintiff's sister, Amy Nowak, purchased the can of Aqua Net hair spray at an Acme Market. The front of the can contained the language "FREE! 33% MORE" and the label "AQUA NET" in large letters. There was no wording on the top of the can. The back of the can contained the usual product promotional claims as well as the ingredients against a light violet background and, in the middle between the claims and the ingredients, and of the same color (white), the following information appeared:

CAUTION: FLAMMABLE. DO NOT USE NEAR FIRE OR FLAME OR WHILE SMOKING.
WARNING: Avoid spraying in eyes. Contents under pressure.
Do not puncture or incinerate.
Do not store at temperature above 1200 F.
Keep out of reach of children. Use only as directed. Intentional misuse by deliberately concentrating and inhaling the contents can be harmful or fatal.

This lettering was of lesser size and prominence than the references on the front and back of the can to "FREE! 33% MORE"; "AQUA NET"; and "HAIR SPRAY."

Amy Nowak attempted to use the product that night but it wouldn't spray. When she pushed the nozzle down "nothing came out." Later, plaintiff tried it but "it didn't work as it should, the spray came out in spurts." When plaintiff started to spray the next evening, "it didn't work at all." She had previously used an Aqua Net product from a pump bottle, as well as a spray can, and didn't know the differences between the contents of each. It was her belief that she could remove the contents from the spray can and pour it into a pump bottle. Additionally, she thought that she would be able to remove the top with a can opener and, when this was tried unsuccessfully, she punctured the side of the can. The spray spurted out and came in contact with an open flame on a nearby gas stove, of which she was unaware, and enveloped her in flames causing serious burns to her head and body. The extent of the injuries and the amount of damages awarded has not been challenged.

B. VALVE SYSTEM

[deleted]

C. ADEQUACY OF WARNING

A "defective condition" is not limited to defects in design or manufacture. The seller must provide with the product every element necessary to make it safe for use. One such element may be warnings and/or instructions concerning use of the product. A seller must give such warning and instructions as are required to inform the user or consumer of the possible risks and inherent limitations of his products. . . .

It must be emphasized that the test of the necessity of warnings or instructions is not to be governed by the reasonable man standard. In the strict liability context we reject standards based upon what the "reasonable" consumer could be expected to know or what the "reasonable" manufacturer could be expected to "foresee" about the consumers who use his product. . . . rather, the sole question here is whether the seller accompanied his product with sufficient instructions and warnings so as to make his Product safe. This is for the jury to determine. The necessity and adequacy of warnings in determining the existence of a defect scan and should be considered with a view to all the evidence. The jury should view the relative degrees of danger associated with use of a product since a greater degree of danger requires a greater degree of protection.

A manufacturer may be liable for the failure to adequately warn where its warning is not prominent, and not calculated to attract the user's attention to the true nature of the danger due to its position, size or coloring of its lettering. A warning may be found to be inadequate if its size or print is too small or inappropriately located on the product. The warning must be sufficient to catch the attention of persons who could be expected to use the product, to apprise them of its dangers, and to advise them of the measures to take to avoid these dangers. The adequacy of the warning is a question of fact for the jury, . . ., and expert testimony is admissible on the issue of adequacy. Dr. Stephen Wilcox, a Ph.D. in experimental psychology, expressed his opinion that the warning contained on the can was defective and inadequate. He pointed out that it was a highly pressurized, extremely flammable product and received disproportionate use by teenagers, which would call for a more explicit warning mindful of teenagers' inclination not to follow instructions. According to Dr. Wilcox, the warning should advise a consumer what to do if the can did not work and that it should have used a symbol because people don't tend to read the writing on cans. He opined that the warning should be more explicit, such as, "IMMINENT DEATH - DANGER", in order to alert the consumer to serious consequences in using a product storing enormous amount of energy. Additionally, he claimed the warning was not appropriately placed on the can inasmuch as it was on the back and nestled among other language so that it blended in and didn't "jump out at you." He also said the warning should have been segregated and of a different color to make it stand out.

Dr. Harold Tanyzer, Professor from Hofstra University, who teaches youngsters about warning labels, also testified that the warning was not adequate or effective. He testified that to be an effective warning it must alert the user and explain specifically what the hazards are. He said that the three signal words most commonly used are "Danger", "Warning", and "Caution." According to Dr. Tanyzer, the warning should be placed on the top of the can where it would be most viewable and should be large, bold and bright to attract the reader's attention. . . .

This evidence, among others, provided sufficient foundation for a jury to conclude that the warnings on the can in question were inadequate and did not sufficiently inform the user of the possible risks in the product. Thus, a finding that the warnings were insufficient to satisfy Faberge's obligation to provide every element necessary to make the product safe for its intended use is supported by the evidence.

As to causation, liability for failure to warn exists "when there is sufficient evidence that a warning might have made a difference." Here, there was specific testimony from Dr. Tanyzer that a better warning "might" have made a difference and "would have greatly decreased the chances this accident would have taken place." He stated further, "in my opinion, had an appropriate warning label been used, in all likelihood, this accident might have never happened." Finally, he opined that the defective warning was a "significant" factor in causing plaintiff's injuries.

Additionally, the plaintiff testified that had the writing been on top of the can, as it was on the exemplar, she would have noticed it and been able to read it. She said specifically that she would not have tried to open the can if it contained language that it would be replaced if the valve failed to work. She explained that she didn't read the language on the back of the can because it consisted of "little, tiny words" and didn't believe "it said anything." Even when a warning is provided, the failure to read it does not necessarily bar recovery where the plaintiff is challenging the adequacy of the efforts of the manufacturer to communicate the dangers of the product to the buyer or user. Notwithstanding a failure to read, a jury could conclude that the danger was sufficiently great that the warning should have been presented in a way immediately obvious to even a casual reader. An ineffective warning is tantamount to no warning at all and a manufacturer cannot rely upon a warning which was insufficient to prevent the injury. . . .

The plaintiff is only required to show by a preponderance of the evidence that the defendant's conduct may have been a substantial factor in causing harm to her, i.e., may have changed the unsafe behavior which ultimately contributed to the plaintiff's injury. Petree, at 1196. The test for proximate cause is whether the defendant's conduct was a "substantial cause" or an "insignificant cause" and "the determination of the issue simply involves the making of a judgment as to whether the defendant's conduct although a cause in the "but for" sense is so insignificant that no ordinary mind would think of it as a cause for which a defendant should be held responsible".

The opinion testimony that different warnings might have made the difference; that the warning placed on top of the can would be noticed; that more prominent warnings would be visible; and that the warnings as contained on the can were nestled in obscurity on the back of the can and didn't "jump out at you" as should be expected, established the inadequacy of the warning.

It is clear that a jury could find that the warnings given were inadequate; that adequate warnings would have caused the plaintiff to notice them and be able to read them; that notice as to what should be done if the can failed to function properly would have caused the plaintiff to refrain from attempting to open the can; and, consequently, that the defective warning was a significant factor in causing piaintiff's injuries.

II. NEW TRIAL

[deleted]

III. DISPOSITION

Defendant's motions have been carefully considered and are held to be without merit. Accordingly, the motion for judgment n.o.v. and/or for a new trial will be denied.

JOHN ELSROTH as Administrator of the Estate of DIANE ELSROTH, Plaintiff, v. JOHNSON & JOHNSON; McNEILAB, INC., and the GREAT ATLANTIC & PACIFIC TEA CO., INC., Defendants

United States District Court for the Southern District of New York

700 F. Supp. 151

November 15, 1988, Decided

OPINION BY: Gerard L. Goettel, United States District Judge

With the California Supreme Court's decision in *Greenman v. Yuba Power Products*, 59 Cal. 2d 57 (1963), this country embarked down the largely uncharted road of strict products liability — a road whose twists and turns are still being mapped by our legislatures and courts. Today's case represents another signpost along that journey. It presents certain unique and difficult questions regarding the extent to which society is prepared to hold manufacturers and retailers liable for product tampering by third parties (in this case, unknown third parties). Before turning to the facts, some background is in order.

In late September of 1982, this country was shocked by a series of murders in the Chicago area stemming from cyanide tampering of Extra-Strength Tylenol capsules. In swift response to those tragedies, the pharmaceutical industry, in concert with the Federal Government, moved to protect consumers from the perils and random madness of product tampering.

On November 5, 1982, barely one month after the Chicago tragedies were made public, the Food and Drug Administration (the "FDA") issued a final rule on tamper-resistant packaging applicable to most over-the-counter drugs, such as Tylenol. As a result of that rule, manufacturers of over-the-counter drugs (with certain limited exceptions) were given a timetable in which to take steps to improve product integrity by virtue of a tamper-resistant package. The rule defines a "tamper-resistant package" as "one having an indicator or barrier to entry which, if breached or missing, can reasonably be expected to provide visible evidence to consumers that tampering has occurred." 21 C.F.R. § 211.132 (1987). As the FDA's comments attending issuance of the rule made clear, the rule allowed manufacturers flexibility in determining the most appropriate of several packaging options available (including various types of wrappers and seals listed by the FDA, although it made clear the list was by no means exhaustive or preclusive).

Following issuance of the rule, the makers of Tylenol have marketed that product in tamper-resistant packaging with the following features: (1) a foil seal glued to the mouth of the container or bottle; (2) a "shrink seal" around the neck and cap of the container; and (3) a sealed box (the end flaps of which are glued shut) in which the product and container are placed. It appears that by 1986, after a considerable period of market losses Tylenol had incredibly regained its dominant position in the market for over-the-counter pain relievers.

Against that backdrop, we turn to the facts underlying the present action, about which there are no material disputes.

I. FACTS

On February 4, 1986, Harriet Notarnicola purchased a box of Extra-Strength Tylenol capsules from a Bronxville grocery store owned and operated by the defendant, the Great Atlantic & Pacific Tea Co. ("A & P"). During her deposition, Mrs. Notarnicola testified that the package did not appear out of the ordinary in any way; *i.e.*, it was not apparent to her that there had been any product tampering. When she returned home, she placed the unopened box in her food closet.

The decedent, Diane Elsroth, was that week visiting her boyfriend, Michael Notarnicola, at the home of Michael's parents. Late on the night of February 7, Diane complained of a headache. Michael went to the kitchen, opened the box and plastic container of Extra-Strength Tylenol purchased by his mother earlier that week, and returned with two capsules and a glass of water for Diane. At his deposition, Michael testified that he noticed nothing unusual about the packaging; *i.e*., the flaps to the box were glued shut, the shrink seal did not appear to be disturbed, and the foil seal further securing the capsules had not been broken.

A short time after ingesting the capsules, Diane retired, mentioning that she was not feeling well. Her dead body was found the next day. The medical examiner concluded that the Tylenol capsules she ingested were contaminated by a lethal dose of potassium cyanide. Her death was listed as a homicide.

The murder remains unsolved, and it has not been determined conclusively how the product was tampered with. There is no genuine dispute, however, as to a crucial, material fact—the tampering in question occurred after the product left the manufacturer's control. Consistent with the FDA's conclusions as to the Chicago incidents in 1982, and the investigation of the Federal Bureau of Investigation in the instant case, the most likely scenario appears to be as follows. An unknown third party purchased or stole the Extra-Strength Tylenol in question at the Bronxville A & P, or at some other location. That individual breached the packaging, and substituted cyanide for some of the medicine contained in several of the gelatin capsules. The individual replaced the now-contaminated capsules in the container and somehow was able to reseal the container and box in such a way that the tampering was not readily detectable. That individual then placed the contaminated box of Extra-Strength Tylenol on the shelf of the Bronxville A&P, where it was purchased on February 4 by Mrs. Notarnicola.

Against this factual backdrop, John Elsroth, administrator of Diane Elsroth's estate, brings this action seeking to hold liable A & P and McNeil Consumer Products Co., a division of McNeilab, Inc. ("McNeil"), the manufacturer of Extra-Strength Tylenol. Plaintiff seeks $1 million in compensatory damages on any one of three alternative grounds: strict products liability, breach of warranty, or negligence. He also seeks $92 million in punitive damages based on the allegedly outrageous conduct of the defendants, and $500,000 for medical, funeral, and other expenses sustained by the estate as well as for pecuniary losses sustained by the decedent's next-of-kin.

The suit originally was brought in New York State court, but was removed to this court on petition of defendant A&P on the basis of diversity.

The defendants move for summary judgment on all claims. . . . We grant defendants' motions for summary judgment.

II. DISCUSSION

A. A & P's Alleged Negligence

[discussion omitted]

B. Strict Products Liability

We consider next the core of plaintiff's complaint — the various claims sounding in strict products liability. . .

We turn, then, to the heart of this case — the alleged marketing of a defective product for which the manufacturer and/or the retailer may be held accountable under a theory of strict products liability. As in most jurisdictions, a products claim in New York may be based on product, design, or warning defects. . . . All three are asserted here, and we consider each in turn.

1. Product Defect

Plaintiff first contends that A & P must be found liable on a product defect theory in that the product sold, Extra-Strength Tylenol capsules, left the seller's hands in "defective" condition laced with potassium cyanide. Since it is conceded the alleged "defect" occurred post-manufacture, plaintiff does not assert this claim against McNeil. He argues, however, that the retailer may be held strictly liable since it is engaged in the business of selling Tylenol and the Tylenol product it sold in this case was "defective." We disagree. . . .

This case is far outside the confines of that rule. There is no evidence here that the retailer poisoned or otherwise altered the product. Instead, this case concerns product tampering by an unknown third party. It appears that individual(s) bought or pilfered the product (either from this A & P or from another store), removed it from the premises, tampered with it, and then placed the contaminated product on A & P's shelves. Although this tampering obviously caused the product to be in an unreasonably dangerous condition when it left the retailer's hands for the second time, that condition cannot be attributed to the retailer on a product defect theory. It is attributable solely to the criminal intervention of a third party outside the ordinary parameters of the retail process.

To hold otherwise in this case would be a perversion of the justification partly underpinning the law of strict products liability, to wit, that manufacturers and retailers are in the best positions to shoulder the costs of products liability as a cost of doing business. . . . If plaintiff's claim sounding in product defect were allowed to stand, retailers would be forced to underwrite the costs of criminal conduct outside the scope of the manufacture-retail process as a cost of doing business, a result far removed from the origins of this doctrine and without justification under any sound notion of public policy. A & P's motion on the product defect claim must be granted. . . .

For all of these reasons, A & P's motion for summary judgment on the product defect claim is granted.

2. Design Defect

Plaintiff contends that both defendants are liable on either of two design defect claims: (a) that the packaging used for Extra-Strength Tylenol capsules is defectively designed in that it is not sufficiently tamper-resistant; and (b) the product here at issue — gelatin capsules — suffers from a design defect in that it is more susceptible to tampering than other forms of the medicine (such as tablets or caplets). We think neither passes muster, and we grant defendants' motions for summary judgment on the design defect claims.

(a) The Packaging

Plaintiff contends that the packaging used in this case obviously was not tamper-resistant enough, which plaintiff attributes to a design defect. He highlights the fact that no evidence was left of the tampering which, in plaintiff's mind, underscores the defect. This claim must fail as a matter of law.

In determining whether a particular design is defective, the question is "whether the product as designed was 'not reasonably safe' — that is, whether it is a product which, if the design defect were known at the time of manufacture, a reasonable person would conclude that the utility of the product did not outweigh the risk inherent in marketing a product designed in that manner." *Voss v. Black & Decker Mfg. Co*., 59 N.Y.2d 102, 108 (1983).

As to the harm, McNeil, through its research, knew that this packaging could be violated by a determined tamperer using sophisticated means, and that no evidence of this kind of sophisticated tampering would be visible to the average consumer. As one McNeil official put it, tampering by "the Rembrandt kind of criminals, the guys that are going to this exotic kind of technology," could not be prevented by this kind of packaging.

McNeil was also operating under the constraint, however, as recognized by the FDA when it drafted the 1982 regulations, that no packaging could prevent this kind of "exotic" tampering — "tamper-proof packaging is not possible." We think this conclusion is a crucial part of the legal calculus to be employed here in determining if a "defect" existed, and we take judicial notice of the FDA's assessment of the state of existing technology.

We begin, therefore, with an isolated risk of determined, sophisticated tampering, but with no reasonable means available to McNeil to ensure that its product would be impervious to that risk. Balanced against those concerns is the undisputed utility of this product, a non-aspirin pain reliever, as reflected by its prodigious sales.

The packaging alternative ultimately designed by McNeil employed not one, not two, but three of the tamper-resistant features listed as alternatives in the 1982 FDA regulations. Although the FDA noted that use of any one option listed might not by itself constitute compliance for a given product line, we think it beyond cavil that the three combined methods employed by McNeil met the FDA's requirement that the packaging, if breached, "*can reasonably be expected* to provide visible evidence to consumers that tampering has occurred."

When all of these factors are thrown into the mix, we find, as a matter of law, that under a utility/risk analysis this packaging was in a condition "reasonably contemplated by the ultimate consumer" and was not "unreasonably dangerous for its intended use." . . .

Moreover, plaintiff has presented no evidence of what other steps might feasibly have been taken to ensure a higher degree of safety. . . . Proof of a safer, feasible design must be part of plaintiff's case in chief at trial, and summary judgment is proper when, after discovery, a party "fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial."

If defendants had simply glued shut the cardboard carton in which the product was contained, we could understand the argument. Those are not the facts, however. A foil seal and shrink seal also were employed. If there are better tamper-resistant features available that would be feasible for use here, plaintiff has not described them. . . .

This, it seems to us, reveals plaintiff's packaging claim for what it really is. Although masquerading as a claim for "better protection against tampering," it is, in reality, a claim for tamper-proof packaging. Unfortunately, no such packaging exists.

For all of these reasons, we reject as a matter of law the contention that the packaging was defective.

3. Warning Defect

[omitted]

C. Punitive Damages

Plaintiff seeks, in addition to compensatory damages, $92 million in punitive damages. It is patently obvious that the kind of willful or wanton disregard for public safety that must underpin a claim for punitive damages is not present here. Thus, even if it could be said that any of plaintiff's claims could withstand these motions, we hold separately that any claim for punitive damages in this case is dismissed.

Conclusion

The emotions in this case are strong, making our decision today all the more difficult. Our task, however, is to serve as a dispassionate arbiter of the law, guided always by the legal principles that are its lifeblood while ever cognizant of the pillars that serve as its foundation: fairness, equity, and justice. An injustice has been done, but we think a second would be perpetrated were we to permit recovery against these defendants for a wrong they did not truly commit.
We do not have here a failure by the manufacturer and retailer to stand behind the goods they market; we do not have an accidental injury caused by goods they have placed in the stream of commerce. We instead are presented fundamentally with the proposition that manufacturers and retailers should be held liable in damages, as a cost of doing business, for the criminal conduct of unknown third parties who misuse the manufacturer's product in carrying out the misdeeds because the criminal cannot be held accountable. Notwithstanding the grievous harm here inflicted, we think such a result is not contemplated by the law, nor is it consonant with sound notions of fairness, equity, and justice.

Defendants' motions for summary judgment are granted, and all claims are dismissed.

SO ORDERED.

Dated: November 15, 1988, White Plains, N.Y.

IV. Intellectual Property

VANNA WHITE, Plaintiff-Appellant, v. SAMSUNG ELECTRONICS AMERICA, INC., a New York corporation, and DAVID DEUTSCH ASSOCIATES, INC., a New York corporation, Defendants-Appellees.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

971 F.2d 1395

June 7, 1991, Argued and Submitted, Pasadena, California
August 19, 1992, Filed

OPINION**:** GOODWIN, Circuit Judge: Partial Concurrence, Partial Dissent by Judge Alarcon.

This case involves a promotional "fame and fortune" dispute. In running a particular advertisement without Vanna White's permission, defendants Samsung Electronics America, Inc. (Samsung) and David Deutsch Associates, Inc. (Deutsch) attempted to capitalize on White's fame to enhance their fortune. White sued, alleging infringement of various intellectual property rights, but the district court granted summary judgment in favor of the defendants. We affirm in part, reverse in part, and remand.

Plaintiff Vanna White is the hostess of "Wheel of Fortune," one of the most popular game shows in television history. An estimated forty million people watch the program daily. Capitalizing on the fame which her participation in the show has bestowed on her, White markets her identity to various advertisers.

The dispute in this case arose out of a series of advertisements prepared for Samsung by Deutsch. The series ran in at least half a dozen publications with widespread, and in some cases national, circulation. Each of the advertisements in the series followed the same theme. Each depicted a current item from popular culture and a Samsung electronic product. Each was set in the twenty-first century and conveyed the message that the Samsung product would still be in use by that time. By hypothesizing outrageous future outcomes for the cultural items, the ads created humorous effects. . . . .

The advertisement which prompted the current dispute was for Samsung video-cassette recorders (VCRs). The ad depicted a robot, dressed in a wig, gown, and jewelry which Deutsch consciously selected to resemble White's hair and dress. The robot was posed next to a game board which is instantly recognizable as the Wheel of Fortune game show set, in a stance for which White is famous. The caption of the ad read: "Longest-running game show. 2012 A.D." Defendants referred to the ad as the "Vanna White" ad. Unlike the other celebrities used in the campaign, White neither consented to the ads nor was she paid.

Following the circulation of the robot ad, White sued Samsung and Deutsch in federal district court under: (1) California Civil Code § 3344; (2) the California common law right of publicity; and (3) § 43(a) of the Lanham Act, 15 U.S.C. § 1125(a). The district court granted summary judgment against White on each of her claims. White now appeals. . . . .

II. *Right of Publicity*

White next argues that the district court erred in granting summary judgment to defendants on White's common law right of publicity claim. In *Eastwood v. Superior Court*, 149 Cal.App.3d 409 (1983), the California court of appeal stated that the common law right of publicity cause of action "may be pleaded by alleging (1) the defendant's use of the plaintiff's identity; (2) the appropriation of plaintiff's name or likeness to defendant's advantage, commercially or otherwise; (3) lack of consent; and (4) resulting injury." . . . .The district court dismissed White's claim for failure to satisfy *Eastwood*'s second prong, reasoning that defendants had not appropriated White's "name or likeness" with their robot ad. We agree that the robot ad did not make use of White's name or likeness. However, the common law right of publicity is not so confined.

The *Eastwood* court did not hold that the right of publicity cause of action could be pleaded only by alleging an appropriation of name or likeness. *Eastwood* involved an unauthorized use of photographs of Clint Eastwood and of his name. Accordingly, the *Eastwood* court had no occasion to consider the extent beyond the use of name or likeness to which the right of publicity reaches. . . . .

These cases teach not only that the common law right of publicity reaches means of appropriation other than name or likeness, but that the specific means of appropriation are relevant only for determining whether the defendant has in fact appropriated the plaintiff's identity. The right of publicity does not require that appropriations of identity be accomplished through particular means to be actionable. . . . . Although the defendants in these cases avoided the most obvious means of appropriating the plaintiffs' identities, each of their actions directly implicated the commercial interests which the right of publicity is designed to protect. . . .

Indeed, if we treated the means of appropriation as dispositive in our analysis of the right of publicity, we would not only weaken the right but effectively eviscerate it. The right would fail to protect those plaintiffs most in need of its protection. Advertisers use celebrities to promote their products. The more popular the celebrity, the greater the number of people who recognize her, and the greater the visibility for the product. The identities of the most popular celebrities are not only the most attractive for advertisers, but also the easiest to evoke without resorting to obvious means such as name, likeness, or voice.

Consider a hypothetical advertisement which depicts a mechanical robot with male features, an African-American complexion, and a bald head. The robot is wearing black hightop Air Jordan basketball sneakers, and a red basketball uniform with black trim, baggy shorts, and the number 23 (though not revealing "Bulls" or "Jordan" lettering). The ad depicts the robot dunking a basketball one-handed, stiff-armed, legs extended like open scissors, and tongue hanging out. Now envision that this ad is run on television during professional basketball games. Considered individually, the robot's physical attributes, its dress, and its stance tell us little. Taken together, they lead to the only conclusion that any sports viewer who has registered a discernible pulse in the past five years would reach: the ad is about Michael Jordan.

Viewed separately, the individual aspects of the advertisement in the present case say little. Viewed together, they leave little doubt about the celebrity the ad is meant to depict. The female-shaped robot is wearing a long gown, blond wig, and large jewelry. Vanna White dresses exactly like this at times, but so do many other women. The robot is in the process of turning a block letter on a game-board. Vanna White dresses like this while turning letters on a game-board but perhaps similarly attired Scrabble-playing women do this as well. The robot is standing on what looks to be the Wheel of Fortune game show set. Vanna White dresses like this, turns letters, and does this on the Wheel of Fortune game show. She is the only one. Indeed, defendants themselves referred to their ad as the "Vanna White" ad. We are not surprised.

Television and other media create marketable celebrity identity value. Considerable energy and ingenuity are expended by those who have achieved celebrity value to exploit it for profit. The law protects the celebrity's sole right to exploit this value whether the celebrity has achieved her fame out of rare ability, dumb luck, or a combination thereof. We decline Samsung and Deutch's invitation to permit the evisceration of the common law right of publicity through means as facile as those in this case. Because White has alleged facts showing that Samsung and Deutsch had appropriated her identity, the district court erred by rejecting, on summary judgment, White's common law right of publicity claim.

III. *The Lanham Act*

[discussion deleted]

IV. *The Parody Defense*

In defense, defendants cite a number of cases for the proposition that their robot ad constituted protected speech. The only cases they cite which are even remotely relevant to this case are *Hustler Magazine v. Falwell* and *L.L. Bean, Inc. v. Drake Publishers, Inc*. Those cases involved parodies of advertisements run for the purpose of poking fun at Jerry Falwell and L.L. Bean, respectively. This case involves a true advertisement run for the purpose of selling Samsung VCRs. The ad's spoof of Vanna White and Wheel of Fortune is subservient and only tangentially related to the ad's primary message: "buy Samsung VCRs." Defendants' parody arguments are better addressed to non-commercial parodies. The difference between a "parody" and a "knock-off" is the difference between fun and profit. . . .

First, for celebrity exploitation advertising to be effective, the advertisement must evoke the celebrity's identity. The more effective the evocation, the better the advertisement. If, as Samsung claims, its ad was based on a "generic" game-show hostess and not on Vanna White, the ad would not have violated anyone's right of publicity, but it would also not have been as humorous or as effective.

Second, even if some forms of expressive activity, such as parody, do rely on identity evocation, the first amendment hurdle will bar most right of publicity actions against those activities. . . . Realizing this, Samsung attempts to elevate its ad above the status of garden-variety commercial speech by pointing to the ad's parody of Vanna White. Samsung's argument is unavailing.

V. *Conclusion*

In remanding this case, we hold only that White has pleaded claims which can go to the jury for its decision.

AFFIRMED IN PART, REVERSED IN PART, and REMANDED.

ORDER

CONCUR BY: ALARCON (In Part)

DISSENT: ALARCON, Circuit Judge, concurring in part, dissenting in part:

. . . . The protection of intellectual property presents the courts with the necessity of balancing competing interests. On the one hand, we wish to protect and reward the work and investment of those who create intellectual property. In so doing, however, we must prevent the creation of a monopoly that would inhibit the creative expressions of others. We have traditionally balanced those interests by allowing the copying of an idea, but protecting a unique expression of it. Samsung clearly used the idea of a glamorous female game show hostess. Just as clearly, it avoided appropriating Vanna White's expression of that role. Samsung did not use a likeness of her. The performer depicted in the commercial advertisement is unmistakably a lifeless robot. Vanna White has presented no evidence that any consumer confused the robot with her identity. Indeed, no reasonable consumer could confuse the robot with Vanna White or believe that, because the robot appeared in the advertisement, Vanna White endorsed Samsung's product.

I would affirm the district court's judgment in all respects.

COMEDY III PRODUCTIONS, INC., Plaintiff and Respondent, v. GARY SADERUP, INC., et al., Defendants and Appellants.

SUPREME COURT OF CALIFORNIA

25 Cal. 4th 387; 21 P.3d 797

April 30, 2001, Filed

Judges: George, C. J., Kennard, J., Baxter, J., Werdegar, J., Chin, J., Brown, J., Mosk, J.
Opinion by: Mosk

A California statute grants the right of publicity to specified successors in interest of deceased celebrities, prohibiting any other person from using a celebrity's name, voice, signature, photograph, or likeness for commercial purposes without the consent of such successors. The United States Constitution prohibits the states from abridging, among other fundamental rights, freedom of speech. (U.S. Const., 1st and 14th Amends.) In the case at bar we resolve a conflict between these two provisions. The Court of Appeal concluded that the lithographs and silkscreened T-shirts in question here received no First Amendment protection simply because they were reproductions rather than original works of art. As will appear, this was error: reproductions are equally entitled to First Amendment protection. We formulate instead what is essentially a balancing test between the First Amendment and the right of publicity based on whether the work in question adds significant creative elements so as to be transformed into something more than a mere celebrity likeness or imitation. Applying this test to the present case, we conclude that there are no such creative elements here and that the right of publicity prevails. On this basis, we will affirm the judgment of the Court of Appeal.

I. The Statute

In this state the right of publicity is both a statutory and a common law right. The statutory right originated in Civil Code section 3344 (hereafter section 3344), enacted in 1971, authorizing recovery of damages by any living person whose name, photograph, or likeness has been used for commercial purposes without his or her consent. Eight years later, we also recognized a common law right of publicity, which the statute was said to complement. But because the common law right was derived from the law of privacy, we held that the cause of action did not survive the death of the person whose identity was exploited and was not descendible to his or her heirs or assignees.

In 1984 the Legislature enacted an additional measure on the subject, creating a second statutory right of publicity that was descendible to the heirs and assignees of deceased persons. The statute was evidently modeled on section 3344: many of the key provisions of the two statutory schemes were identical. The 1984 measure is the statute in issue in the case at bar. At the time of trial and while the appeal was pending before the Court of Appeal, the statute was numbered section 990 of the Civil Code.

Section 990 declares broadly that "Any person who uses a deceased personality's name, voice, signature, photograph, or likeness, in any manner, on or in products, merchandise, or goods, or for purposes of advertising or selling, or soliciting purchases of, products, merchandise, goods, or services, without prior consent from the person or persons specified in subdivision (c), shall be liable for any damages sustained by the person or persons injured as a result thereof." The amount recoverable includes "any profits from the unauthorized use," as well as punitive damages, attorney's fees, and costs.

The statute defines "deceased personality" as a person "whose name, voice, signature, photograph, or likeness has commercial value at the time of his or her death," whether or not the person actually used any of those features for commercial purposes while alive. . . . The statute further declares that "The rights recognized under this section are property rights" that are transferable before or after the personality dies, by contract or by trust or will. Consent to use the deceased personality's name, voice, photograph, etc., must be obtained from such a transferee or, if there is none, from certain described survivors of the personality. . . The right to require consent under the statute terminates if there is neither transferee nor survivor. [Under the new statute, this period has increased to 70 years.]

The statute provides a number of exemptions from the requirement of consent to use. Thus a use "in connection with any news, public affairs, or sports broadcast or account, or any political campaign" does not require consent. . .

II. Facts

Plaintiff Comedy III Productions, Inc. (hereafter Comedy III), brought this action against defendants Gary Saderup and Gary Saderup, Inc. (hereafter collectively Saderup), seeking damages and injunctive relief for violation of section 990 and related business torts. The parties waived the right to jury trial and the right to put on evidence, and submitted the case for decision on the following stipulated facts:

Comedy III is the registered owner of all rights to the former comedy act known as The Three Stooges, who are deceased personalities within the meaning of the statute. Saderup is an artist with over 25 years' experience in making charcoal drawings of celebrities. These drawings are used to create lithographic and silkscreen masters, which in turn are used to produce multiple reproductions in the form, respectively, of lithographic prints and silkscreened images on T-shirts. . .

Without securing Comedy III's consent, Saderup sold lithographs and T-shirts bearing a likeness of The Three Stooges reproduced from a charcoal drawing he had made. . . . Saderup's profits from the sale of unlicensed lithographs and T-shirts bearing a likeness of The Three Stooges was $75,000 and Comedy III's reasonable attorney fees were $150,000.

On these stipulated facts the court found for Comedy III and entered judgment against Saderup awarding damages of $75,000 and attorney's fees of $150,000 plus costs. The court also issued a permanent injunction restraining Saderup from violating the statute by use of any likeness of The Three Stooges . . . .

Saderup appealed. The Court of Appeal modified the judgment by striking the injunction. The court reasoned that Comedy III had not proved a likelihood of continued violation of the statute, and that the wording of the injunction was overbroad because it exceeded the terms of the statute and because it "could extend to matters and conduct protected by the First Amendment . . . ."

We granted review . .

III. Discussion

A. The Statutory Issue

Saderup contends the statute applies only to uses of a deceased personality's name, voice, photograph, etc., for the purpose of advertising, selling, or soliciting the purchase of, products or services. He then stresses the stipulated fact that the lithographs and T-shirts at issue in this case did not constitute an advertisement, endorsement, or sponsorship of any product. He concludes the statute therefore does not apply in the case at bar. As will appear, the major premise of his argument—his construction of the statute—is unpersuasive.

As noted above, the statute makes liable any person who, without consent, uses a deceased personality's name, voice, photograph, etc., "in any manner, on or in products, merchandise, or goods, or for purposes of advertising or selling, or soliciting purchases of, products, merchandise, goods, or services . . . ." Saderup's construction reads the emphasized phrase out of the statute.

We therefore give effect to the plain meaning of the statute: it makes liable any person who, without consent, uses a deceased personality's name, voice, photograph, etc., either (1) "on or in" a product, or (2) in "advertising or selling" a product. The two uses are not synonymous: in the apt example given by the Court of Appeal, there is an obvious difference between "placing a celebrity's name on a 'special edition' of a vehicle, and using that name in a commercial to endorse or tout the same or another vehicle."

Applying this construction of the statute to the facts at hand, we agree with the Court of Appeal that Saderup sold more than just the incorporeal likeness of The Three Stooges. Saderup's lithographic prints of The Three Stooges are themselves tangible personal property, consisting of paper and ink, made as products to be sold and displayed on walls like similar graphic art. Saderup's T-shirts are likewise tangible personal property, consisting of fabric and ink, made as products to be sold and worn on the body like similar garments. By producing and selling such lithographs and T-shirts, Saderup thus used the likeness of The Three Stooges "on . . . products, merchandise, or goods" within the meaning of the statute. . . .

B. The Constitutional Issue

Saderup next contends that enforcement of the judgment against him violates his right of free speech and expression under the First Amendment. He raises a difficult issue, which we address below.

The right of publicity is often invoked in the context of commercial speech when the appropriation of a celebrity likeness creates a false and misleading impression that the celebrity is endorsing a product. Because the First Amendment does not protect false and misleading commercial speech, and because even nonmisleading commercial speech is generally subject to somewhat lesser First Amendment protection, the right of publicity may often trump the right of advertisers to make use of celebrity figures.

But the present case does not concern commercial speech. As the trial court found, Saderup's portraits of The Three Stooges are expressive works and not an advertisement for or endorsement of a product. Although his work was done for financial gain, "the First Amendment is not limited to those who publish without charge. . . . [An expressive activity] does not lose its constitutional protection because it is undertaken for profit."

The tension between the right of publicity and the First Amendment is highlighted by recalling the two distinct, commonly acknowledged purposes of the latter. First, "'to preserve an uninhibited marketplace of ideas' and to repel efforts to limit the '"uninhibited, robust and wide-open" debate on public issues.'" Second, to foster a "fundamental respect for individual development and self-realization. The right to self-expression is inherent in any political system which respects individual dignity. Each speaker must be free of government restraint regardless of the nature or manner of the views expressed unless there is a compelling reason to the contrary." . . . .

For similar reasons, speech about public figures is accorded heightened First Amendment protection in defamation law. As the United States Supreme Court held . . ., public figures may prevail in a libel action only if they prove that the defendant's defamatory statements were made with actual malice, i.e., actual knowledge of falsehood or reckless disregard for the truth, whereas private figures need prove only negligence. *New York Times v. Sullivan*, 376 U.S. 254 (1964). The rationale for such differential treatment is, first, that the public figure has greater access to the media and therefore greater opportunity to rebut defamatory statements, and second, that those who have become public figures have done so voluntarily and therefore "invite attention and comment." Giving broad scope to the right of publicity has the potential of allowing a celebrity to accomplish through the vigorous exercise of that right the censorship of unflattering commentary that cannot be constitutionally accomplished through defamation actions.

Nor do Saderup's creations lose their constitutional protections because they are for purposes of entertaining rather than informing. Nor does the fact that expression takes a form of nonverbal, visual representation remove it from the ambit of First Amendment protection.

Moreover, the United States Supreme Court has made it clear that a work of art is protected by the First Amendment even if it conveys no discernable message. . . . Nor does the fact that Saderup's art appears in large part on a less conventional avenue of communications, T-shirts, result in reduced First Amendment protection. . . First Amendment doctrine does not disfavor nontraditional media of expression. . . .

The present case exemplifies this kind of creative labor. Moe and Jerome (Curly) Howard and Larry Fein fashioned personae collectively known as The Three Stooges, first in vaudeville and later in movie shorts, over a period extending from the 1920's to the 1940's. The three comic characters they created and whose names they shared—Larry, Moe, and Curly—possess a kind of mythic status in our culture. Their journey from ordinary vaudeville performers to the heights (or depths) of slapstick comic celebrity was long and arduous. Their brand of physical humor—the nimble, comically stylized violence, the "nyuk-nyuks" and "whoop-whoop-whoops," eye-pokes, slaps and head conks—created a distinct comedic trademark. Through their talent and labor, they joined the relatively small group of actors who constructed identifiable, recurrent comic personalities that they brought to the many parts they were scripted to play.

In sum, society may recognize, as the Legislature has done here, that a celebrity's heirs and assigns have a legitimate protectible interest in exploiting the value to be obtained from merchandising the celebrity's image, whether that interest be conceived as a kind of natural property right or as an incentive for encouraging creative work. [T]he Legislature has a rational basis for permitting celebrities and their heirs to control the commercial exploitation of the celebrity's likeness. . . .

Another way of stating the inquiry is whether the celebrity likeness is one of the "raw materials" from which an original work is synthesized, or whether the depiction or imitation of the celebrity is the very sum and substance of the work in question. We ask, in other words, whether a product containing a celebrity's likeness is so transformed that it has become primarily the defendant's own expression rather than the celebrity's likeness. And when we use the word "expression," we mean expression of something other than the likeness of the celebrity. . . .

In sum, when an artist is faced with a right of publicity challenge to his or her work, he or she may raise as affirmative defense that the work is protected by the First Amendment inasmuch as it contains significant transformative elements or that the value of the work does not derive primarily from the celebrity's fame.

Turning to the present case, . . . the inquiry is into whether Saderup's work is sufficiently transformative. . . Without denying that all portraiture involves the making of artistic choices, we find it equally undeniable, under the test formulated above, that when an artist's skill and talent is manifestly subordinated to the overall goal of creating a conventional portrait of a celebrity so as to commercially exploit his or her fame, then the artist's right of free expression is outweighed by the right of publicity. . . .

Turning to Saderup's work, we can discern no significant transformative or creative contribution. His undeniable skill is manifestly subordinated to the overall goal of creating literal, conventional depictions of The Three Stooges so as to exploit their fame. Indeed, were we to decide that Saderup's depictions were protected by the First Amendment, we cannot perceive how the right of publicity would remain a viable right other than in cases of falsified celebrity endorsements.

Moreover, the marketability and economic value of Saderup's work derives primarily from the fame of the celebrities depicted. While that fact alone does not necessarily mean the work receives no First Amendment protection, we can perceive no transformative elements in Saderup's works that would require such protection.

IV. Disposition

The judgment of the Court of Appeal is affirmed.

LUTHER R. CAMPBELL AKA LUKE SKYWALKER, ET AL., PETITIONERS
v. ACUFF-ROSE MUSIC, INC.

510 U.S. 569
U.S. Supreme Court

March 7, 1994, Decided

SOUTER, J., delivered the opinion for a unanimous Court. Kennedy, J., filed a concurring opinion.

We are called upon to decide whether 2 Live Crew's commercial parody of Roy Orbison's song, "Oh, Pretty Woman," may be a fair use within the meaning of the Copyright Act of 1976. Although the District Court granted summary judgment for 2 Live Crew, the Court of Appeals reversed, holding the defense of fair use barred by the song's commercial character and excessive borrowing. Because we hold that a parody's commercial character is only one element to be weighed in a fair use enquiry, and that insufficient consideration was given to the nature of parody in weighing the degree of copying, we reverse and remand.

I

In 1964, Roy Orbison and William Dees wrote a rock ballad called "Oh, Pretty Woman" and assigned their rights in it to respondent Acuff-Rose Music, Inc. Acuff-Rose registered the song for copyright protection.

Petitioners Luther R. Campbell, Christopher Wongwon, Mark Ross, and David Hobbs, are collectively known as 2 Live Crew, a popular rap music group. In 1989, Campbell wrote a song entitled "Pretty Woman," which he later described in an affidavit as intended, "through comical lyrics, to satirize the original work. . . ." On July 5, 1989, 2 Live Crew's manager informed Acuff-Rose that 2 Live Crew had written a parody of "Oh, Pretty Woman," that they would afford all credit for ownership and authorship of the original song to Acuff-Rose, Dees, and Orbison, and that they were willing to pay a fee for the use they wished to make of it. Enclosed with the letter were a copy of the lyrics and a recording of 2 Live Crew's song. Acuff-Rose's agent refused permission, stating that "I am aware of the success enjoyed by `The 2 Live Crews', but I must inform you that we cannot permit the use of a parody of `Oh, Pretty Woman.'" Nonetheless, in June or July, 1989, 2 Live Crew released records, cassette tapes, and compact discs of "Pretty Woman" in a collection of songs entitled "As Clean As They Wanna Be." The albums and compact discs identify the authors of "Pretty Woman" as Orbison and Dees and its publisher as Acuff-Rose.

Almost a year later, after nearly a quarter of a million copies of the recording had been sold, Acuff-Rose sued 2 Live Crew and its record company, Luke Skyywalker Records, for copyright infringement. . . .

We granted certiorari, to determine whether 2 Live Crew's commercial parody could be a fair use.

II

It is uncontested here that 2 Live Crew's song would be an infringement of Acuff-Rose's rights in "Oh, Pretty Woman," under the Copyright Act of 1976, but for a finding of fair use through parody. From the infancy of copyright protection, some opportunity for fair use of copyrighted materials has been thought necessary to fulfill copyright's very purpose, "[t]o promote the Progress of Science and useful Arts. . . ." U.S. Const., Art. I, 8, cl. 8. . . .

A

The first factor in a fair use enquiry is "the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes." 107(1). . . . The central purpose of this investigation is to see, in Justice Story's words, whether the new work merely "supersede[s] the objects" of the original creation, . . or instead adds something new, with a further purpose or different character, altering the first with new expression, meaning, or message; it asks, in other words, whether and to what extent the new work is "transformative." Although such transformative use is not absolutely necessary for a finding of fair use, the goal of copyright, to promote science and the arts, is generally furthered by the creation of transformative works. Such works thus lie at the heart of the fair use doctrine's guarantee of breathing space within the confines of copyright, . . . and the more transformative the new work, the less will be the significance of other factors, like commercialism, that may weigh against a finding of fair use. . . . .

Modern dictionaries describe a parody as a "literary or artistic work that imitates the characteristic style of an author or a work for comic effect or ridicule," or as a "composition in prose or verse in which the characteristic turns of thought and phrase in an author or class of authors are imitated in such a way as to make them appear ridiculous." For the purposes of copyright law, the nub of the definitions, and the heart of any parodist's claim to quote from existing material, is the use of some elements of a prior author's composition to create a new one that, at least in part, comments on that author's works. . . .

The fact that parody can claim legitimacy for some appropriation does not, of course, tell either parodist or judge much about where to draw the line. Like a book review quoting the copyrighted material criticized, parody may or may not be fair use, and petitioner's suggestion that any parodic use is presumptively fair has no more justification in law or fact than the equally hopeful claim that any use for news reporting should be presumed fair. . . . Parody, like any other use, has to work its way through the relevant factors, and be judged case by case, in light of the ends of the copyright law. . .

The threshold question when fair use is raised in defense of parody is whether a parodic character may reasonably be perceived. Whether, going beyond that, parody is in good taste or bad does not and should not matter to fair use. . . .

While we might not assign a high rank to the parodic element here, we think it fair to say that 2 Live Crew's song reasonably could be perceived as commenting on the original or criticizing it, to some degree. 2 Live Crew juxtaposes the romantic musings of a man whose fantasy comes true with degrading taunts, a bawdy demand for sex, and a sigh of relief from paternal responsibility. The later words can be taken as a comment on the naivete of the original of an earlier day, as a rejection of its sentiment that ignores the ugliness of street life and the debasement that it signifies. It is this joinder of reference and ridicule that marks off the author's choice of parody from the other types of comment and criticism that traditionally have had a claim to fair use protection as transformative works. . . .

. . . . The mere fact that a use is educational and not for profit does not insulate it from a finding of infringement, any more than the commercial character of a use bars a finding of fairness. If, indeed, commerciality carried presumptive force against a finding of fairness, the presumption would swallow nearly all of the illustrative uses listed in the preamble paragraph of 107, including news reporting, comment, criticism, teaching, scholarship, and research, since these activities "are generally conducted for profit in this country." . . . .

The use, for example, of a copyrighted work to advertise a product, even in a parody, will be entitled to less indulgence under the first factor of the fair use enquiry than the sale of a parody for its own sake, let alone one performed a single time by students in school. . . .

C

The third factor asks whether "the amount and substantiality of the portion used in relation to the copyrighted work as a whole," 107(3) . . . are reasonable in relation to the purpose of the copying. Here, attention turns to the persuasiveness of a parodist's justification for the particular copying done, and the enquiry will harken back to the first of the statutory factors, for, as in prior cases, we recognize that the extent of permissible copying varies with the purpose and character of the use. . . .

We conclude that taking the heart of the original and making it the heart of a new work was to purloin a substantial portion of the essence of the original.". . . . . Where we part company with the court below is in applying these guides to parody, and in particular to parody in the song before us. Parody presents a difficult case. Parody's humor, or in any event its comment, necessarily springs from recognizable allusion to its object through distorted imitation. Its art lies in the tension between a known original and its parodic twin. When parody takes aim at a particular original work, the parody must be able to "conjure up" at least enough of that original to make the object of its critical wit recognizable. What makes for this recognition is quotation of the original's most distinctive or memorable features, which the parodist can be sure the audience will know. Once enough has been taken to assure identification, how much more is reasonable will depend, say, on the extent to which the song's overriding purpose and character is to parody the original or, in contrast, the likelihood that the parody may serve as a market substitute for the original. But using some characteristic features cannot be avoided. . . .

This is not, of course, to say that anyone who calls himself a parodist can skim the cream and get away scot free. In parody . . . context is everything, and the question of fairness asks what else the parodist did besides go to the heart of the original. It is significant that 2 Live Crew not only copied the first line of the original, but thereafter departed markedly from the Orbison lyrics for its own ends. 2 Live Crew not only copied the bass riff and repeated it, but also produced otherwise distinctive sounds, interposing "scraper" noise, overlaying the music with solos in different keys, and altering the drum beat. This is not a case, then, where "a substantial portion" of the parody itself is composed of a "verbatim" copying of the original. It is not, that is, a case where the parody is so insubstantial, as compared to the copying, that the third factor must be resolved as a matter of law against the parodists.

. . . As to the music, we express no opinion whether repetition of the bass riff is excessive copying, and we remand to permit evaluation of the amount taken, in light of the song's parodic purpose and character, its transformative elements, and considerations of the potential for market substitution sketched more fully below.

D

The fourth fair use factor is "the effect of the use upon the potential market for or value of the copyrighted work." 107(4). It requires courts to consider not only the extent of market harm caused by the particular actions of the alleged infringer, but also "whether unrestricted and widespread conduct of the sort engaged in by the defendant . . . would result in a substantially adverse impact on the potential market" for the original. . . .

We do not, of course, suggest that a parody may not harm the market at all, but when a lethal parody, like a scathing theater review, kills demand for the original, it does not produce a harm cognizable under the Copyright Act. Because "parody may quite legitimately aim at garroting the original, destroying it commercially as well as artistically," . . . . the role of the courts is to distinguish between "[b]iting criticism [that merely] suppresses demand [and] copyright infringement[, which] usurps it." . . .

Although 2 Live Crew submitted uncontroverted affidavits on the question of market harm to the original, neither they nor Acuff-Rose introduced evidence or affidavits addressing the likely effect of 2 Live Crew's parodic rap song on the market for a non-parody, rap version of "Oh, Pretty Woman." And while Acuff-Rose would have us find evidence of a rap market in the very facts that 2 Live Crew recorded a rap parody of "Oh, Pretty Woman" and another rap group sought a license to record a rap derivative, there was no evidence that a potential rap market was harmed in any way by 2 Live Crew's parody, rap version. . . .

III

It was error for the Court of Appeals to conclude that the commercial nature of 2 Live Crew's parody of "Oh, Pretty Woman" rendered it presumptively unfair. No such evidentiary presumption is available to address either the first factor, the character and purpose of the use, or the fourth, market harm, in determining whether a transformative use, such as parody, is a fair one. The court also erred in holding that 2 Live Crew had necessarily copied excessively from the Orbison original, considering the parodic purpose of the use. We therefore reverse the judgment of the Court of Appeals and remand for further proceedings consistent with this opinion.

It is so ordered.

Appendix A
"Oh, Pretty Woman" by Roy Orbison and William Dees

Pretty Woman, walking down the street, Pretty Woman, the kind I like to meet, Pretty Woman, I don't believe you, you're not the truth, No one could look as good as you Mercy

Pretty Woman, won't you pardon me, Pretty Woman, I couldn't help but see, Pretty Woman, that you look lovely as can be Are you lonely just like me?

Pretty Woman, stop a while, Pretty Woman, talk a while, Pretty Woman give your smile to me Pretty woman, yeah, yeah, yeah Pretty Woman, look my way, Pretty Woman, say you'll stay with me Cause I need you, I'll treat you right Come to me baby, Be mine tonight

Pretty Woman, don't walk on by, Pretty Woman, don't make me cry, Pretty Woman, don't walk away, Hey, O.K. If that's the way it must be, O.K. I guess I'll go on home, it's late There'll be tomorrow night, but wait!

What do I see Is she walking back to me? Yeah, she's walking back to me! Oh, Pretty Woman.

Appendix B
"Pretty Woman" as Recorded by 2 Live Crew

Pretty woman walkin' down the street Pretty woman girl you look so sweet Pretty woman you bring me down to that knee Pretty woman you make me wanna beg please Oh, pretty woman

Big hairy woman you need to shave that stuff Big hairy woman you know I bet it's tough Big hairy woman all that hair it ain't legit Cause you look like "Cousin It" Big hairy woman

Bald headed woman girl your hair won't grow Bald headed woman you got a teeny weeny afro Bald headed woman you know your hair could look nice Bald headed woman first you got to roll it with rice Bald headed woman here, let me get this hunk of biz for ya Ya know what I'm saying you look better than rice a roni Oh bald headed woman

Big hairy woman come on in And don't forget your bald headed friend Hey pretty woman let the boys Jump in

Two timin' woman girl you know you ain't right Two timin' woman you's out with my boy last night Two timin' woman that takes a load off my mind Two timin' woman now I know the baby ain't mine Oh, two timin' woman Oh pretty woman

TWO PESOS, INC., PETITIONER v. TACO CABANA, INC.

Supreme Court of the United States

505 U.S. 763
June 26, 1992

WHITE, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and BLACKMUN, O'CONNOR, SCALIA, KENNEDY, and SOUTER, JJ., joined. SCALIA, J., filed a concurring opinion. STEVENS, J. and THOMAS, J., filed opinions concurring in the judgment.

The issue in this case is whether the trade dress of a restaurant may be protected under § 43(a) of the Trademark Act of 1946 (Lanham Act), based on a finding of inherent distinctiveness, without proof that the trade dress has secondary meaning.

I

Respondent Taco Cabana, Inc., operates a chain of fast-food restaurants in Texas. The restaurants serve Mexican food. The first Taco Cabana restaurant was opened in San Antonio in September 1978, and five more restaurants had been opened in San Antonio by 1985. Taco Cabana describes its Mexican trade dress as

> "a festive eating atmosphere having interior dining and patio areas decorated with artifacts, bright colors, paintings and murals. The patio includes interior and exterior areas with the interior patio capable of being sealed off from the outside patio by overhead garage doors. The stepped exterior of the building is a festive and vivid color scheme using top border paint and neon stripes. Bright awnings and umbrellas continue the theme."

In December 1985, a Two Pesos, Inc., restaurant was opened in Houston. Two Pesos adopted a motif very similar to the foregoing description of Taco Cabana's trade dress. Two Pesos restaurants expanded rapidly in Houston and other markets, but did not enter San Antonio. In 1986, Taco Cabana entered the Houston and Austin markets and expanded into other Texas cities, including Dallas and El Paso where Two Pesos was also doing business.

In 1987, Taco Cabana sued Two Pesos in the United States District Court for the Southern District of Texas for trade dress infringement under § 43(a) of the Lanham Act and for theft of trade secrets under Texas common law. The case was tried to a jury, which was instructed to return its verdict in the form of answers to five questions propounded by the trial judge. The jury's answers were: Taco Cabana has a trade dress; taken as a whole, the trade dress is nonfunctional; the trade dress is inherently distinctive; the trade dress has not acquired a secondary meaning[4] in the Texas market; and the alleged infringement creates a likelihood of confusion on the part of ordinary customers as to the source or association of the restaurant's goods or services. Because, as the jury was told, Taco Cabana's trade dress was protected if it either was inherently distinctive or had acquired a secondary meaning, judgment was entered awarding damages to Taco Cabana. In the course of calculating damages, the trial court held that Two Pesos had intentionally and deliberately infringed Taco Cabana's trade dress.

> Secondary meaning is used generally to indicate that a mark or dress "has come through use to be uniquely associated with a specific source." Restatement (Third) of Unfair Competition § 13. "To establish secondary meaning, a manufacturer must show that, in the minds of the public, the primary significance of a product feature or term is to identify the source of the product rather than the product itself."

The Court of Appeals ruled that the instructions adequately stated the applicable law and that the evidence supported the jury's findings. In particular, the Court of Appeals rejected petitioner's argument that a finding of no secondary meaning contradicted a finding of inherent distinctiveness.

In so holding, the court below followed precedent in the Fifth Circuit . . that trademark law requires a demonstration of secondary meaning only when the claimed trademark is not sufficiently distinctive of itself to identify the producer; the court held that the same principles should apply to protection of trade dresses. The Court of Appeals noted that this approach conflicts with decisions of other courts, particularly the holding of the Court of Appeals for the Second Circuit. We granted certiorari to resolve the conflict among the Courts of Appeals on the question whether trade dress that is inherently distinctive is protectible under § 43(a) without a showing that it has acquired secondary meaning. We find that it is, and we therefore affirm.

II

The Lanham Act was intended to make "actionable the deceptive and misleading use of marks" and "to protect persons engaged in . . . commerce against unfair competition.". . .

A trademark is defined in 15 U.S.C. § 1127 as including "any word, name, symbol, or device or any combination thereof" used by any person "to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown." In order to be registered, a mark must be capable of distinguishing the applicant's goods from those of others. . . .

Marks which are merely descriptive of a product are not inherently distinctive. When used to describe a product, they do not inherently identify a particular source, and hence cannot be protected. However, descriptive marks may acquire the distinctiveness which will allow them to be protected under the Act. Section 2 of the Lanham Act provides that a descriptive mark that otherwise could not be registered under the Act may be registered if it "has become distinctive of the applicant's goods in commerce." . . . This acquired distinctiveness is generally called "secondary meaning." . . .

The general rule regarding distinctiveness is clear: An identifying mark is distinctive and capable of being protected if it *either* (1) is inherently distinctive *or* (2) has acquired distinctiveness through secondary meaning. . . . It is, of course, also undisputed that liability. . . requires proof of the likelihood of confusion.

The Court of Appeals determined that the District Court's instructions were consistent with the foregoing principles and that the evidence supported the jury's verdict. Both courts thus ruled that Taco Cabana's trade dress was not descriptive but rather inherently distinctive, and that it was not functional. . . . In going on to affirm the judgment for respondent, the Court of Appeals held that Taco Cabana's inherently distinctive trade dress was entitled to protection despite the lack of proof of secondary meaning. It is this issue that is before us for decision, and we agree with its resolution by the Court of Appeals. . . .

Petitioner argues that the jury's finding that the trade dress has not acquired a secondary meaning shows conclusively that the trade dress is not inherently distinctive. . . . We see no basis for requiring secondary meaning for inherently distinctive trade dress protection under § 43(a) but not for other distinctive words, symbols, or devices capable of identifying a producer's product.

Engrafting onto § 43(a) a requirement of secondary meaning for inherently distinctive trade dress also would undermine the purposes of the Lanham Act. Protection of trade dress, no less than of trademarks, serves the Act's purpose to "secure to the owner of the mark the goodwill of his business and to protect the ability of consumers to distinguish among competing producers. National protection of trademarks is desirable, Congress concluded, because trademarks foster competition and the maintenance of quality by securing to the producer the benefits of good reputation." By making more difficult the identification of a producer with its product, a secondary meaning requirement for a nondescriptive trade dress would hinder improving or maintaining the producer's competitive position. . . .

On the other hand, adding a secondary meaning requirement could have anticompetitive effects, creating particular burdens on the startup of small companies. It would present special difficulties for a business, such as respondent, that seeks to start a new product in a limited area and then expand into new markets. Denying protection for inherently distinctive nonfunctional trade dress until after secondary meaning has been established would allow a competitor, which has not adopted a distinctive trade dress of its own, to appropriate the originator's dress in other markets and to deter the originator from expanding into and competing in these areas. . . .

III

We agree with the Court of Appeals that proof of secondary meaning is not required to prevail on a claim under the Lanham Act where the trade dress at issue is inherently distinctive, and accordingly the judgment of that court is affirmed.

It is so ordered.

Ty, Inc., Plaintiff-Appellee, v. GMA Accessories, Inc., Defendant-Appellant

United States Court of Appeals for the Seventh Circuit

132 F.3d 1167

December 19, 1997, Decided

PRIOR HISTORY: Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

JUDGES: Posner, Chief Judge, and Bauer and Flaum, Circuit Judges.

OPINION BY: Chief Judge Posner.

Ty, the manufacturer of the popular "Beanie Babies" line of stuffed animals, has obtained a preliminary injunction under the Copyright Act against the sale by GMA (and also a retailer, but we can disregard that aspect of the injunction) of "Preston the Pig" and "Louie the Cow." These are bean-bag animals manufactured by GMA that Ty contends are copies of its copyrighted pig ("Squealer") and cow ("Daisy"). Ty began selling the "Beanie Babies" line, including Squealer, in 1993, and it was the popularity of the line that induced GMA to bring out its own line of bean-bag stuffed animals three years later. GMA does not contest the part of the injunction that enjoins the sale of Louie, but asks us on a variety of grounds to vacate the other part, the part that enjoins it from selling Preston.

We have appended to our opinion five pictures found in the appellate record. The first shows Squealer (the darker pig, actually pink) and Preston (white). The second is a picture of two real pigs. The third and fourth are different views of the design for Preston that Janet Salmon submitted to GMA several months before Preston went into production. The fifth is a picture of the two bean-bag cows; they are nearly identical. A glance at the first picture shows a striking similarity between the two bean-bag pigs as well. The photograph was supplied by GMA and actually understates the similarity (the animals themselves are part of the record). The "real" Preston is the same length as Squealer and has a virtually identical snout. The difference in the lengths of the two animals in the picture is a trick of the camera. The difference in snouts results from the fact that the pictured Preston was a manufacturing botch. And GMA put a ribbon around the neck of the Preston in the picture, but the Preston that it sells doesn't have a ribbon.

The two pigs are so nearly identical that if the second is a copy of the first, the second clearly infringes Ty's copyright. But identity is not infringement. The Copyright Act forbids only copying; if independent creation results in an identical work, the creator of that work is free to sell it. The practical basis for this rule is that unlike the case of patents and trademarks, the creator of an expressive work—an author or sculptor or composer— cannot canvass the entire universe of copyrighted works to discover whether his poem or song or, as in this case, "soft sculpture" is identical to some work in which copyright subsists, especially since unpublished, unregistered works are copyrightable. [cites omitted] But identity can be powerful evidence of copying. [cites omitted] The more a work is both like an already copyrighted work and—for this is equally important—unlike anything that is in the public domain, the less likely it is to be an independent creation. As is generally true in the law, circumstantial evidence—evidence merely probabilistic rather than certain—can confer sufficient confidence on an inference, here of copying, to warrant a legal finding.

The issue of copying can be broken down into two sub-issues. The first is whether the alleged copier had access to the work that he is claimed to have copied; the second is whether, if so, he used his access to copy. It might seem that access could not be an issue where, as in this case, the allegedly copied work is a mass-produced consumer product purchasable for $ 5. But we shall see that GMA has attempted to make an issue of access.

Obviously, access does not entail copying. An eyewitness might have seen the defendant buy the copyrighted work; this would be proof of access, but not of copying. But copying entails access. If, therefore, two works are so similar as to make it highly probable that the later one is a copy of the earlier one, the issue of access need not be addressed separately, since if the later work was a copy its creator must have had access to the original. [cites omitted] Of course the inference of access, and hence of copying, could be rebutted by proof that the creator of the later work could not have seen the earlier one or (an alternative mode of access) a copy of the earlier one. . . . The plaintiff must produce some (other) evidence of access. He must produce evidence of access, all right—but, as we have just said, a similarity that is so close as to be highly unlikely to have been an accident of independent creation is evidence of access.

Two works may be strikingly similar—may in fact be identical—not because one is copied from the other but because both are copies of the same thing in the public domain. In such a case—imagine two people photographing Niagara Falls from the same place at the same time of the day and year and in identical weather—there is no inference of access to anything but the public domain, and, equally, no inference of copying from a copyrighted work. A similarity may be striking without being suspicious.

But here it is both. GMA's pig is strikingly similar to Ty's pig but not to anything in the public domain--a real pig, for example, which is why we have included in our appendix a photograph of real pigs. The parties' bean-bag pigs bear little resemblance to real pigs even if we overlook the striking anatomical anomaly of Preston--he has three toes, whereas real pigs have cloven hooves. We can imagine an argument that the technology of manufacturing bean-bag animals somehow prevents the manufacturer from imitating a real pig. But anyone even slightly familiar with stuffed animals knows that there are many lifelike stuffed pigs on the market, and whether they are stuffed with beans or other materials does not significantly affect their verisimilitude—though here we must emphasize that any factual assertions in this opinion should be treated as tentative, since the case is before us on an appeal from the abbreviated record of a preliminary-injunction proceeding and a full trial may cast the facts in a different light.

Real pigs are not the only pigs in the public domain. But GMA has not pointed to any fictional pig in the public domain that Preston resembles. Preston resembles only Squealer, and resembles him so closely as to warrant an inference that GMA copied Squealer. In rebuttal all that GMA presented was the affidavit of the designer, Salmon, who swears, we must assume truthfully, that she never looked at a Squealer before submitting her design. But it is not her design drawing that is alleged to infringe the copyright on Squealer; it is the manufactured Preston, the soft sculpture itself, which, as a comparison of the first with the third and fourth pictures in the appendix reveals, is much more like Squealer than Salmon's drawing is. And remember that the manufactured Preston *in the photograph* is a sport, with its stubby snout and its ribbon. Interestingly, these are features of Salmon's drawing but not of the production-model Preston, suggesting design intervention between Salmon's submission and actual production. . . .

The Beanie Babies are immensely popular. They are also, it is true, sometimes hard to find. Ty's practice, apparently, is to create a shortage (that is, to price its bean-bag animals below the market-clearing price) in order to excite the market. But it is unbelievable that a substantial company like GMA which is in the same line of business as Ty could not have located and purchased a Squealer if it wanted to copy it. A glance at the last picture in the appendix shows an identity between Louie the Cow and Ty's Daisy that is so complete (and also not explainable by reference to resemblance to a real cow or other public domain figure) as to compel an inference of copying. If GMA thus must have had access to Louie, it is probable, quite apart from any inference from the evidence of similarity, that it had access to Squealer as well.

Access (and copying) may be inferred when two works are so similar to each other and not to anything in the public domain that it is likely that the creator of the second work copied the first, but the inference can be rebutted by disproving access or otherwise showing independent creation—and in this connection GMA complains that the district judge refused to conduct an evidentiary hearing at which it might have presented evidence of independent creation. If genuine issues of material fact are created by the response to a motion for a preliminary injunction, an evidentiary hearing is indeed required. But as in any case in which a party seeks an evidentiary hearing, he must be able to persuade the court that the issue is indeed genuine and material and so a hearing would be productive—he must show in other words that he has and intends to introduce evidence that if believed will so weaken the moving party's case as to affect the judge's decision on whether to issue an injunction. Here is where GMA falters. The only evidence that it seeks to present is the designer's oral testimony in support of the claim of independent creation. Her testimony would presumably have duplicated her affidavit, which was already in evidence; at least, GMA has not indicated what her testimony would add to her affidavit. Affidavits are ordinarily inadmissible at trials but they are fully admissible in summary proceedings, including preliminary-injunction proceedings. So the evidence that GMA wants to put before the district judge was before him when he ruled. . . .

So, on the record compiled in the preliminary-injunction proceedings, Ty has indeed a strong case. But that is not the end of our inquiry. The granting of a preliminary injunction depends on proof of irreparable harm if the injunction is withheld as well as on the likelihood of success on the merits when the case is fully tried. It is true that the stronger the case on the merits, the less irreparable harm must be shown. If the likelihood of a substantive mistake—relief granted without an actual infringement of the plaintiff's rights—is slight, the fact that the plaintiff may not have a compelling need for interim relief is not a great worry; for if his rights really were infringed, he is entitled to an injunction without demonstrating irreparable harm, which is required to be shown only if *preliminary* injunctive relief is sought. But a plaintiff who cannot show any irreparable harm at all from the withholding of a preliminary injunction is not entitled to the injunction however strong his case on the merits, for he has no need for preliminary relief in such a case, no need therefore to short-circuit the ordinary processes of the law. GMA argues that Ty has in fact suffered no irreparable harm.

It relies primarily on a short-term promotional license that Ty granted McDonald's to give away miniature Beanie Babies ("Teenie Beanie Babies") to McDonald's customers in their meal packets. This shows, says GMA, that Ty does not insist on having the exclusive right to distribute Beanie Babies to the consuming public, that it is willing to "sell" (or rent) that right, and hence that it would be fully compensated for any losses stemming from GMA's copying simply by an award of damages measured either by GMA's profits on its sales of Preston or by the reduction in Ty's profits caused by the diversion of customers to the look-alike pig (whichever is greater). These are indeed allowable measures of damages . . . , but they do not demonstrate an absence of irreparable harm. . . .

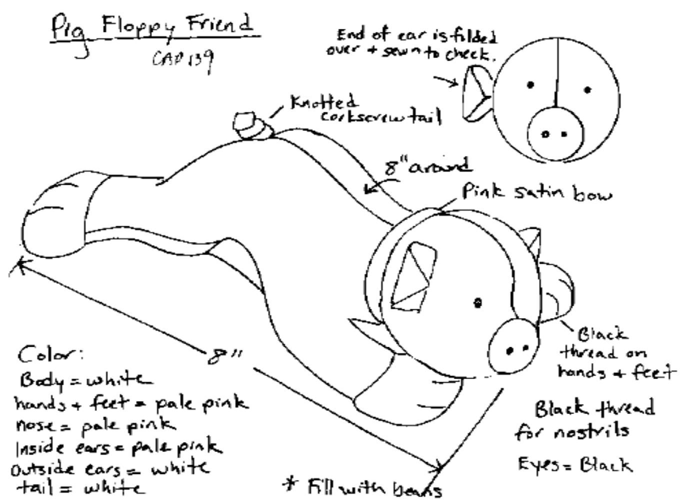
Ty wants to limit the distribution of Beanie Babies, and has succeeded in doing so, as shown by the existence of a secondary market in which prices as high as $2,200 for a Beanie Baby ("Peanuts the Elephant") have been reported. The profits in the secondary market go to the purchasers of the Babies, not to Ty. Why Ty wants to enrich its customers and perhaps its retailers is unclear—perhaps to encourage adult purchases of the product (as a collectible), perhaps to incite children to pester their parents for it out of fear of not keeping up with their playmates—but is not our business. It is germane only as showing that GMA's infringement is not only depriving Ty of the income on some number of pigs but also disrupting its scheme of distribution. The harm to its marketing plan cannot readily be monetized and so is appropriately described as irreparable. The harm is aggravated by differences in appearance and quality control (remember the defective Preston) that while not big enough to rebut an inference of copying could impair Ty's goodwill if customers buy Preston thinking it is a Beanie Baby rather than a knockoff. This is a type of loss more commonly associated with trademark cases, but it is applicable to copyright as well. Such an award draws additional sustenance from the doctrine of "moral right," the right of the creator of intellectual property to the preservation of the integrity of his work—a doctrine that is creeping into American copyright law.

If GMA could show greater irreparable harm to itself from the grant of the injunction than irreparable harm to Ty from its denial, this would be another consideration to throw into the hopper in determining the appropriateness of the preliminary injunction. It has not attempted to show this.

We find no error of law, no clear error of fact, and no abuse of discretion in the grant of the preliminary injunction to Ty. The judgment of the district court is therefore AFFIRMED.

Ty, Inc.'s "Squeeler"

GMA's "Preston the Pig"



VI. Contract Law

ROGER J. DINES v. LIBERTY MUTUAL INSURANCE COMPANY

Appeals Court of Massachusetts, Worcester

28 Mass. App. Ct. 195; 548 N.E.2d 1268

October 13, 1989
January 11, 1990

JUDGES: Warner, C.J., Kass, & Smith, JJ.

OPINION BY: SMITH

The plaintiff is engaged in the business of towing and storing vehicles. He brought an action in District Court seeking to recover for storage of a vehicle owned by the defendant. The case was tried on a statement of agreed facts, which we summarize as follows.

On October 15, 1985, the State police recovered a stolen trailer. Its owner was unknown. The police ordered it towed to the plaintiff's storage facility. On January 7, 1986, the defendant, owner of the trailer, learned that it was in the plaintiff's possession but did nothing to regain it.

On March 11, 1986, the plaintiff discovered that the defendant was the owner of the property. On March 14, 1986, the plaintiff gave written notice to the defendant that its trailer was at his storage facility. He enclosed an itemized invoice for $2,980 in storage charges, based on twenty dollars a day from October 15, 1985, the date that he received the trailer from the police. The defendant refused to pay the charges, claiming that it owed only from January 7, 1986, the date that it learned the location of the trailer. The defendant retained possession of the trailer.

On March 11, 1987, the defendant brought an action in the nature of replevin against the plaintiff, seeking recovery of the trailer. On March 18, 1987, the parties entered into an agreement. The plaintiff released the trailer to the defendant, and the defendant agreed to drop its replevin action. [**Note**: an action for replevin is an old common law remedy for recover of property wrongful held by another person.] The defendant also agreed that the plaintiff could bring an action in an attempt to recover storage charges. The defendant later sent the plaintiff a check for $1,260 as payment of storage charges from January 7, 1986, to March 10, 1986, at the rate of twenty dollars per day. The plaintiff accepted the check as partial payment and without prejudice to an action against the defendant for the balance of the storage charges. The plaintiff then brought the present action in which he asked for $10,400. That sum represented storage charges from the date he received the trailer from the State police to the date that he returned it to the defendant.

The trial judge found that the plaintiff's storage rates were reasonable . . . The judge ruled that the plaintiff was entitled to twenty dollars per day for the period which he claimed, October 15, 1985, the date that the plaintiff received the trailer until March 18, 1987. He held that a "quasi-contract " existed between the parties. The judge then limited the plaintiff's recovery to the fair and reasonable value of the trailer, which he set at $5,000. Judgment was issued in favor of the plaintiff for $3,740 ($5,000 minus $1,260 already paid to the plaintiff).

Both parties have appealed to this court. . . .

The judge's finding that a contract implied in law (or a quasi-contract) existed between the parties was not erroneous. . . . It has long been recognized that one who has involuntarily received another's property has the right to recover "compensation for the care and expense of keeping and preserving it." . . . Other jurisdictions have applied this concept to award storage charges to a facility in the same set of circumstances confronted here.

"The underlying basis for awarding quantum meruit damages in a quasi-contract case is unjust enrichment of one party and unjust detriment to the other party." . . . Here, once the property was recovered by the police, it was stored in a safe facility, preventing vandalism. The defendant benefited from the storage of its property.

The defendant's argument that an owner of a vehicle, stored in the circumstances of the present case, does not incur storage costs until receipt of notice of the vehicle's location is not sound. The benefit to the owner starts from the first day of storage. There is nothing in case or statutory law that supports the defendant's position. . . .

In these circumstances, the amount of the plaintiff's recovery, however, is limited to the fair market value of the stored item. . . . If the plaintiff were allowed to recover more than the fair value of the trailer, then he would then have more than the benefit conferred on the defendant.

Judgment affirmed.

W. O. LUCY AND J. C. LUCY v. A. H. ZEHMER AND IDA S. ZEHMER

Supreme Court of Virginia

196 Va. 493; 84 S.E.2d 516

November 22, 1954

JUDGES: Present, Eggleston, Buchanan, Miller, Smith and Whittle, JJ.

BUCHANAN, J., delivered the opinion of the court.

This suit was instituted by W. O. Lucy and J. C. Lucy, complainants, against A. H. Zehmer and Ida S. Zehmer, his wife, defendants, to have specific performance of a contract by which it was alleged the Zehmers had sold to W. O. Lucy a tract of land owned by A. H. Zehmer in Dinwiddie county containing 471.6 acres, known as the Ferguson farm, for $50,000. J. C. Lucy, the other complainant, is a brother of W. O. Lucy, to whom W. O. Lucy transferred a half interest in his alleged purchase.

The instrument sought to be enforced was written by A. H. Zehmer on December 20, 1952, in these words: "We hereby agree to sell to W. O. Lucy the Ferguson Farm complete for $50,000.00, title satisfactory to buyer," and signed by the defendants, A. H. Zehmer and Ida S. Zehmer. . . .

Depositions were taken and the decree appealed from was entered holding that the complainants had failed to establish their right to specific performance, and dismissing their bill. The assignment of error is to this action. . . . .

W. O. Lucy, a lumberman and farmer, thus testified in substance: He had known Zehmer for fifteen or twenty years and had been familiar with the Ferguson farm for ten years. Seven or eight years ago he had offered Zehmer $20,000 for the farm which Zehmer had accepted, but the agreement was verbal and Zehmer backed out. On the night of December 20, 1952, around eight o'clock, he took an employee to McKenney, where Zehmer lived and operated a restaurant, filling station and motor court. While there he decided to see Zehmer and again try to buy the Ferguson farm. He entered the restaurant and talked to Mrs. Zehmer until Zehmer came in. He asked Zehmer if he had sold the Ferguson farm. Zehmer replied that he had not. Lucy said, "I bet you wouldn't take $50,000.00 for that place." Zehmer replied, "Yes, I would too; you wouldn't give fifty." Lucy said he would and told Zehmer to write up an agreement to that effect. Zehmer took a restaurant check and wrote on the back of it, "I do hereby agree to sell to W. O. Lucy the Ferguson Farm for $50,000 complete." Lucy told him he had better change it to "We" because Mrs. Zehmer would have to sign it too. Zehmer then tore up what he had written, wrote the agreement quoted above and asked Mrs. Zehmer, who was at the other end of the counter ten or twelve feet away, to sign it. Mrs. Zehmer said she would for $50,000 and signed it. Zehmer brought it back and gave it to Lucy, who offered him $5 which Zehmer refused, saying, "You don't need to give me any money, you got the agreement there signed by both of us."

The discussion leading to the signing of the agreement, said Lucy, lasted thirty or forty minutes, during which Zehmer seemed to doubt that Lucy could raise $50,000. Lucy suggested the provision for having the title examined and Zehmer made the suggestion that he would sell it "complete, everything there," . . . .

Lucy took a partly filled bottle of whiskey into the restaurant with him for the purpose of giving Zehmer a drink if he wanted it. Zehmer did, and he and Lucy had one or two drinks together. Lucy said that while he felt the drinks he took he was not intoxicated, and from the way Zehmer handled the transaction he did not think he was either.

December 20 was on Saturday. Next day Lucy telephoned to J. C. Lucy and arranged with the latter to take a half interest in the purchase and pay half of the consideration. On Monday he engaged an attorney to examine the title. The attorney reported favorably on December 31 and on January 2 Lucy wrote Zehmer stating that the title was satisfactory, that he was ready to pay the purchase price in cash and asking when Zehmer would be ready to close the deal. Zehmer replied by letter, mailed on January 13, asserting that he had never agreed or intended to sell.

Mr. and Mrs. Zehmer were called by the complainants as adverse witnesses. Zehmer testified in substance as follows:

He bought this farm more than ten years ago for $11,000. He had had twenty-five offers, more or less, to buy it, including several from Lucy, who had never offered any specific sum of money. He had given them all the same answer, that he was not interested in selling it. On this Saturday night before Christmas it looked like everybody and his brother came by there to have a drink. He took a good many drinks during the afternoon and had a pint of his own. When he entered the restaurant around eight-thirty Lucy was there and he could see that he was "pretty high." He said to Lucy, "Boy, you got some good liquor, drinking, ain't you?" Lucy then offered him a drink. "I was already high as a Georgia pine, and didn't have any more better sense than to pour another great big slug out and gulp it down, and he took one too."

After they had talked a while Lucy asked whether he still had the Ferguson farm. He replied that he had not sold it and Lucy said, "I bet you wouldn't take $50,000.00 for it." Zehmer asked him if he would give $50,000 and Lucy said yes. Zehmer replied, "You haven't got $50,000 in cash." Lucy said he did and Zehmer replied that he did not believe it. They argued "pro and con for a long time," mainly about "whether he had $50,000 in cash that he could put up right then and buy that farm."

Finally, said Zehmer, Lucy told him if he didn't believe he had $50,000, "you sign that piece of paper here and say you will take $50,000.00 for the farm." He, Zehmer, "just grabbed the back off of a guest check there" and wrote on the back of it. At that point in his testimony Zehmer asked to see what he had written to "see if I recognize my own handwriting." He examined the paper and exclaimed, "Great balls of fire, I got 'Firgerson' for Ferguson. I have got satisfactory spelled wrong. I don't recognize that writing if I would see it, wouldn't know it was mine."

After Zehmer had, as he described it, "scribbled this thing off," Lucy said, "Get your wife to sign it." Zehmer walked over to where she was and she at first refused to sign but did so after he told her that he "was just needling him [Lucy], and didn't mean a thing in the world, that I was not selling the farm." Zehmer then "took it back over there and I was still looking at the dern thing. I had the drink right there by my hand, and I reached over to get a drink, and he said, 'Let me see it.' He reached and picked it up, and when I looked back again he had it in his pocket and he dropped a five dollar bill over there, and he said, 'Here is five dollars payment on it.' I said, 'Hell no, that is beer and liquor talking. I am not going to sell you the farm. I have told you that too many times before.'". . . .

The defendants insist that the evidence was ample to support their contention that the writing sought to be enforced was prepared as a bluff or dare to force Lucy to admit that he did not have $50,000; that the whole matter was a joke; that the writing was not delivered to Lucy and no binding contract was ever made between the parties.

It is an unusual, if not bizarre, defense. When made to the writing admittedly prepared by one of the defendants and signed by both, clear evidence is required to sustain it.

[1] In his testimony Zehmer claimed that he "was high as a Georgia pine," and that the transaction "was just a bunch of two doggoned drunks bluffing to see who could talk the biggest and say the most." That claim is inconsistent with his attempt to testify in great detail as to what was said and what was done. . . . The record is convincing that Zehmer was not intoxicated to the extent of being unable to comprehend the nature and consequences of the instrument he executed, and hence that instrument is not to be invalidated on that ground. . . . .

[2] The appearance of the contract, the fact that it was under discussion for forty minutes or more before it was signed; Lucy's objection to the first draft because it was written in the singular, and he wanted Mrs. Zehmer to sign it also; the rewriting to meet that objection and the signing by Mrs. Zehmer; the discussion of what was to be included in the sale, the provision for the examination of the title, the completeness of the instrument that was executed, the taking possession of it by Lucy with no request or suggestion by either of the defendants that he give it back, are facts which furnish persuasive evidence that the execution of the contract was a serious business transaction rather than a casual, jesting matter as defendants now contend.

. . . . Zehmer's version was that he said to Lucy: "I am not trying to claim it wasn't a deal on account of the fact the price was too low. If I had wanted to sell $50,000.00 would be a good price, in fact I think you would get stuck at $50,000.00." A disinterested witness testified that what Zehmer said to Lucy was that "he was going to let him up off the deal, because he thought he was too tight, didn't know what he was doing. Lucy said something to the effect that 'I have been stuck before and I will go through with it.'"

[3] If it be assumed, contrary to what we think the evidence shows, that Zehmer was jesting about selling his farm to Lucy and that the transaction was intended by him to be a joke, nevertheless the evidence shows that Lucy did not so understand it but considered it to be a serious business transaction and the contract to be binding on the Zehmers as well

as on himself. The very next day he arranged with his brother to put up half the money and take a half interest in the land. The day after that he employed an attorney to examine the title. The next night, Tuesday, he was back at Zehmer's place and there Zehmer told him for the first time, Lucy said, that he wasn't going to sell and he told Zehmer, "You know you sold that place fair and square." After receiving the report from his attorney that the title was good he wrote to Zehmer that he was ready to close the deal.

Not only did Lucy actually believe, but the evidence shows he was warranted in believing, that the contract represented a serious business transaction and a good faith sale and purchase of the farm.

In the field of contracts, as generally elsewhere, "We must look to the outward expression of a person as manifesting his intention rather than to his secret and unexpressed intention. The law imputes to a person an intention corresponding to the reasonable meaning of his words and acts.'" . . . At no time prior to the execution of the contract had Zehmer indicated to Lucy by word or act that he was not in earnest about selling the farm. . . . .

. . . An agreement or mutual assent is of course essential to a valid contract but the law imputes to a person an intention corresponding to the reasonable meaning of his words and acts. If his words and acts, judged by a reasonable standard, manifest an intention to agree, it is immaterial what may be the real but unexpressed state of his mind. . . . So a person cannot set up that he was merely jesting when his conduct and words would warrant a reasonable person in believing that he intended a real agreement. . . . . Whether the writing signed by the defendants and now sought to be enforced by the complainants was the result of a serious offer by Lucy and a serious acceptance by the defendants, or was a serious offer by Lucy and an acceptance in secret jest by the defendants, in either event it constituted a binding contract of sale between the parties. . . .

The complainants are entitled to have specific performance of the contracts sued on. The decree appealed from is therefore reversed and the cause is remanded for the entry of a proper decree requiring the defendants to perform the contract in accordance with the prayer of the bill.

Reversed and remanded.

The City of Everett, Plaintiff, v. Al Mitchell, Petitioner

Supreme Court of Washington

631 P.2d 366

July 23, 1981

JUDGES: En Banc. Dolliver, J. Brachtenbach, C.J., Rosellini, Stafford, Utter, Hicks, Williams, and Dimmick, JJ., and Cochran, J. Pro Tem., concur. Dore, J., did not participate in the disposition of this case.

OPINION**:**

The City of Everett commenced an interpleader action against the seller (the Sumstad Estate) and the buyer (Al and Rosemary Mitchell) of a safe to determine who is entitled to a sum of money found in the safe. Both the Estate and the Mitchells moved for summary judgment. [Note: Interpleader is a civil action initiated by a plaintiff who holds property but does not know to whom the property should be transferred; the plaintiff asks the court to decide.] The trial court entered summary judgment in favor of the Estate. The Court of Appeals affirmed.

Petitioners, Mr. and Mrs. Mitchell, are the proprietors of a small secondhand store. On August 12, 1978, the Mitchells attended Alexander's Auction, where they frequently had shopped to obtain merchandise for their own use and for use as inventory in their business. At the auction the Mitchells purchased a used safe with an inside compartment for $50. As they were told by the auctioneer when they purchased the safe, the Mitchells found that the inside compartment of the safe was locked. The safe was part of the Sumstad Estate.

Several days after the auction, the Mitchells took the safe to a locksmith to have the locked compartment opened. The locksmith found $32,207 inside. The Everett Police Department, notified by the locksmith, impounded the money.

We agree with the Court of Appeals that the question is not whether the Estate, through its agent, entrusted the safe and its contents to the auctioneer who sold it in the ordinary course of business. Clearly the entrustment did occur. The issue is whether there was in fact a sale of the safe and its unknown contents at the auction. In contrast to the Court of Appeals, we find that there was.

A sale is a consensual transaction. The subject matter which passes is to be determined by the intent of the parties as revealed by the terms of their agreement in light of the surrounding circumstances. The objective manifestation theory of contracts, which is followed in this state, lays stress on the outward manifestation of assent made by each party to the other. The subjective intention of the parties is irrelevant.

A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent. If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake, or something else of the sort. . .

The apparent mutual assent of the parties, essential to the formation of a contract, must be gathered from their outward expressions and acts, and not from an unexpressed intention.

The inquiry, then, is into the outward manifestations of intent by a party to enter into a contract. We impute an intention corresponding to the reasonable meaning of a person's words and acts. If the offeror, judged by a reasonable standard, manifests an intention to agree in regard to the matter in question, that agreement is established.

There are few reported cases on whether the unknown contents of an item pass with its sale, and even fewer that deal with consensual transactions. . . . The case upon which the Court of Appeals relies, *West Coast Airlines, Inc. v. Miner's Aircraft & Engine Serv., Inc.*, is inapposite. In that case, a commercial scrap metal company, Junk Traders, removed several containers of scrap metal from plaintiff West Coast Airlines' storage yard. Inadvertently, two containers in which aircraft engines were stored were removed by Junk Traders along with the scrap metal. West Coast, however, retained Federal Aviation Agency documents of title for the engines. A year later, Mr. Miner, president of Miner's Aircraft, learned about the engines from a competitor of Junk Traders. He purchased both engines for $125 and shortly thereafter resold one of them to a fourth party without the Federal Aviation Agency documents. West Coast first became aware of the mistake as a result of a telephone conversation in which Mr. Miner told a West Coast employee that the federal records for the engines would be "worth a jug of booze to me". Shortly thereafter, West Coast commenced suit to recover the engines.

In *West Coast Airlines*, the aircraft engines were clearly not intended to be sold to Junk Traders. The inclusion of the engines in the sale of scrap metal was inadvertent and wholly unknown to both parties. Neither party was aware the sealed containers might hold anything other than scrap metal. Furthermore, West Coast Airlines retained the federal documents that must be transferred to the purchaser upon the sale of an aircraft engine, a clear indication it did not intend to pass title to the engines.

In the case before us, the purchasers stated in their affidavit:

“[W]e saw that the top outer-most door with a combination lock was open, and that the inner door was locked shut. That inner door required a key to open, and we learned that the safe would have to be taken to a locksmith to get the inner door opened because no key was available. We also learned that the combination for the outer lock was unknown. The auctioneer told the bidders that both this and the other safe had come from an estate, that both were still locked, that neither had been opened, and that the required combinations and key were unavailable for either.”

The auctioneer's affidavit stated that:

“I told the crowd at the auction that [the safes] were from an estate, that they were still locked and had never been opened by me and that I didn't have the combinations.”

These affidavits are undisputed. In addition, the Mitchells were aware of the rule of the auction that all sales were final. Furthermore, the auctioneer made no statement reserving rights to any contents of the safe to the Estate. Under these circumstances, we hold reasonable persons would conclude that the auctioneer manifested an objective intent to sell the safe and its contents and that the parties mutually assented to enter into that sale of the safe and the contents of the locked compartment.

In the words of the dissenting judge in the Court of Appeals:

“The unique facts of this case make it one of those apparently rare instances in history in which the objective manifestations of the contracting parties reflected a mutual assent to the sale of the unknown contents of the object sold. The function of a safe is to provide a place for storing one's money or other valuables. When a locked safe is sold without the key, under all of the circumstances present in this case, the reasonable expectations of the buyer should be protected.”

We concur in this view.

While the request by the Mitchells for attorney fees was properly denied, we hold it was error to grant the Estate's motion for summary judgment and error not to grant the motion for summary judgment by the Mitchells. The Court of Appeals is affirmed as to attorney fees and reversed as to the granting of the summary judgment to the Estate. This matter is remanded to the trial court for entry of the summary judgment in favor of the Mitchells.

Morris Lefkowitz v. Great Minneapolis Surplus Store, Inc.

Supreme Court of Minnesota

251 Minn. 188; 86 N.W.2d 689

December 20, 1957

COUNSEL: Louis F. Davis, for appellant.

Morris Lefkowitz, pro se, for respondent.

JUDGE: Murphy, Justice.

OPINION: This is an appeal from an order of the Municipal Court of Minneapolis denying the motion of the defendant for amended findings of fact, or, in the alternative, for a new trial. The order for judgment awarded the plaintiff the sum of $138.50 as damages for breach of contract.

This case grows out of the alleged refusal of the defendant to sell to the plaintiff a certain fur piece which it had offered for sale in a newspaper advertisement. It appears from the record that on April 6, 1956, the defendant published the following advertisement in a Minneapolis newspaper:

"Saturday 9 a.m. sharp
3 Brand New
Fur Coats
Worth to $100.00
First Come
First Served
$1 Each"

On April 13, the defendant again published an advertisement in the same newspaper as follows:

"Saturday 9 a.m.
2 Brand New Pastel
Mink 3-Skin Scarfs
Selling for $89.50
Out they go
Saturday. Each $1.00
1 Black Lapin Stole
Beautiful,
worth $139.50
$ 1.00
First Come
First Served"

The record supports the findings of the court that on each of the Saturdays following the publication of the above-described ads the plaintiff was the first to present himself at the appropriate counter in the defendant's store and on each occasion demanded the coat and the stole so advertised and indicated his readiness to pay the sale price of $1. On both occasions, the defendant refused to sell the merchandise to the plaintiff, stating on the first occasion that by a "house rule" the offer was intended for women only and sales would not be made to men, and on the second visit that plaintiff knew defendant's house rules.

The trial court properly disallowed plaintiff's claim for the value of the fur coats since the value of these articles was speculative and uncertain. The only evidence of value was the advertisement itself to the effect that the coats were "Worth to $100.00," how much less being speculative especially in view of the price for which they were offered for sale. With reference to the offer of the defendant on April 13, 1956, to sell the "1 Black Lapin Stole * * * worth $139.50

* * *" the trial court held that the value of this article was established and granted judgment in favor of the plaintiff for that amount less the $1 quoted purchase price.

1. The defendant contends that a newspaper advertisement offering items of merchandise for sale at a named price is a "unilateral offer" which may be withdrawn without notice. He relies upon authorities which hold that, where an advertiser publishes in a newspaper that he has a certain quantity or quality of goods which he wants to dispose of at certain prices and on certain terms, such advertisements are not offers which become contracts as soon as any person to whose notice they may come signifies his acceptance by notifying the other that he will take a certain quantity of them. Such advertisements have been construed as an invitation for an offer of sale on the terms stated, which offer, when received, may be accepted or rejected and which therefore does not become a contract of sale until accepted by the seller; and until a contract has been so made, the seller may modify or revoke such prices or terms. [citations omitted]

The defendant relies principally on Craft v. Elder & Johnston Co. supra. In that case, the court discussed the legal effect of an advertisement offering for sale, as a one-day special, an electric sewing machine at a named price. The view was expressed that the advertisement was "not an offer made to any specific person but was made to the public generally. Thereby it would be properly designated as a unilateral offer and not being supported by any consideration could be withdrawn at will and without notice." It is true that such an offer may be withdrawn before acceptance. Since all offers are by their nature unilateral because they are necessarily made by one party or on one side in the negotation of a contract, the distinction made in that decision between a unilateral offer and a unilateral contract is not clear. On the facts before us we are concerned with whether the advertisement constituted an offer, and, if so, whether the plaintiff's conduct constituted an acceptance.

There are numerous authorities which hold that a particular advertisement in a newspaper or circular letter relating to a sale of articles may be construed by the court as constituting an offer, acceptance of which would complete a contract. [citations omitted] The test of whether a binding obligation may originate in advertisements addressed to the general public is "whether the facts show that some performance was promised in positive terms in return for something requested." 1 Williston, Contracts (Rev. ed.) § 27.

The authorities above cited emphasize that, where the offer is clear, definite, and explicit, and leaves nothing open for negotiation, it constitutes an offer, acceptance of which will complete the contract. The most recent case on the subject is Johnson v. Capital City Ford Co. (La. App.) 85 So. (2d) 75, in which the court pointed out that a newspaper advertisement relating to the purchase and sale of automobiles may constitute an offer, acceptance of which will consummate a contract and create an obligation in the offeror to perform according to the terms of the published offer.

Whether in any individual instance a newspaper advertisement is an offer rather than an invitation to make an offer depends on the legal intention of the parties and the surrounding circumstances. We are of the view on the facts before us that the offer by the defendant of the sale of the Lapin fur was clear, definite, and explicit, and left nothing open for negotiation. The plaintiff having successfully managed to be the first one to appear at the seller's place of business to be served, as requested by the advertisement, and having offered the stated purchase price of the article, he was entitled to performance on the part of the defendant. We think the trial court was correct in holding that there was in the conduct of the parties a sufficient mutuality of obligation to constitute a contract of sale.

2. The defendant contends that the offer was modified by a "house rule" to the effect that only women were qualified to receive the bargains advertised. The advertisement contained no such restriction. This objection may be disposed of briefly by stating that, while an advertiser has the right at any time before acceptance to modify his offer, he does not have the right, after acceptance, to impose new or arbitrary conditions not contained in the published offer.

Affirmed.

Mary Mesaros and Anthony C. Mesaros, Plaintiffs-Appellants, v. The United States of America, The United States Department of the Treasury, Bureau of the Mint, Defendants-Appellees

United States Court of Appeals for the Federal Circuit

845 F.2d 1576

May 6, 1988, Decided

JUDGES: Mayer, Circuit Judge, and Skelton and Baldwin, Senior Circuit Judges. Opinion by: Skelton

On May 23, 1986, plaintiffs Mary Mesaros and husband Anthony C. Mesaros filed a class action lawsuit for themselves and others similarly situated (thirty-three of whom were named) in the United States District Court for the Southern District of Georgia, against the United States of America, the United States Department of the Treasury, the Bureau of the Mint, (defendants) seeking damages for an alleged breach of contract by defendants in failing to deliver a quantity of Statue of Liberty commemorative coins they had ordered from defendants pursuant to an advertisement mailed to plaintiffs and published in newspapers and other news media by the United States Mint. Plaintiffs also filed a motion for certification of the class.

The defendants filed a motion to dismiss plaintiffs' suit, or in the alternative for summary judgment. On April 13, 1987, the court granted judgment for defendants on their motion in its entirety. No action was taken by the court on the class action motion because it was moot after the other action by the court. The plaintiffs filed an appeal in the United States Court of Appeals for the Eleventh Circuit. On motion of defendants, the case was transferred to this court.

The facts in the case, as stated in an order of the district court dated April 13, 1987, (with a few omissions and additions), and as shown by the record are as follow.

In July 1985, Congress passed the Statue of Liberty-Ellis Island Commemorative Coin Act. The purpose of the Act was to provide funds, through the sale of a limited number of specially-minted commemorative coins, "to restore and renovate the Statue of Liberty and the facilities used for immigration at Ellis Island," and to establish an endowment to provide for the upkeep and maintenance of these national monuments. . . .

The provision of the Act that is directly implicated in this action is § 105(c), which reads: "The Secretary [of the Treasury] shall accept prepaid orders for [commemorative] coins prior to the issuance of the coins. Sales under this subsection shall be at a reasonable discount to reflect the benefit of prepayment." A related provision, § 105(d), authorized bulk sales of commemorative coins at a discount. Pursuant to these provisions, in November and December 1985, the Mint mailed certain advertising materials to persons, including the plaintiffs, whose names were included on a list of previous customers/coin collectors. These materials described the various coins the issuance of which was authorized by the Act, and encouraged potential purchasers to forward early payment for commemorative coins. The materials represented, *inter alia*, that "if [the Mint] receives your reservation by December 31, 1985, you will enjoy a favorable *Pre-Issue Discount* saving you up to 16% on your coins." Payment could be made either by check, money order, or credit card. Apparently, the Mint had not previously dealt with credit card sales, and the processing of credit card orders, which in this case turned out to be an almost impossible ordeal, was contracted to the Mellon Bank in Pittsburgh, Pennsylvania.

The materials included an order form. Directly above the space provided on this form for the customer's signature was the following:

> VERY IMPORTANT -- PLEASE READ: YES, Please accept my order for the U.S. Liberty Coins I have indicated. I understand that all sales are final and not subject to refund. Verification of my order will be made by the Department of the Treasury, U.S. Mint. My coins may be delivered in multiple shipments. If my order is received by December 31, 1985, I will be entitled to purchase the coins at the Pre-Issue Discount price shown. I have read, understand and agree to the above.

Demand for the coins far exceeded the Mint's expectations. There was an insufficient quantity of five-dollar gold coins, however, with which to fill the orders of many of those who responded to the Mint's promotional materials. The last order for gold coins that was filled was accepted "some time between December 31, 1985, and January 6, 1986. This exhausted the supply of 500,000 gold coins the issuance of which was authorized by the Act. A great many would-be acquisitors of gold coins were disappointed by the news of the sell-out. These individuals, many of whom were coin dealers, developed a more serious case of disappointment when it became apparent that the gold coins had increased in value by approximately 200% within the first few months of 1986. . . .

Plaintiffs allege that on November 26, 1985, Mary Mesaros forwarded to the Mint an order for certain Statue of Liberty coins. Information concerning Anthony Mesaros' credit card was included on the order form, reflecting that the sum of $1,675 should be charged against Mr. Mesaros' credit account. Subsequently, on December 30, 1985, Anthony Mesaros forwarded orders for an additional eighteen gold coins to the Mint. These orders were placed in the names of members of the Mesaros family, and were paid for with nine separate checks.

On February 18, 1986, the Mesaroses were informed by form letter that the Mint "had tried but was unable" to process the Mesaroses' November 26, 1985, credit card order. The letter directed the plaintiffs to contact their financial institution for details relating to the rejection of their order. A new order form was forwarded to the Mesaroses along with the form letter, with which the plaintiffs were informed that they could order "the options currently available." The options then available, of course, did not include five-dollar gold coins. . . .

During the early months of 1986, rumors and information began to filter through the ranks of coin collectors and dealers concerning rejections of credit card orders under circumstances similar to those faced by the Mesaroses. It was becoming apparent by March or April that persons who had paid by wires, money orders or checks, dated as late as the end of December, were receiving their coins from the Mint, while many persons who had submitted credit card orders (in November in certain cases) were not receiving their coins. These disappointed credit card customers were sent form letters by the Mint informing them either that the Mint had "tried but was unable" to process their orders (such as that received by the Mesaroses, *see supra*), or that their order could not be processed because the gold coins had sold out. According to plaintiffs, the rejection of their credit card order, and the rejection of other collectors' and dealers' credit card orders, is inexplicable on any reasonable basis, in that there existed no inaccuracies in the information provided to the Mint and no shortage of credit on the part of those submitting orders. . . .

The record shows that the Mint and the Mellon Bank were simply swamped with a deluge of 756,000 orders, of which 186,000 were credit card orders. Cash orders were filled fairly promptly by the Mint, but credit card orders before being filled had to be sent by the Mint to the Mellon Bank in Pittsburgh for verification, investigation, and determination of validity. This was at best a slow process. Credit card orders, when approved by the Mellon Bank were certified as valid and returned to the Mint to be filled. Before all of the 186,000 credit card orders could be verified by the Mellon Bank and thereafter filled by the Mint, all of the gold coins had been sold by the Mint in filling cash orders, and no more coins were available. As a result, 13,000 unverified and uncertified credit card orders could not be filled, and were rejected by the Mint. The Mesaros order was in this rejected group. . . .

On May 23, 1986, plaintiffs filed suit in the district court, seeking either damages on a breach of contract theory or, in the alternative, mandamus relief in the form of a court order forcing defendants to accept plaintiffs' credit card order. Such mandamus relief would ultimately require, according to plaintiffs, the government to deliver the plaintiffs the gold coins that they ordered in November 1985.

Breach of Contract

The plaintiffs claim that the Mint breached an express contract with them and that they are entitled to recover money damages from defendants for this breach. . . .

The plaintiffs contend that the materials sent to them by the Mint, including the order form, constituted an offer that upon acceptance by the plaintiffs created a binding contract between them and the government whereby the government was bound and obligated to deliver the coins ordered by them. The great weight of authority is against the plaintiffs. It is well established that materials such as those mailed to prospective customers by the Mint are no more than advertisements or invitations to deal. They are mere notices and solicitations for offers which create no power of acceptance in the recipient. . . .

A basic rule of contracts holds that whether an offer has been made depends on the objective reasonableness of the alleged offeree's belief that the advertisement or solicitation was intended as an offer. Generally, it is considered unreasonable for a person to believe that advertisements and solicitations are offers that bind the advertiser. Otherwise, the advertiser could be bound by an excessive number of contracts requiring delivery of goods far in excess of amounts available. That is particularly true in the instant case where the gold coins were limited to 500,000 by the Act of Congress. We conclude that a thorough reading, construction, and interpretation of the materials sent to the plaintiffs by the Mint makes clear that the contention of the plaintiffs that they reasonably believed the materials were intended as an offer is unreasonable as a matter of law. This is especially true in view of the words "YES, Please accept my order . . ." that were printed on the credit card form, which showed that the credit card order was an offer *from the plaintiffs* to the Mint to buy the coins, which offer might or might not be accepted by the Mint. Accordingly, the Mint materials were intended solely as solicitations of offers from customers that were subject to acceptance by the Mint before the Mint would be bound by a contract. . . .

The plaintiffs rely on *Lefkowitz v. Great Minneapolis Surplus Store*, 251 Minn. 188, 86 N.W.2d 689 (1957). In that case a store advertised one fur stole worth $139.50 for sale for $1.00 on a first-come, first-served basis when the store opened at 9:00 a.m. The plaintiff arrived first, but the store refused to sell the stole to him. The plaintiff sued for breach of contract. The court held under these unusual facts that the advertisement constituted an offer. That case is clearly distinguishable from our case on the facts. Here the Mint had 35,500,000 coins for sale to the general public for which it received over 756,000 orders. The Mint advertisement did not state that the coins would be sold on a first-come, first-served basis, as in *Lefkowitz*, or on any other particular basis. Since the coins could be paid for with checks, money orders or credit cards, it would have been impossible for the Mint to have processed the sales on a first-come, first-served basis. The situation in *Lefkowitz* was so different that it is of no help to the plaintiffs.

We hold that the Mint advertisement materials were not an offer of sale of the coins that could be accepted by the plaintiffs to create a contract, and that no contract was made between the plaintiffs and the government with reference to the coins.

The plaintiffs failed to allege any genuine issue of material fact, and, therefore, the court was correct as a matter of law in granting summary judgment for the defendants.

In view of our decision, it is not necessary to consider plaintiffs' motion to certify their petition as a class action.

The decision of the district court in his well-written order is affirmed.

AFFIRMED.

JOHN SOLDAU, Plaintiff-Appellant, v. ORGANON INC., a Delaware Corp., Defendant-Appellee

United States Court of Appeals for The Ninth Circuit

860 F.2d 355

November 2, 1988

JUDGES: James R. Browning, Chief Judge, Dorothy W. Nelson and William C. Canby, Jr., Circuit Judges.
OPINION**:** PER CURIAM

John Soldau was discharged by Organon, Inc. He received a letter from Organon offering to pay him double the normal severance pay in consideration of a release by Soldau of all claims against Organon. The letter incorporated the proposed release. Soldau signed and dated the release, and deposited it in a mailbox outside a post office. On returning home he found he had received a check from Organon in the amount of the increased severance pay. He returned to the post office, persuaded a postal employee to open the mailbox, and retrieved the release. He cashed Organon's check. He then filed suit against Organon, alleging violation of state law and of the Age Discrimination in Employment Act (ADEA). The district court granted summary judgment for Organon, stating "the release was deemed fully communicated to Organon, and a binding contract was formed, at the time plaintiff deposited the executed release in the mailbox. The fact that plaintiff retrieved the release from the mailbox is of no consequence under California statutory and decisional law."

The district court was clearly correct under California law.[3] Soldau does not argue to the contrary. Instead, he contends that the formation and validity of the release are governed by federal law, and would not have been effective unless and until it had been received by Organon. We need not decide which body of law controls. Under federal as well as California law, Soldau's acceptance was effective when it was mailed.

The so-called "mailbox" or "effective when mailed" rule was adopted and followed as federal common law by the Supreme Court prior to *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938) . . . . We could not change the rule, and there is no reason to believe the Supreme Court would be inclined to do so. It is almost universally accepted in the common law world. It is enshrined in the Retatement (Second) of Contracts, and endorsed by the major contract treatises.

Soldau rests his case upon decisions of the Court of Claims, . . . rejecting mailing of the acceptance as the crucial event resulting in a contract, in favor of the receipt of the acceptance by the offeror. No other federal court has agreed. Commentators are also virtually unanimous in rejecting the Court of Claims' repudiation of the "effective when mailed" rule, pointing to the long history of the rule; its importance in creating certainty for contracting parties; its essential soundness, on balance, as a means of allocating the risk during the period between the making of the offer and the communication of the acceptance or rejection to the offeror; and the inadequacy of the rationale offered by the Court of Claims for the change.

Since Soldau's contractual obligation to release Organon in return for Organon's obligation to make the enhanced severance payment arose when Soldau deposited his acceptance in the post office mailbox, his subsequent withdrawal of the acceptance was ineffectual.

AFFIRMED.

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[3] 1 Cal. Civil Code § 1583 provides, "Consent is deemed to be fully communicated between the parties as soon as the party accepting a proposal has put his acceptance in the course of transmission to the proposer . . . ."

JO LAVERNE ALDEN, Appellee v. VERNON E. PRESLEY, Executor of the Estate of Elvis A. Presley, et al., Appellants

Supreme Court of Tennessee

637 S.W.2d 862

August 30, 1982

JUDGES: Wm. M. D. Fones, J. wrote the opinion. Concur: Harbison, C.J., Cooper, Brock, Drowota, JJ.

This is an action against the estate of Elvis Presley to enforce a gratuitous promise to pay off the mortgage on plaintiff's home made by decedent but not consummated prior to his death.

The trial court denied recovery but the Court of Appeals found that plaintiff had relied upon the promise to her detriment and awarded plaintiff judgment on the theory of promissory estoppel.

I.

Plaintiff alleged that she relied to her detriment on a promise made by the decedent to pay off the mortgage indebtedness on plaintiff's home. Defendant did not deny a promise was made by decedent but contended that plaintiff's continued reliance upon that promise following decedent's death constituted an unreasonable and unjustified action on her part, and furthermore, that any damage done to plaintiff occurred as a result of affirmative action taken by her despite her knowledge of decedent's death and with full knowledge that decedent's executor had denied legal liability to fulfill the promise.

Plaintiff, Jo Laverne Alden, is the mother of Ginger Alden, the former girlfriend of the late Elvis Presley. Presley was a singer of great renown throughout the world and a man of substantial wealth. In January of 1977, Presley became engaged to Ginger Alden. He was quite generous to several members of the Alden family including Ginger and her mother, the plaintiff. Gifts to plaintiff included the funds for landscaping the lawn and installing a swimming pool for the Alden home. Due to his close relationship with plaintiff's daughter, Presley also became aware of plaintiff's desire to obtain a divorce from her husband. Presley offered to pay all expenses incurred in the divorce proceeding, including furnishing plaintiff an attorney; to advance plaintiff money to purchase her husband's equity in the Alden home; and to pay off the remaining mortgage indebtedness on the Alden home.

As a result of these promises, plaintiff filed for divorce on the grounds of irreconcilable differences. On August 1, 1977, a property settlement agreement was executed in which plaintiff paid her husband $5,325.00 for his equity in return for a deed conveying all of his interest in the home to plaintiff plus a release of the husband from all further liability upon the mortgage indebtedness on the Alden home. The mortgage indebtedness at the time of the execution of the settlement agreement was in the sum of $39,587.66, and it is this amount which is the subject of the present suit, all the other gifts and promises to plaintiff having been fulfilled.

On August 16, 1977, Presley died suddenly leaving unpaid the mortgage indebtedness on the Alden home. On August 25, 1977, Drayton Beecher Smith, II, an attorney for the Presley estate, informed plaintiff that the estate would not assume liability for the mortgage indebtedness.

Plaintiff filed the present suit on February 14, 1978, to enforce the promise made by decedent to pay the home mortgage. On March 3, 1978, Smith informed plaintiff he could no longer represent her in the divorce action since he was serving as an attorney for decedent's estate. Plaintiff failed to employ new counsel and the divorce action was dismissed for failure to prosecute.

Plaintiff re-filed her divorce action in April 1978, upon the same grounds and sought approval of the property settlement agreement executed in August, 1977, in conjunction with the original divorce suit. The divorce was granted in April, 1980, on the grounds of irreconcilable differences, and the property settlement was approved by the court. Plaintiff did not disclose to the court in the divorce case that decedent's estate had informed her it was not their intention to pay the mortgage on the Alden home.

In the instant case, the trial court held that decedent did make a promise unsupported by consideration to plaintiff, that no gift was consummated for failure of delivery, that plaintiff and her husband suffered no detriment as she "wound up much better off after their association with Elvis A. Presley than either would have been if he had never made any promise to Jo Laverne Alden," and that plaintiff did not rely upon the promise since her divorce petition was filed subsequent to the present suit and subsequent to being told that decedent's estate would not accept legal responsibility for decedent's promise.

The Court of Appeals concurred in the trial court finding that there was no gift for failure of delivery, holding that delivery is not complete unless "complete dominion and control of the gift is surrendered by the donor and acquired by the donee."

However, the Court of Appeals reversed the remainder of the trial court's decision by adopting and applying the doctrine of promissory estoppel holding that plaintiff had foregone remedies available to her in the divorce petition in reliance upon the promise made to her by decedent. The Court of Appeals reasoned the estate should be estopped from dishonoring that promise.

We concur in the reasoning of the trial court and Court of Appeals' findings that decedent did not make a gift of the money necessary to pay off the mortgage as there was no actual or constructive delivery. We find it unnecessary to address the question of whether or not Tennessee recognizes the doctrine of promissory estoppel because plaintiff has failed, as a matter of law, to prove essential elements of promissory estoppel, to-wit: detrimental reliance, and a loss suffered as a result of detrimental reliance.

II.

The Court of Appeals relied upon definitions of promissory estoppel found in the *Restatement of Contracts* and L. Simpson's, *Law of Contracts*. Since these works present representative definitions of promissory estoppel we quote with approval from the Court of Appeals' opinion as follows:

> "A concise statement concerning promissory estoppel is found in *Restatement of Contracts*, Section 90, as follows:
>
> > 'A promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise.'
>
> A more thorough examination of the doctrine, its elements and limitations is set forth in L. Simpson, *Law of Contracts* § 61 (2d ed. 1965); to-wit:
>
> > Detrimental action or forbearance by the promisee in reliance on a gratuitous promise, within limits constitutes a substitute for consideration, or a sufficient reason for enforcement of the promise without consideration. This doctrine is known as promissory estoppel. A promisor who induces substantial change of position by the promisee in reliance on the promise is estopped to deny its enforceability as lacking consideration. The reason for the doctrine is to avoid an unjust result, and its reason defines its limits. No injustice results in refusal to enforce a gratuitous promise where the loss suffered in reliance is negligible, nor where the promissee's action in reliance was unreasonable or unjustified by the promise. The limits of promissory estoppel are: (1) the detriment suffered in reliance must be substantial in an economic sense; (2) the substantial loss to the promisee in acting in reliance must have been foreseeable by the promisor; (3) the promisee must have acted reasonable in justifiable reliance on the promise as made."

III.

[omitted]

IV.

The residence of the Aldens and the mortgage indebtedness thereon was obviously subject to such disposition as alimony, as the circumstances of the parties justified at the time that the divorce was granted, April 1980.

Mrs. Alden did not inform the court that the estate had denied legal responsibility for the mortgage indebtedness, after she had entered into the property settlement agreement, but instead, affirmatively sought approval of the property settlement agreement. Beyond question, she was entitled to relief from that portion of the property settlement agreement wherein she assumed the mortgage indebtedness, upon revealing to the divorce court that she agreed to assume the mortgage only because decedent promised to pay it off gratuitously, but that the estate denied liability subsequent to the execution of the property settlement agreement. She was represented by counsel and must be charged with the knowledge that those facts constituted a change of circumstances that, as a matter of law, entitled her to relief from that portion of the agreement.

In this action plaintiff has shown that decedent's promise induced her to assume a $39,587 mortgage as part of a property settlement agreement dated August 1, 1977. However, the property settlement agreement was not binding upon plaintiff or her husband until approved by the court and the estate's denial of liability for decedent's gratuitous promise before submission of the agreement to the court removed the element of detrimental reliance from the factual scenario of this case. It follows, plaintiff's reliance on the promise after August 25, 1977, was not reasonably justified and she suffered no loss as a result of justifiable reliance.

The judgment of the Court of Appeals is reversed and this case is dismissed.

Louisa W. Hamer, Appellant, v. Franklin Sidway, as Executor, etc., Respondent

Court of Appeals of New York

124 N.Y. 538; 27 N.E. 256

April 14, 1891, Decided

PRIOR HISTORY: Appeal from order of the General Term of the Supreme Court in the fourth judicial department, made July 1, 1890, which reversed a judgment in favor of plaintiff entered upon a decision of the court on trial at Special Term and granted a new trial.

DISPOSITION: Order reversed and judgment of Special Term affirmed.

SYLLABUS:

William E. Story, Sr., defendant Sidway's testator, agreed with William E. Story, 2d, his nephew, plaintiff's assignor, that if he would refrain from drinking liquor, using tobacco, swearing and playing cards or billiards for money until he should become twenty-one years of age he would pay him $5,000. William E. Story, 2d performed his part of the agreement; he became of age in 1875. Soon thereafter he wrote to William E. Story, Sr., advising him of such performance, stating that the sum specified was due him, and asking payment. William E. Story, Sr., replied admitting the agreement and the performance and stating that he had the money in bank, set apart, which he proposed to hold for William E. Story, 2d until the latter was capable of taking care of it. It was thereupon agreed between the parties that the money should remain in the hands of William E. Story, Sr., on interest. . .

It is not essential in order to make out a good consideration for a promise to show that the promisor was benefited or the promisee injured; a waiver on the part of the latter of a legal right is sufficient.

William E. Story, Sr., died in 1887 without having paid any portion of the sum agreed upon. . . .

The plaintiff [Louisa Hammer] presented a claim to the executor of William E. Story, Sr., for $5,000 and interest from the 6th day of February, 1875. She acquired it through several mesne assignments from William E. Story, 2d. [Note: this means that Hammer bought the legal claim from the nephew.] The claim being rejected by the executor, this action was brought. It appears that William E. Story, Sr., was the uncle of William E. Story, 2d; that at the celebration of the golden wedding of Samuel Story and wife, father and mother of William E. Story, Sr., on the 20th day of March, 1869, in the presence of the family and invited guests he promised his nephew that if he would refrain from drinking, using tobacco, swearing and playing cards or billiards for money until he became twenty-one years of age he would pay him a sum of $5,000. The nephew assented thereto and fully performed the conditions inducing the promise. When the nephew arrived at the age of twenty-one years and on the 31st day of January, 1875, he wrote to his uncle informing him that he had performed his part of the agreement and had thereby become entitled to the sum of $5,000. The uncle received the letter and a few days later and on the sixth of February, he wrote and mailed to his nephew the following letter:

> “Buffalo, Feb. 6, 1875
> W. E. Story, Jr.:
>
> Dear Nephew — Your letter of the 31st ult. came to hand all right, saying that you had lived up to the promise made to me several years ago. I have no doubt but you have, for which you shall have five thousand dollars as I promised you. I had the money in the bank the day you was 21 years old that I intend for you, and you shall have the money certain. Now, Willie I do not intend to interfere with this money in any way till I think you are capable of taking care of it and the sooner that time comes the better it will please me. I would hate very much to have you start out in some adventure that you thought all right and lose this money in one year. . . .
> Truly Yours,
> W. E. STORY.
>
> P. S. — You can consider this money on interest.”

The nephew received the letter and thereafter consented that the money should remain with his uncle in accordance with the terms and conditions of the letters. The uncle died on the 29th day of January, 1887, without having paid over to his nephew any portion of the said $5,000 and interest.

OPINION BY: PARKER, J

The question which provoked the most discussion by counsel on this appeal, and which lies at the foundation of plaintiff's asserted right of recovery, is whether by virtue of a contract defendant's testator William E. Story became indebted to his nephew William E. Story, 2d, on his twenty-first birthday in the sum of five thousand dollars. The trial court found as a fact that "on the 20th day of March, 1869, William E. Story agreed to and with William E. Story, 2d, that if he would refrain from drinking liquor, using tobacco, swearing, and playing cards or billiards for money until he should become 21 years of age then he, the said William E. Story, would at that time pay him, the said William E. Story, 2d, the sum of $5,000 for such refraining, to which the said William E. Story, 2d, agreed," and that he "in all things fully performed his part of said agreement."

The defendant contends that the contract was without consideration to support it, and, therefore, invalid. He asserts that the promisee by refraining from the use of liquor and tobacco was not harmed but benefited; that that which he did was best for him to do independently of his uncle's promise, and insists that it follows that unless the promisor was benefited, the contract was without consideration. A contention, which if well founded, would seem to leave open for controversy in many cases whether that which the promisee did or omitted to do was, in fact, of such benefit to him as to leave no consideration to support the enforcement of the promisor's agreement. Such a rule could not be tolerated, and is without foundation in the law. . . . . Courts "will not ask whether the thing which forms the consideration does in fact benefit the promisee or a third party, or is of any substantial value to anyone. It is enough that something is promised, done, forborne or suffered by the party to whom the promise is made as consideration for the promise made to him." (Anson's Prin. of Con. 63.)

. . . . Now, applying this rule to the facts before us, the promisee used tobacco, occasionally drank liquor, and he had a legal right to do so. That right he abandoned for a period of years upon the strength of the promise of the testator that for such forbearance he would give him $5,000. We need not speculate on the effort which may have been required to give up the use of those stimulants. It is sufficient that he restricted his lawful freedom of action within certain prescribed limits upon the faith of his uncle's agreement, and now having fully performed the conditions imposed, it is of no moment whether such performance actually proved a benefit to the promisor, and the court will not inquire into it, but were it a proper subject of inquiry, we see nothing in this record that would permit a determination that the uncle was not benefited in a legal sense. Few cases have been found which may be said to be precisely in point, but such as have been support the position we have taken.

In *Shadwell v. Shadwell* (9 C. B. [N. S.] 159), an uncle wrote to his nephew as follows:

"My Dear Lancey — I am so glad to hear of your intended marriage with Ellen Nicholl, and as I promised to assist you at starting, I am happy to tell you that I will pay to you 150 pounds yearly during my life and until your annual income derived from your profession of a chancery barrister shall amount to 600 guineas, of which your own admission will be the only evidence that I shall require.
"Your affectionate uncle,
"CHARLES SHADWELL."

It was held that the promise was binding and made upon good consideration.

In *Lakota v. Newton*, an unreported case in the Superior Court of Worcester, Mass., the complaint averred defendant's promise that "if you (meaning plaintiff) will leave off drinking for a year I will give you $100," plaintiff's assent thereto, performance of the condition by him, and demanded judment therefor. Defendant demurred on the ground, among others, that the plaintiff's declaration did not allege a valid and sufficient consideration for the agreement of the defendant. The demurrer was overruled.

In *Talbott v. Stemmons* (a Kentucky case not yet reported), the step-grandmother of the plaintiff made with him the following agreement: "I do promise and bind myself to give my grandson, Albert R. Talbott, $500 at my death, if he will never take another chew of tobacco or smoke another cigar during my life from this date up to my death, and if he breaks this pledge he is to refund double the amount to his mother." The executor of Mrs. Stemmons demurred to the complaint on the ground that the agreement was not based on a sufficient consideration. The demurrer was sustained and an appeal taken therefrom to the Court of Appeals, where the decision of the court below was reversed. In the opinion of the court it is said that "the right to use and enjoy the use of tobacco was a right that belonged to the plaintiff and not forbidden by law. The abandonment of its use may have saved him money or contributed to his health, nevertheless, the surrender of that right caused the promise, and having the right to contract with reference to the subject-matter, the abandonment of the use was a sufficient consideration to uphold the promise." Abstinence from the use of intoxicating liquors was held to furnish a good consideration for a promissory note in *Lindell v. Rokes* (60 Mo. 249).

. . . . In further consideration of the questions presented, then, it must be deemed established for the purposes of this appeal, that on the 31st day of January, 1875, defendant's testator was indebted to William E. Story, 2d, in the sum of $5,000.

The order appealed from should be reversed and the judgment of the Special Term affirmed, with costs payable out of the estate.

William Michael JONES, Petitioner, v. Free Flight Sport Aviation, Inc., Respondents

Supreme Court of Colorado

623 P.2d 370
January 5, 1981

JUDGES: En Banc. Justice Erickson delivered the Opinion of the Court. Justice Lee does not participate.

We granted certiorari to review the decision. In an action for damages by the plaintiff for personal injuries sustained in an airplane crash, the trial court granted the defendants' motion for partial summary judgment. Summary judgment was based upon the execution of an exculpatory agreement which the court held insulated the defendants from liability for simple negligence involving the crash of an airplane. . . . The court of appeals affirmed. We affirm the court of appeals.

On November 17, 1973, the plaintiff, William Michael Jones, who was then seventeen years old, signed a contract with the defendant, Free Flight Sport Aviation, Inc. (Free Flight). The contract allowed Jones to use Free Flight's recreational skydiving facilities, which included use of an airplane to ferry skydivers to the parachute jumping site. A covenant not to sue and a clause exempting Free Flight from liability were included in the contract:

> "2A. EXEMPTION FROM LIABILITY. The [plaintiff] exempts and releases the Corporation, its, owners, officers, agents, servants, employees, and lessors from any and all liability, claims, demands or actions or causes of action whatsoever arising out of any damage, loss or injury to the [plaintiff] or the [plaintiff's] property while upon the premises or aircraft of the Corporation or while participating in any of the activities contemplated by this Agreement, whether such loss, damage, or injury results from the negligence of the Corporation, its officers, agents, servants, employees, or lessors or from some other cause."

The contract also contained an alternative provision which would have permitted Jones to use Free Flight's facilities at an increased cost, but without releasing Free Flight from liability for negligence.

On December 28, 1973, Jones attained the age of eighteen. Ten months later, on October 19, 1974, he suffered serious personal injuries in an airplane crash which occurred shortly after takeoff from Littleton Airport. Free Flight furnished the airplane as part of its skydiving operation. [Inferences can be gleaned from the record that indicate that Jones used Free Flight's services on several occasions between November 17, 1973, the date that the contract was signed, and October 19, 1974, the date of the crash.]

On November 21, 1975, nearly two years after attaining his majority, Jones filed suit against Free Flight alleging negligence and willful and wanton misconduct as the cause of the airplane crash. The defendants included the owners and operators of the airplane, the airport, and Free Flight. Based upon the exculpatory agreement, the trial court granted summary judgment in favor of the defendants. The court of appeals affirmed the trial court.

Jones asserts three grounds for reversal of the summary judgment. First, he claims that he disaffirmed the contract with Free Flight within a reasonable time after he attained his majority by filing suit. Second, he asserts that the exculpatory agreement is void as a matter of public policy. Third, he contends that inasmuch as an exculpatory agreement must be strictly construed against the party seeking to avoid liability for negligence, the injuries which he sustained as a result of the airplane crash were beyond the scope of the agreement.

I.

Summary Judgment

Summary judgment is only granted if the pleadings, admissions, depositions, answers to interrogatories, and affidavits establish that no genuine issue exists as to any material fact and judgment should be entered as a matter of law. C.R.C.P. 56(c). It is, however, a drastic remedy, and should only be granted upon a clear showing that there is no genuine issue as to any material fact. In determining whether summary judgment is proper, the trial court must resolve all doubts as to whether an issue of fact exists against the moving party. However, the existence of a difficult or complicated question of law, when there is no issue as to the facts, is not a bar to summary judgment.

Consequently, our review of the order granting summary judgment necessarily involves a determination of whether a genuine issue as to any material fact exists which would foreclose the defendants from obtaining summary judgment as a matter of law.

II. Ratification

As a matter of public policy, the courts have protected minors from improvident and imprudent contractual commitments by declaring that the contract of a minor is voidable at the election of the minor after he attains his majority. A minor may disaffirm a contract made during his minority within a reasonable time after attaining his majority or he may, after becoming of legal age, by acts recognizing the contract, ratify it.

Affirmance is not merely a matter of intent. It may be determined by the actions of a minor who accepts the benefits of a contract after reaching the age of majority, or who is silent or acquiesces in the contract for a considerable length of time. What act constitutes ratification or disaffirmance is ordinarily a question of law to be determined by the trial court. We agree that what constitutes a reasonable time for affirmance or disaffirmance is ordinarily a question of fact to be determined by the facts in a particular case. We conclude, however, that the trial court properly determined that Jones ratified the contract, as a matter of law, by accepting the benefits of the contract when he used Free Flight's facilities on October 19, 1974.

Thus, since Jones ratified the contract, the factual issue of whether his suit for personal injuries was filed within a reasonable time after attaining his majority and constituted disaffirmance of the contract, is not relevant. Accordingly, the entry of summary judgment on the issue of ratification was not error.

III. The Contract

Jones' assertion that his contract with Free Flight is void as a matter of public policy, raises two issues: (A) whether the contract with Free Flight is an adhesion contract; and (B) the validity of the exculpatory provisions of the contract. Our consideration of the two issues necessarily involves a determination, as a matter of law, whether summary judgment was properly granted based upon the undisputed facts in this case.

A. Adhesion Contract

An adhesion contract is a contract drafted unilaterally by a business enterprise and forced upon an unwilling and often unknowing public for services that cannot readily be obtained elsewhere. An adhesion contract is generally not bargained for, but is imposed on the public for a necessary service on a take or leave it basis. . . .

The various elements of an adhesion contract may be characterized as substantive (those that appear in the contract) and procedural (those that must be identified by resort to evidence relating to the formation of the contract). However, whether the issue is substantive or procedural, the determination of whether the contract is an adhesion contract is a matter of law for the court to resolve. Thus, in the absence of any genuine issue of material fact, the issue of whether a contract is an adhesion contract, does not preclude the entry of summary judgment.

We conclude that the record in the instant case supports the trial court's determination that the contract between Jones and Free Flight was not an adhesion contract as a matter of law.

Jones contends that this was an adhesion contract because he was not allowed to select the alternative provision which would have allowed him to participate in the activities without releasing Free Flight from liability for its negligence, and that a genuine issue as to his lack of choice precluded the entry of summary judgment. We disagree. . . . The fact that a contract is a printed form contract and offered on a "take-it-or-leave-it" basis does not alone cause it to be an adhesion contract.

We also agree with the court of appeals' conclusion that nothing in the record establishes a disparity in bargaining power, or that the services provided by Free Flight could not be obtained elsewhere.

B. The Exculpatory Provisions

Jones asserts that the exculpatory agreement is void as a matter of public policy. We disagree. The court of appeals [previously] held that an exculpatory clause in a contract relating to recreational activities will be given effect where the intention of the parties is expressed in sufficiently clear and unequivocal language and does not fall within any of the categories where the public interest is directly involved.

Jones, however, claims that summary judgment should not have been granted.

The determination of the sufficiency and validity of an exculpatory agreement is a question of law for the court to determine. Generally, an issue relating to the validity of an exculpatory agreement does not preclude the entry of summary judgment.

An exculpatory agreement, which attempts to insulate a party from liability from his own negligence, must be closely scrutinized, and in no event will such an agreement provide a shield against a claim for willful and wanton negligence.

In determining whether an exculpatory agreement is valid, there are four factors which a court must consider: (1) the existence of a duty to the public; (2) the nature of the service performed; (3) whether the contract was fairly entered into; and (4) whether the intention of the parties is expressed in clear and unambiguous language.

Measured against the four factors which determine the validity of an exculpatory agreement, we conclude that the trial court correctly held, as a matter of law, that the exculpatory agreement was valid. Therefore, the granting of defendants' motion for summary judgment was not error.

The duty to the public factor is not present in this case. . . . In light of the foregoing factors, we conclude that the contract between Jones and Free Flight does not fall within the category of agreements affecting the public interest.

We conclude that an insufficient number of these characteristics are present in the instant case to establish that the contract between Jones and Free Flight affected the public interest. The service provided by Free Flight was not a matter of practical necessity for even some members of the public; because the service provided by Free Flight was not an essential service, it did not possess a decisive advantage of bargaining strength over Jones; and the contract was not an adhesion contract.

Finally, in our consideration of the remaining factors that must be reviewed in considering the validity of an exculpatory agreement, we note that there was no disagreement between the parties that the contract was fairly entered into. Likewise, the agreement expressed the parties' intention in clear and unambiguous language; the contract used the word "negligence" and specifically included injuries sustained "while upon the aircraft of the Corporation."

We conclude that the exculpatory agreement was not void as a matter of public policy, and that there was no genuine issue as to any material fact.

Accordingly, the trial court properly granted a partial summary judgment on the simple negligence issue and we, therefore, affirm the decision of the court of appeals.

SUCCESSION OF RICHARD ALVIN FLOOD, ET AL v. FIDELITY & GUARANTY LIFE INSURANCE COMPANY

Court of Appeal of Louisiana, First Circuit

394 So. 2d 1311

January 26, 1981

JUDGES: COVINGTON, CHIASSON and LEAR, JJ.

OPINION BY: LEAR

Fidelity & Guaranty Life Insurance Company (hereinafter called Fidelity), the defendant-appellant, seeks reversal of the decision of the lower court which upheld the validity of a life insurance policy issued on the life of the late Richard Alvin Flood which, appellant contends, was fraudulently procured. The estate of decedent, Flood, instituted these proceedings to recover the proceeds of the policy of life insurance. The estate is now postured as plaintiff-appellees.

In 1971, Richard Alvin Flood resided with his wife and family in Houma, Louisiana. Mr. Flood was employed by the Transcontinental Gas Pipeline Corporation. Ellen Flood, his wife, was employed by Houtz Insurance Agency as an underwriter of personal casualty insurance.

In February, 1971, defendant, Fidelity, received an application for life insurance purportedly bearing the signature of Richard Flood. A policy of life insurance was issued, and Ellen Flood was designated as the beneficiary. In August, 1971, a change of ownership form was submitted to defendant-appellant purportedly bearing the signature of Richard Flood and changing the ownership of the policy to Ellen Flood. Subsequent to these events, Richard Alvin Flood was murdered (in 1972) at the hands of his wife, Ellen Flood. The details of the homicide and the findings and adjudications of the guilt of Ellen Flood are found in *State v. Flood*, 301 So.2d 637 (La.1974). Excerpts of the pertinent part of the findings of the Supreme Court are as follows:

> Richard and Ellen Flood were married in 1965. At the time of Richard's death on June 2, 1972, he was about 27 years old. Richard was described as a healthy robust man about 5'-10, weighing about 190 pounds. Mr. Flood was employed at Transcontinental Gas Pipeline Company as a maintenance man earning an annual salary of $8,745.00. Defendant was employed at Houtz Insurance Agency as an underwriter of personal casualty insurance, with a salary of $475.00 per month. The couple lived in a house trailer. The evidence is that defendant was unhappy in marriage and was having sexual relations with other men. There is further evidence that, during April of 1972 (about two months prior to Richard's death), defendant made inquiry in regard to obtaining a $100,000.00 life insurance policy on the life of her husband. The inquiry included questions by her as to whether her husband would have to be apprised of the policy. She was given an affirmative answer to this line of questioning. The evidence reveals that thereafter no further action was taken by her in regard to the policy.
>
> Richard Flood had two life insurance policies. One was a group policy through his employment of $25,000.00. The other policy was a $5,000.00 whole life type policy with a $5,000.00 declining term rider, under which policy, the beneficiary would receive approximately $9,300.00 at the time of Flood's death. The ownership of this latter policy was changed from Richard Flood to Ellen Flood on August 2, 1971. Defendant was the beneficiary under both of these policies.
>
> The jury concluded that defendant murdered her husband by arsenic poisoning. The motive was there. She was unhappy and going out with other men. There was some evidence that she was fearful of her husband. Further, her attempt to take out a large life insurance policy on his life without his knowledge is certainly evidence which indicates a motive, as well as the fact that she would receive about $35,000.00 as the beneficiary under the other two policies then in effect. There is also some evidence upon which the jury could conclude that she did, in fact, administer the arsenic. The evidence that six medicine bottles found in her trailer contained arsenic is revealing. This is particularly significant in view of the fact that the medicines called for by the labels on these bottles would not have contained any arsenic. Two of the medicines in these bottles, tylenol and paregoric, are the types which the jury could infer that Flood was taking for relief of headaches and diarrhea, some of the symptoms of his illness. Also noteworthy is the evidence of defendant feeding Richard ice at the hospital when no feeding had been ordered. At that time, his condition had been improving; however, from then on, he deteriorated and

died several hours later. Finally, there is no dispute that he died of arsenic poisoning. The remaining evidence is also directed at proving the crime charged.

Suffice it to say that Richard Flood was poisoned by the use of arsenic. His wife was tried for his murder and convicted in 1973.

Fidelity denied Mrs. Flood's request for payment of the insurance policy based upon her being charged with her husband's death. It returned all premiums to Mrs. Flood.

In 1977, a demand for payment of the policy was brought on behalf of the estate of Richard Flood or in the alternative for the benefit of the minor child of Richard and Ellen Flood. It was denied by Fidelity which reasoned that the policy had been obtained through the forgery and fraud of Mrs. Flood. This suit followed.

Plaintiff's evidence consisted of the certificate of death, the application and insurance policy and its demand letter. The theory of plaintiff's case was that the policy of insurance is valid because the insurer is estopped from denying coverage when, as here, its agent has signed the application purporting to witness the signature of the insured (Richard Flood).

The defendant, in an effort to prove forgery and fraud, called several witnesses. The agent, David Coignet, testified that Mrs. Flood presented him with an application which she represented was signed by her husband. Acting upon that representation, he testified that he signed his name as a witness to the signature. He further admitted that the change of ownership form, which changed ownership of the policy from Mr. Flood to Mrs. Flood, bore a signature purporting to be that of Mr. Flood which wasn't in fact witnessed by him; that all transactions concerning the policy of life insurance herein complained of were handled by Mrs. Flood.

Defendant-appellant also adduced evidence to establish the handwriting style of Mr. Flood and called as a witness Mr. Gilbert J. Portier, Jr. of New Orleans, Louisiana. Mr. Portier was qualified as an expert in handwriting identification. He testified that the known signature of Mr. Flood was not the same as the signature on the insurance policy nor that found on the change of ownership form. Finally, appellant offered without objection the opinion of the Louisiana Supreme Court, rendered in *State of Louisiana v. Ellen Flood*, 301 So.2d 637.

The lower court rendered judgment in favor of plaintiff in the amount of $ 9,000.00. In his written reasons for judgment, the trial judge concluded that it would be sheer speculation on the part of the court to conclude that Mr. Flood had no knowledge of the application and policy of insurance and did not approve and authorize the action taken by his wife in obtaining the said insurance. It further found that there was no direct provable evidence to establish the wife's motive at the time the policy was applied for and, finally, construed defendant's failure to call Mrs. Flood as a factor militating against defendant's claim.

We must decide whether or not the policy of insurance was fraudulently obtained and, if so, whether such fraud voids the contract under Louisiana law.

The case at bar involves a calculated attempt by Ellen Flood to subvert the laws of Louisiana in order to realize a pecuniary gain. Life insurance policies are procured because life is, indeed precarious and uncertain. But our law does not and cannot sanction any scheme which has as its purpose the certain infliction of death for, inter alia, financial gain through receipt of the proceeds of life insurance.

The genesis of this litigation is the escalating criminal action of Ellen Flood, bent on taking the life of her lawful husband. Our courts have previously adjudicated (1) the issue of the cause of death of Richard Flood, (2) the culprit in that death, and (3) the motives for the death. [1] Under the peculiar circumstances of the case, it was unreasonable of the trial court not to consider and to assign great weight to the mountain of circumstantial evidence tending to prove Mrs. Flood's scheme to defraud both the insurer, Fidelity, and the insured, Mr. Flood.

Louisiana follows the majority rule which holds, as a matter of public policy, that a beneficiary named in a life insurance policy is not entitled to the proceeds of the insurance if the beneficiary feloniously kills the insured.

Article 1881 of our Civil Code [2] provides that contracts made through fraud are voidable by the parties. [3] Article 1847(7) defines, in pertinent part, fraud and an instance in which its invocation will nullify a contract. [4]

Additionally, Title 22 of the Revised Statutes, Section 619(B) governs the standard for life insurance applications:

> "B. In any application for life or health and accident insurance made in writing by the insured, all statements therein made by the insured shall, in the absence of fraud, be deemed representations and not warranties. The falsity of any such statement shall not bar the right to recovery under the contract unless such false statement was made with actual intent to deceive or unless it materially affected either the acceptance of the risk or the hazard assumed by the insurer."

It is clear to us that the entirety of the transaction here reviewed is tainted with the intendment of Ellen Flood to contravene the prohibitory law. The fact that plaintiff seeks to install in her stead a contingent beneficiary is of no consequence. To sanction this policy in any way would surely shackle the spirit, letter and life of our laws.

For the foregoing reasons, the decision of the lower court is reversed, and judgment is entered in favor of defendant-appellant, Fidelity & Guaranty Life Insurance Company, dismissing the suit of plaintiff-appellee, Succession of Richard Alvin Flood, all costs to be paid by the plaintiff-appellee.

REVERSED.

R. D. RYNO, JR., APPELLANT, v. LEE TYRA AND KATHY TYRA, APPELLEES

Court of Appeals of Texas, Second District, Fort Worth

752 S.W.2d 148

April 28, 1988

JUDGES: Hill, David F. Farris, and Keltner, JJ.

OPINION BY: Farris

This is a conversion case. Appellees sued appellant for the conversion of an automobile worth $125,000 which appellees won from appellant on the flip of a coin. The trial court entered judgment for appellees based upon jury findings of damages of $135,000, including $10,000 in exemplary damages. Ryno complains that the trial court erred in granting the appellees judgment because, at the time of the alleged conversion, Ryno owned the automobile and the judgment enforces a gambling contract.

We affirm the judgment of the trial court because the evidence is sufficient to prove that the Tyras owned the automobile at the time of its conversion and the Tyras' cause of action does not require enforcement of a gambling contract. In affirming the judgment of the trial court, we also overrule Ryno's points of error complaining of the sufficiency of evidence of the amount of damages and of the awarded exemplary damages.

Lee Tyra and Ryno testified, agreeing on most of the facts material to the points on appeal. At the time of the wager, Ryno owned Bavarian Motors, an automobile dealership in Fort Worth. On March 5, 1981, Tyra discussed with Ryno Tyra's purchase of a 1980 BMW M-1 which Ryno agreed to sell to Tyra for the price of $125,000. Tyra testified that Ryno proposed a double or nothing coin flip. Tyra agreed and won the coin flip whereupon, according to Tyra, Ryno handed Tyra the keys to the car, said, "It's yours," and handed Tyra the "German title" to the BMW. Tyra testified that on several occasions, he took the BMW into Bavarian Motors for repairs and servicing, and upon each occasion, it was returned to him, and Ryno never asked for a return of the BMW or payment for it. Ryno provided the Tyras with paper dealer's tags for use on the BMW because it could not be licensed for street use.

The German title was introduced into evidence but no translation was offered. However, a Texas Highway Department employee identified the German title as the only document accepted by his agency in issuing a Texas certificate of title. Ryno denied that the document he gave Tyra was a German title, and Tyra never obtained a Texas certificate of title to the BMW.

Ryno admitted that he proposed the coin flip; however, he testified that it was in jest and the parties to the bet each knew that they were in jest from the other's facial expressions. Ryno sold Bavarian Motors, and after the sale of the dealership, its representatives requested that Tyra loan the BMW for display at an auto show. After the show, the BMW was returned to Bavarian Motors' premises where it was taken by Ryno. An employee of Bavarian Motors called Tyra and told him the BMW had been stolen. Ryno admitted taking the car from Bavarian Motors without permission on February 8 or 9, 1982 and later selling it to a third party.

In addition to contending that the gamble was a jest, Ryno attempted by his testimony to tie the delivery of the BMW to Tyra as part of the consideration in a Canadian oil deal in which both he and the appellees were involved.

The jury's answers to the issues submitted to it included findings: that Ryno intended to transfer to Tyra all of Ryno's ownership interest in the BMW at the time he delivered the documents, keys and possession of the BMW to Tyra; that the appellees' damages for the conversion were $125,000; that Ryno had acted with a malicious and conscious disregard for the rights of the appellees; and that appellees be awarded $10,000 in exemplary damages.

Ryno claims that the trial court's judgment is erroneous because the evidence shows him to be the owner of the BMW, precluding him from converting it from another. Ryno [also argues] that the trial court's judgment is erroneous because it enforces a gambling contract.

We overrule Ryno's point of error because we find there was sufficient evidence to sustain the jury finding that Ryno intended to transfer to Tyra Ryno's ownership interest in the BMW at the time he delivered the documents, keys, and possession of the automobile to Tyra. See Floyd v. Patterson, 72 Tex. 202, 10 S.W. 526 (Tex. 1888). The elements necessary to establish a gift are delivery, acceptance, and intent. A gift is a transfer of property made voluntarily and gratuitously. Delivery and acceptance of the BMW are undisputed. After considering all the evidence with regard to Ryno's intent to deliver possession of the BMW to Tyra, we are not persuaded that the evidence in support of a jury finding is so weak or the evidence to the contrary so overwhelming that the finding should be set aside and a new trial ordered.

We agree with appellant that his wager with Tyra was unenforceable. See Castilleja v. Camero, 414 S.W.2d 424, 427 (Tex. 1967). The trial court could not have compelled Ryno to honor his wager by delivering the BMW to appellees. However, Ryno did deliver the BMW to appellees and the facts incident to that delivery are sufficient to establish a transfer by gift of the BMW from Ryno to the Tyras.

We overrule Ryno's point of error because the jury finding of Ryno's intent to transfer ownership relieved the Tyras of relying upon a gambling contract as a basis of their cause of action for conversion. The Tyras are seeking not the enforcement of a gambling contract, but rather damages for conversion of property determined by the jury to be that of appellees.

Ryno's also complains that there was no finding of the value of the automobile at the time and place of conversion sufficient to sustain the judgment. In his argument, Ryno contends there was no proof of the automobile's market value. We disagree. The jury found that $125,000 would fairly and reasonably compensate the Tyras for their damages resulting from the conversion of the BMW. On cross-examination, Ryno qualified himself as one who could give an opinion as to the car's fair market value and testified that he thought it was worth $125,000 when he took it from the dealership after the auto show. An employee of Bavarian Motors testified that the automobile's value was $125,000. We find that in the absence of any contest of the automobile's value, it was unnecessary for the trial court to submit an issue on compensatory damages. Further, the damage issue as submitted was sufficient, particularly in light of Ryno's failure to request any instructions or definitions in connection with the issue. Ryno's point of error is overruled.

We also overrule Ryno's point of error which complains about the judgment award of exemplary damages because that point is based solely upon a claim that there is no finding of actual damages, an argument we have rejected.

The judgment of the trial court is affirmed.

ZIVICH ET AL., APPELLANTS, v. MENTOR SOCCER CLUB, INC., APPELLEE

Supreme Court of Ohio

82 Ohio St. 3d 367

June 29, 1998, Decided

JUDGES: FRANCIS E. SWEENEY, SR., J. MOYER, C.J., RESNICK, COOK and LUNDBERG STRATTON, JJ., concur. DOUGLAS and PFEIFER, JJ., concur in judgment only. COOK, J., concurring. Opinion by: SWEENEY

We are asked to decide whether the exculpatory agreement executed by Mrs. Zivich on behalf of her minor son released the Club from liability for the minor child's claims and the parents' claims as a matter of law. We find that the exculpatory agreement is valid as to all claims. Summary judgment was appropriately entered in the Club's favor. The judgment of the court of appeals is affirmed. . . .

Appellants first argue that since [the soccer game] had concluded, the injury occurred outside the scope of the exculpatory agreement. We find this contention meritless. We quote, with approval, Judge Nader's majority opinion rejecting this argument: "It should not come as any great surprise for a parent to learn that, during a period of inactivity at a soccer practice, his or her child fiddled with loose equipment, climbed on nearby bleachers, or scaled the goal. It should be equally clear that coaches supervising the practices will not be able to completely prevent such unauthorized activity, as some degree of bedlam is unavoidable, when children of tender years are brought together to play a game, and when their emotions are aroused. The risk of a seven-year-old child climbing on a goal shortly after winning an intrasquad scrimmage is, therefore, a natural incident of his participation in soccer practice. Thus, Bryan's injuries fall within the ambit of the release."

We next consider whether the release is valid. With respect to adult participants, the general rule is that releases from liability for injuries caused by negligent acts arising in the context of recreational activities are enforceable. These holdings recognize the importance of individual autonomy and freedom of contract. Here, however, the exculpatory agreement was executed by a parent on behalf of the minor child.

Appellants contend that the release is invalid on public policy grounds. In support of their argument, they refer to the general principle that contracts entered into by a minor, unless for "necessaries," are voidable by the minor, once the age of majority is reached, or shortly thereafter. . . . The Club argues that the proper focus is not whether the release violates public policy; but rather that public policy itself justifies the enforcement of this agreement. This is also the position advocated by Judge Ford in his concurring opinion. We agree with the Club and Judge Ford.

The General Assembly has enacted statutes designed to encourage landowners to open their land to public use for recreational activities without fear of liability. These provide that private entities that hold land open for recreational use without charge are immune from tort liability for any injury caused by a recreational user. Then, in 1996, new statutes were enacted, effective January 27, 1997, which accord qualified immunity to unpaid athletic coaches and sponsors of athletic events. Hence, the General Assembly has articulated its intent of encouraging the sponsorship of sports activities and protecting volunteers. However, these statutes were enacted after this cause of action arose. Thus, our role is to render a decision that fills the gap left open before the effective date of the statutory enactments.

It cannot be disputed that volunteers in community recreational activities serve an important function. Organized recreational activities offer children the opportunity to learn valuable life skills. It is here that many children learn how to work as a team and how to operate within an organizational structure. Children also are given the chance to exercise and develop coordination skills. Due in great part to the assistance of volunteers, nonprofit organizations are able to offer these activities at minimal cost. In fact, the American Youth Soccer Organization pays only nineteen of its four hundred thousand staff members. The Little League pays only seventy of its 2.5 million members. Clearly, without the work of its volunteers, these nonprofit organizations could not exist and scores of children would be without the benefit and enjoyment of organized sports. Yet, the threat of liability strongly deters many individuals from volunteering for nonprofit organizations. Insurance for the organizations is not the answer, because individual volunteers may still find themselves potentially liable when an injury occurs. Thus, although volunteers offer their services without receiving any financial return, they place their personal assets at risk.

Therefore, faced with the very real threat of a lawsuit, and the potential for substantial damage awards, nonprofit organizations and their volunteers could very well decide that the risks are not worth the effort. Hence, invalidation of exculpatory agreements would reduce the number of activities made possible through the uncompensated services of volunteers and their sponsoring organizations.

Therefore, we conclude that although Bryan, like many children before him, gave up his right to sue for the negligent acts of others, the public as a whole received the benefit of these exculpatory agreements. Because of this agreement, the Club was able to offer affordable recreation and to continue to do so without the risks and overwhelming costs of litigation. Bryan's parents agreed to shoulder the risk. Public policy does not forbid such an agreement. In fact, public policy supports it. Accordingly, we believe that public policy justifies giving parents authority to enter into these types of binding agreements on behalf of their minor children. We also believe that the enforcement of these agreements may well promote more active involvement by participants and their families, which, in turn, promotes the overall quality and safety of these activities. . . .

Based upon these protections, Judge Ford believes that many decisions made by parents "fall within the penumbra of parental authority, *e.g.*, the school that the child will attend, the religion that the child will practice, the medical care that the child will receive, and the manner in which the child will be disciplined." He found it notable that the law empowers a parent to consent to medical procedures for a minor child, gives a parent the general authority to decide to decline medical treatment for the child, and destroys the child's cause of action for battery when consent is given. Thus, Judge Ford believes that invalidating the release as to the minor's claim is inconsistent with conferring other powers on parents to make important life choices for their children. . . .

When Mrs. Zivich signed the release she did so because she wanted Bryan to play soccer. She made an important family decision and she assumed the risk of physical injury on behalf of her child and the financial risk on behalf of the family as a whole. Thus, her decision to release a volunteer on behalf of her child simply shifted the cost of injury to the parents. Apparently, she made a decision that the benefits to her child outweighed the risk of physical injury. Mrs. Zivich did her best to protect Bryan's interests and we will not disturb her judgment. In fact, the situation is more analogous to Ohio's informed consent law than to the law governing children's property rights. This statute gives parents the authority to consent to medical procedures on a child's behalf. In both cases, the parent weighs the risks of physical injury to the child and the attendant costs to herself against the benefits of a particular activity.

Therefore, we hold that parents have the authority to bind their minor children to exculpatory agreements in favor of volunteers and sponsors of nonprofit sport activities where the cause of action sounds in negligence. These agreements may not be disaffirmed by the child on whose behalf they were executed.

Having upheld the release agreement against Bryan's claims, we find it also valid as to Mr. and Mrs. Zivich's claims for loss of consortium. Mrs. Zivich, the signatory on the agreement, acknowledged that she had read its contents and did not ask any questions about it. Parents may release their own claims growing out of injury to their minor children. We adopt this rule of law, finding it consistent with principles of freedom of contract. Thus, we hold that parents may release their own claims arising out of the injury to their minor children. Accordingly, we find that Mrs. Zivich is barred from recovery as to her claims. . . .

As a separate ground for recovery, appellants also contend that the injury was caused by the Club's willful and wanton misconduct. . . . . We have held that while a participant in recreational activities can contract with the proprietor to relieve the proprietor from any damages or injuries he may negligently cause, the release is invalid as to willful and wanton misconduct.

To support this claim, appellants assert that the Club's former president, David Bolsen, attended a seminar just before his term of office ended. It was at the seminar that he learned of the need to anchor the goals and to post warning labels on them. Bolsen testified that because his term expired two weeks later, he only had time to relay the information to a few persons. However, no action was taken to secure the goals. Appellants argue that Bolsen's failure to take more affirmative steps to ensure that the Club and the city implemented the safety recommendations amounts to willful and wanton misconduct. Like the court of appeals, we reject this argument.

There is no evidence that the former president intended that Bryan should be injured. Nor did the former president utterly fail to exercise any care whatsoever. Even accepting as true the appellants' claim that club officials knew about the safety problems but failed to act, this action does not amount to willful and wanton misconduct. As noted by the appellate court, "Park officials testified that the City never had anchored the goals in the past, and, apparently, of the thousands of young boys and girls playing soccer in the youth league throughout the years, no other child had been injured in this manner." Thus, reasonable minds could not conclude that the risk posed by the unanchored goal was so great as to require immediate remedial action.

Moreover, the evidence established that the city, not the Club, was responsible for the upkeep of the soccer fields and the purchase, storage, maintenance and placement of the soccer goals.

We find that appellants failed to produce sufficient evidence to present a jury question on the claim of willful and wanton misconduct.

Accordingly, we affirm the court of appeals' judgment, albeit on somewhat different grounds. We uphold its decision that the release is valid as to the parents' claims. However, we hold that the release is also valid as to the minor child's claim.

Judgment affirmed.

MOYER, C.J., RESNICK, COOK and LUNDBERG STRATTON, JJ., concur.

DOUGLAS and PFEIFER, JJ., concur in judgment only.

COOK, J., concurring.

Footnotes

3 The words "release," "waiver" and "exculpatory agreement" have been used interchangeably by the courts. These defenses are based on contract principles. "Exculpatory agreements, also called 'releases' or 'waivers,' are basically written documents in which one party agrees to release, or 'exculpate,' another from potential tort liability for future conduct covered in the agreement."

KENNETH SUTTON et al., Plaintiffs and Appellants, v. DONALD WARNER et al., Defendants and Appellants.

Court of Appeal of California, First Appellate District

12 Cal. App. 4th 415

January 12, 1993, Decided

JUDGES: Opinion by Kline, P. J., with Benson and Phelan, JJ., concurring.

INTRODUCTION

Arlene and Donald Warner appeal from a judgment granting specific performance of an oral agreement to purchase real property in favor of respondents Gloria and Kenneth Sutton. The Warners contend on appeal that substantial evidence does not support the judgment and that numerous errors of law compel reversal.

We affirm.

STATEMENT OF FACTS

In 1983, Arlene Warner inherited a one-third interest in a home at 101 Molimo Street in San Francisco. She and her husband, Donald Warner, desired to retain the property. In order to obtain full title, the Warners bought out the other heirs, which required them to obtain a loan for $170,000. The Molimo Street property, having a value of approximately $185,000, could not support a loan in that amount by itself. They could not afford the payments on that mortgage and therefore sought assistance from others.

Donald Warner and Kenneth Sutton were friends. Warner suggested to Sutton in October of 1983 that the Suttons rent the Molimo Street property. The Suttons became tenants and made all rent payments in cash.

In January 1984, Donald Warner proposed that the Suttons purchase the residence so that the estate could be settled. His proposal included a $15,000 down payment towards the purchase price of $185,000. According to the Suttons, they were to have five years to purchase the home. In addition, under the terms of this agreement, the Suttons were required to make all mortgage payments and real estate tax payments. In sum, the Warners were not to have to make any payments on the Molimo Street property.

John Murphy, a long-time acquaintance of Kenneth Sutton and Donald Warner, testified that he overheard discussions between the two which supported Sutton's version of the contract.

Donald Warner confirmed that, but for the sale of the Molimo Street property to the Suttons, he and his wife would not have acquired the remaining interests in that property. He admitted receipt of the $15,000, but testified that the Suttons had only six months in which to exercise their option, or they would lose their interest in the property. . . . The court found the Warners' version of the contract neither credible nor reasonable.

Kenneth Sutton testified that he and his wife had made a number of improvements to the property in reliance upon the oral purchase agreement. Sutton also testified that he was concerned about proof of payment of the down payment. He requested a receipt for the $15,000 so he would have proof of payment should the Warners die. Sutton testified that Warner gave him a previously prepared one-page memorandum, exhibit 2, dated April 4, 1984. This document acknowledged the receipt of the $15,000, identified the property, and evidenced the obligation of the Warners to sell the property to the Suttons. The document provided:

> "Received from Kenneth Sutton the amount of $15,000 toward the purchase of 101 Molimo, San Francisco. In any event where me, Donald L Warner and my wife, Arlene M Warner die, Ken Sutton is to have first option of buying 101 Molimo at the price of $185,000 minus the $15,000 already received[,] leaving a $170,000.00 Balance. If Mr. Sutton cannot buy the house at 101 Molimo he is to paid [*sic*] $15,000 out of our estate and said property to be sold. Mr. Sutton has 6 months to buy and must pay rent to meet agreement at $1000.00 per month. [P] S/ Donald L Warner and Arlene M Warner."

The Suttons maintained that this document was not the contract and that they intended to have a formal contract prepared.

Shortly after execution of the receipt, the Warners began the process to obtain the $170,000 loan. The loan transaction closed in late summer or fall of 1984. Up to that time, the Suttons had paid $1,000 per month in rent. Upon consummation of the financing, they began paying an increased amount. The Suttons contended that they paid the sum of $1,881 per month in cash commencing in September 1984. This was equal to the full amount of the new loan's monthly mortgage payment. The Suttons continued to pay the full amount of the mortgage payment each and every month in cash until 1987, when they began using checks to be able to evidence their ability to pay to a potential lender.

Kenneth Sutton produced evidence of cash deposits to the Warners' checking account in exactly that amount. In September of 1986, the mortgage amount was fixed at $1,544. Although there were numerous checks after that date for the sum of $1,500, Warner confirmed that he received $44 in cash on multiple occasions from the Suttons in addition to the monthly rent check for $1,500.

Sutton testified that in late 1986, he, his wife, and Warner explored creative financing for the house. . . .

Thereafter, in January 1987, a meeting occurred at the Molimo Street property with the Suttons, the Warners, and Attorney Garrett Checcini representing the Suttons. According to Checcini, the purpose of the meeting was to formalize the arrangement between the parties. Checcini testified that he was willing to cosign a loan to enable the Suttons to obtain financing. Kenneth Sutton summarized the terms of the agreement, to the effect that the original purchase price was $185,000, that a down payment of $15,000 had been made, along with additional paydowns on the principal balance. No objection to these facts was voiced by either Donald or Arlene Warner. Checcini testified that no agreement was consummated at that meeting because Donald Warner consumed a six-pack of beer during the forty-five-minute meeting and became inebriated.

During this period, the Suttons continued to pay rent in the amount of the mortgage payments. Meanwhile, the value of the property rose to somewhere between $250,000 and $320,000. . . .

In July 1988, the Warners offered to sell the property to the Suttons for $250,000, which they contended was less than its fair market value. The Suttons did not dispute the value of the property. A letter from Warners' counsel at this time also advised the Suttons that in the event they did not exercise the option to purchase the property for that sum, their rent would be increased.

Upon the Suttons' receipt of the letter from the Warners' attorney, this litigation ensued.

I. *SUBSTANTIAL EVIDENCE SUPPORTS ORAL AGREEMENT*

[omitted]

II. *STATUTE OF FRAUDS*

The Warners contend that the statute of frauds prevents enforcement of the agreement and that there is no substantial evidence of part performance by the Suttons or of equitable estoppel sufficient to take the agreement outside the operation of the statute. The record supports the trial court's determination that part performance by the Suttons sufficed to remove the bar of the statute.

The doctrine of part performance by the purchaser is a well- recognized exception to the statute of frauds as applied to contracts for the sale or lease of real property. Payment of the purchase price alone, without the buyer obtaining possession or making substantial improvements to the property, is not sufficient part performance to preclude application of the statute of frauds. The part performance by the buyer must clearly relate to, and must be pursuant to, the terms of the oral agreement. . . . Two distinct elements underlie application of the part performance exception: "first, the extent to which the evidentiary function of the statutory formalities [of the statute of frauds] is fulfilled by the conduct of the parties; second, the reliance of the promisee, providing a compelling substantive basis for relief in addition to the expectations created by the promise." (Rest.2d, Contracts, § 129, com. b., p. 322.)

The Warners contend that the Suttons could not demonstrate adequate part performance, as they never entered possession pursuant to the oral agreement. Rather, they originally took possession as tenants and continued in possession after the making of the oral agreement. . . . Possession must be . . . actual, visible, notorious and exclusive, so that it manifests clearly that the buyer is claiming and asserting a distinctive ownership of the property inconsistent with the right of possession or ownership in any other person. At the same time, as the trial court recognized, continued possession, under the circumstances presented, did not preclude part performance. To apply a transfer of possession requirement to preclude former tenants from ever establishing an oral contract to purchase would be unjust under the circumstances of this case. . . .

After entering the oral agreement, the Suttons made a $15,000 down payment and increased their monthly payments to the Warners from the original $1,000 per month rental payment to payments in the precise amount of the variable mortgage payments due under the $170,000 loan. They reimbursed the Warners for property taxes in the sum of $800 every six months. Although it was disputed whether the dollar value of improvements made by the Suttons in reliance upon the oral agreement constituted "substantial" improvements, it is undisputed that many of the improvements—such as painting the interior of the house and the installation of a toilet and entry lamp—were done by the Suttons' own labor. The trial court found that these actions were unequivocally related to the purchase agreement. We cannot gainsay this determination. Furthermore, the Warners did not dispute the *existence* of an oral lease-option agreement. Rather, the dispute centered upon when the option would expire. The actions taken by the Suttons in reliance upon the oral agreement, when considered together with the Warners' admission that there was an oral agreement of some duration, satisfy both elements of the part performance doctrine—evidence of the existence of the oral contract on the terms found by the court and reliance by the Suttons upon that contract warranting specific performance relief.

DISPOSITION

The judgment is affirmed.

Benson, J., and Phelan, J., concurred

JOSEPH B. DOHERTY, SR., Plaintiff, Appellee, v. DOHERTY INSURANCE AGENCY, INC., Defendant, Appellant

United States Court of Appeals for the First Circuit

878 F.2d 546

June 23, 1989

JUDGES**:** Campbell, Chief Judge, Bownes and Breyer, Circuit Judges.

OPINION BY: Chief Judge Campbell

A district court jury found for plaintiff Joseph Doherty on his contract claim for monthly retirement payments against defendant Doherty Insurance Agency ("Insurance"). The latter now contends that the district court erred in denying its motions for a directed verdict, judgment notwithstanding the verdict and a new trial; that Doherty's claim was barred by the statute of frauds; and that the district court abused its discretion by commenting to the jury about the evidence. Finding no merit to these contentions, we affirm.

I. In 1978, Joseph Doherty retired from his family business at the age of 68, after 32 years of service. On a monthly basis thereafter, Insurance provided Doherty with retirement benefits in a stipulated amount. In 1982, however, family relations fractured, and a newly elected board of directors voted to terminate Doherty's retirement payments. Soon after the checks ceased to arrive, Doherty brought this diversity action in the United States District Court for the District of Massachusetts, alleging breach of Insurance's oral promise to pay retirement benefits for Doherty's remaining life. The parties agreed that Massachusetts law applied. . . .

II. Joseph Doherty is one of five Doherty children: four sons — John, Bill, Joe (the plaintiff), and Jim —and a daughter, Margaret. In the mid-1930s, the second son, Bill, founded a small insurance and real estate agency in Andover, Massachusetts. In 1937, Jim joined the business. In 1946, the two brothers formed an unincorporated partnership. Most of the company's business was insurance sales, but the brothers occasionally would also sell real estate. In 1955, Bill discovered that he was seriously, perhaps terminally, ill. Concerned that Jim would be left to run the family business alone, Bill and Jim sought the help of other family members. They first asked John, who refused to join the business. They then turned to Joe.

In 1955, Joe Doherty was 45 years old. He had earned a Bachelor's degree from Boston College, and later a Master's degree in Education from Harvard University. In 1951, he and his family moved to Easthampton, Connecticut, where he served as the superintendent of schools. By 1955, Joe had built up 18 years of equity in school retirement plans.

In September of 1955, Jim called Joe and arranged to meet with him in Massachusetts, where New England school superintendents were holding an annual meeting. After the meeting, the two brothers sat on the back steps of the Ocean House, and Jim told Joe about Bill's illness, and asked Joe to join the family business. Jim related the full terms of the employment offer: salary, a company car, and insurance. Joe asked Jim about retirement. Jim responded that retirement would be taken care of, and agreed that Joe would retire at salary.

Joe took several months to consider Jim's offer. In the meantime, he received an offer to serve as superintendent of schools in a New Jersey district, a position which would have been more challenging, with greater potential for advancement, than his position in Easthampton. He also was offered a renewal of his contract in Easthampton. In mid-February of 1956, Joe prepared a list of the "pros" and "cons" of joining in the family business in Andover. Among the "cons" listed was "all retirement benefits wasted," but among the "pros" was "improved retirement plan." Sometime in March of 1956, Joe informed his brothers that he had decided to accept their offer. The brothers met at a restaurant in Sturbridge, Massachusetts, for a luncheon to celebrate Joe's decision. Subsequently, Joe and his family moved to Andover, and he began working with his brothers in July 1956.

Upon Joe's move to Andover, the brothers formed two corporations, Doherty Insurance Agency, Inc. ("Insurance") and Doherty Realty Agency, Inc. ("Realty"). Insurance was the corporate successor to Jim's and Bill's earlier partnership. Bill and Jim were the sole shareholders of Insurance, but the three brothers held equal shares in Realty. The three brothers served as directors for each of the two corporations. Joe was elected president of both corporations. The two corporations shared a small office in Andover.

Upon Joe's arrival, the three brothers agreed that the first order of business was for Joe to obtain a license to sell insurance. Joe was tutored for his insurance exam, and after obtaining his insurance license late in the summer of 1956, attended an intensive five-week course about insurance. Joe subsequently became a real estate broker and an appraiser, and worked primarily in the real estate side of the business. From late 1956 until Joe's retirement in 1978, Insurance paid Joe's weekly salary.

In addition to receiving his salary from Insurance, Joe was covered under Insurance's medical plan, had life insurance through Insurance, and was listed as a full-time employee of Insurance. The three brothers shared equally in annual profit sharing payments received by Insurance.

In 1970, Bill retired from Insurance at full salary. In 1975, just before Joe's 65th birthday, Jim "reminded" Joe that Joe was eligible for retirement on the same terms as those enjoyed by Bill. Joe retired on January 1, 1978. Initially, he received payments in the amount of $2,000 per month, on checks drawn on Insurance's corporate bank account. Later, the amount was reduced slightly to an amount representing Joe's salary less any social security benefits he received. Jim retired in 1980 on the same terms. Insurance's financial statements reflected the retirement payments to the three brothers (and others) under the heading "Commitments." The statements for the years 1977–1981 noted, "The Agency has unfunded deferred compensation agreements with four former officers and employees; whereby, the Agency is required to pay benefits aggregating annually for their remaining lives."

Upon Jim's retirement, the business passed on to the next generation. Jim's children ran Insurance, while some of Joe's children were responsible for Realty. In 1981, a dispute arose, and Joe's children left the business. At the next meeting of Insurance's board of directors, on January 5, 1982, Jim's children voted to terminate Joe's retirement payments. Joe never received another retirement check from Insurance. However, the pension payments to Jim and Bill were continued. Insurance's 1981–1982 financial statement reflected this change, noting, under the heading "Commitments," that "The Agency has revocable unfunded deferred compensation agreements. . . ."

We are satisfied that a reasonable jury could, from these facts, find for plaintiff Joseph Doherty. The discussion between Joe and Jim on the steps of the Ocean House in 1956, as related by Joe, supports Joe's claim that the brothers exchanged mutual promises concerning the terms of Joe's future employment, including Jim's promise to pay lifetime retirement benefits. The parties' subsequent conduct tends to confirm the existence of such a promise. Joe forfeited 18 years of accrued retirement benefits in order to work with his brothers. Joe's "pros and cons" list included the "pro" of an improved retirement plan. Many years later, Jim "reminded" Joe that he would be eligible to retire at full salary upon his 65th birthday. Insurance's financial statement tended to confirm an agreement, and Insurance actually paid Joe's pension for four years before recharacterizing the agreement as "revocable" and terminating the pension checks. A reasonable jury could have inferred from this history that retirement at full salary was part of the basic understanding between Jim and Joe. . . .

We conclude that the district court did not err in leaving it to the jury to resolve the parties' dispute over the existence of a retirement agreement for Joe.

III. [omitted]

IV. Insurance argues that enforcement of the oral contract for lifetime employment, including retirement benefits, is barred by the Massachusetts statute of frauds, because it was impossible for the parties to perform the contract within a year.[5] Massachusetts courts, however, have consistently ruled that "this clause of the statute [exempting contracts capable of performance in a year's time] applies only to contracts which by their terms cannot be performed within the year. It does not apply to contracts which may be performed within, although they may also extend beyond, that period." . . . A contract for lifetime employment is not subject to the statute of frauds, because the contract may be performed within one year if the employee happens to die within the year. . . .

The fact that the present contract provided for retirement benefits and that the instant dispute, arising during Joe's senior years, pertains to the payment of compensation during retirement, does not indicate that the contract could not have been performed within its initial year, had Joe had the misfortune to die then, while still in his 40s. The jury expressly found that in exchange for Joe's promise to join his brothers in Andover and "work with them for the balance of his working days," Jim (on behalf of Insurance) promised that Joe's "compensation would include retirement benefits for his remaining life." If Joe were to have died within the year, he would have completely fulfilled his promise to work "for the balance of his working days" (because his working days would have been over), and Insurance would have fulfilled its promise to compensate him for his remaining life.[6] The contract was analogous, therefore, to a contract for lifetime employment rather than to one for a term of years. This oral agreement falls outside the statute of frauds, because it "may [have been] performed within, although [it] may also extend beyond, [a one-year] period." The oral agreement was enforceable under Massachusetts law.

V. [omitted]

There was no error.

Affirmed.

Footnotes:

5 The statute provides: "Actionable contracts; necessity of writing. No action shall be brought: . . . upon an agreement that is not to be performed within one year from the making thereof; unless the promise, contract or agreement upon which such action is brought, or some memorandum or note thereof, is in writing and signed by the party to be charged therewith or by some person thereunto by him lawfully authorized." Mass. Gen. Laws ch. 259, § 1(5) (1986).

6 If Joe had died before retirement, Insurance would not have been required to provide retirement benefits. Insurance's promise was to provide retirement benefits for the duration of Joe's life after completion of his "working days." If Joe had died during his working days, he would have had no remaining life during which to pay retirement. Therefore, upon Joe's death, Insurance would have fully performed its promise even though it never paid retirement benefits.

SHIRLEY MacLAINE PARKER, Plaintiff and Respondent, v. TWENTIETH CENTURY-FOX FILM CORPORATION, Defendant and Appellant

Supreme Court of California

3 Cal. 3d 176

September 30, 1970

JUDGES: In Bank. Opinion by Burke, J., with McComb, Peters and Tobriner, JJ., and Kaus and Roth, JJ., concurring. Dissent by Sullivan, Acting C. J.

Defendant Twentieth Century-Fox Film Corporation appeals from a summary judgment granting to plaintiff the recovery of agreed compensation under a written contract for her services as an actress in a motion picture. As will appear, we have concluded that the trial court correctly ruled in plaintiff's favor and that the judgment should be affirmed.

Plaintiff is well known as an actress, and in the contract between plaintiff and defendant is sometimes referred to as the "Artist." Under the contract, dated August 6, 1965, plaintiff was to play the female lead in defendant's contemplated production of a motion picture entitled "Bloomer Girl." The contract provided that defendant would pay plaintiff a minimum "guaranteed compensation" of $53,571 per week for 14 weeks commencing May 23, 1966, for a total of $750,000. Prior to May 1966 defendant decided not to produce the picture and by a letter dated April 4, 1966, it notified plaintiff of that decision and that it would not "comply with our obligations to you under" the written contract.

By the same letter and with the professed purpose "to avoid any damage to you," defendant instead offered to employ plaintiff as the leading actress in another film tentatively entitled "Big Country, Big Man" (hereinafter, "Big Country"). The compensation offered was identical, as were 31 of the 34 numbered provisions or articles of the original contract. Unlike "Bloomer Girl," however, which was to have been a musical production, "Big Country" was a dramatic "western type" movie. "Bloomer Girl" was to have been filmed in California; "Big Country" was to be produced in Australia. Also, certain terms in the proffered contract varied from those of the original. Plaintiff was given one week within which to accept; she did not and the offer lapsed. Plaintiff then commenced this action seeking recovery of the agreed guaranteed compensation.

The complaint sets forth two causes of action. The first is for money due under the contract; the second, based upon the same allegations as the first, is for damages resulting from defendant's breach of contract. Defendant in its answer admits the existence and validity of the contract, that plaintiff complied with all the conditions, covenants and promises and stood ready to complete the performance, and that defendant breached and "anticipatorily repudiated" the contract. It denies, however, that any money is due to plaintiff either under the contract or as a result of its breach, and pleads as an affirmative defense to both causes of action plaintiff's allegedly deliberate failure to mitigate damages, asserting that she unreasonably refused to accept its offer of the leading role in "Big Country."

Plaintiff moved for summary judgment, the motion was granted, and summary judgment for $750,000 plus interest was entered in plaintiff's favor. This appeal by defendant followed. . . .

As stated, defendant's sole defense to this action which resulted from its deliberate breach of contract is that in rejecting defendant's substitute offer of employment plaintiff unreasonably refused to mitigate damages.

The general rule is that the measure of recovery by a wrongfully discharged employee is the amount of salary agreed upon for the period of service, less the amount which the employer affirmatively proves the employee has earned or with reasonable effort might have earned from other employment. However, before projected earnings from other employment opportunities not sought or accepted by the discharged employee can be applied in mitigation, the employer must show that the other employment was comparable, or substantially similar, to that of which the employee has been deprived; the employee's rejection of or failure to seek other available employment of a different or inferior kind may not be resorted to in order to mitigate damages.

In the present case defendant has raised no issue of *reasonableness of efforts* by plaintiffs to obtain other employment; the sole issue is whether plaintiff's refusal of defendant's substitute offer of "Big Country" may be used in mitigation. Nor, if the "Big Country" offer was of employment different or inferior when compared with the original "Bloomer Girl" employment, is there an issue as to whether or not plaintiff acted reasonably in refusing the substitute offer.

Despite defendant's arguments to the contrary, no case cited or which our research has discovered holds or suggests that reasonableness is an element of a wrongfully discharged employee's option to reject, or fail to seek, different or inferior employment lest the possible earnings therefrom be charged against him in mitigation of damages.

Applying the foregoing rules to the record in the present case, with all intendments in favor of the party opposing the summary judgment motion — here, defendant — it is clear that the trial court correctly ruled that plaintiff's failure to accept defendant's tendered substitute employment could not be applied in mitigation of damages because the offer of the "Big Country" lead was of employment both different and inferior, and that no factual dispute was presented on that issue. The mere circumstance that "Bloomer Girl" was to be a musical review calling upon plaintiff's talents as a dancer as well as an actress, and was to be produced in the City of Los Angeles, whereas "Big Country" was a straight dramatic role in a "Western Type" story taking place in an opal mine in Australia, demonstrates the difference in kind between the two employments; the female lead as a dramatic actress in a western style motion picture can by no stretch of imagination be considered the equivalent of or substantially similar to the lead in a song-and-dance production.

Additionally, the substitute "Big Country" offer proposed to eliminate or impair the director and screenplay approvals accorded to plaintiff under the original "Bloomer Girl" contract, and thus constituted an offer of inferior employment. No expertise or judicial notice is required in order to hold that the deprivation or infringement of an employee's rights held under an original employment contract converts the available "other employment" relied upon by the employer to mitigate damages, into inferior employment which the employee need not seek or accept.

In view of the determination that defendant failed to present any facts showing the existence of a factual issue with respect to its sole defense — plaintiff's rejection of its substitute employment offer in mitigation of damages — we need not consider plaintiff's further contention that for various reasons plaintiff was excused from attempting to mitigate damages.

The judgment is affirmed.

DISSENT BY: SULLIVAN, Acting C. J.

The basic question in this case is whether or not plaintiff acted reasonably in rejecting defendant's offer of alternate employment. The answer depends upon whether that offer (starring in "Big Country, Big Man") was an offer of work that was substantially similar to her former employment (starring in "Bloomer Girl") or of work that was of a different or inferior kind. To my mind this is a factual issue which the trial court should not have determined on a motion for summary judgment. The majority have not only repeated this error but have compounded it by applying the rules governing mitigation of damages in the employer-employee context in a misleading fashion. Accordingly, I respectfully dissent.

The familiar rule requiring a plaintiff in a tort or contract action to mitigate damages embodies notions of fairness and socially responsible behavior which are fundamental to our jurisprudence. Most broadly stated, it precludes the recovery of damages which, through the exercise of due diligence, could have been avoided. Thus, in essence, it is a rule requiring reasonable conduct in commercial affairs. This general principle governs the obligations of an employee after his employer has wrongfully repudiated or terminated the employment contract. Rather than permitting the employee simply to remain idle during the balance of the contract period, the law requires him to make a reasonable effort to secure other employment. He is not obliged, however, to seek or accept any and all types of work which may be available. Only work which is in the same field and which is of the same quality need be accepted.

In California, it has been held that he must accept employment which is "substantially similar." . . .

The relevant language excuses acceptance only of employment which is of a *different kind*. It has never been the law that the mere existence of *differences between two jobs in the same field* is sufficient, as a matter of law, to excuse an employee wrongfully discharged from one from accepting the other in order to mitigate damages. Such an approach would effectively eliminate any obligation of an employee to attempt to minimize damage arising from a wrongful discharge. The only alternative job offer an employee would be required to accept would be an offer of his former job by his former employer.

Although the majority appear to hold that there was a difference "in kind" between the employment offered plaintiff in "Bloomer Girl" and that offered in "Big Country", an examination of the opinion makes crystal clear that the majority merely point out differences between the two *films* (an obvious circumstance) and then assert that these constitute a difference in the *kind* of *employment*. The entire rationale of the majority boils down to this: that the "*mere* *circumstances*" that "Bloomer Girl" was to be a musical review while "Big Country" was a straight drama "demonstrates the difference in kind" since a female lead in a western is not "the equivalent of or substantially similar to" a lead in a musical. This is merely attempting to prove the proposition by repeating it. It shows that the vehicles for the display of the star's talents are different but it does not prove that her employment as a star in such vehicles is of necessity different *in kind* and either inferior or superior.

The inquiry in cases such as this should not be whether differences between the two jobs exist (there will always be differences) but whether the differences which are present are substantial enough to constitute differences in the *kind* of employment or, alternatively, whether they render the substitute work employment of an *inferior kind*.

It seems to me that *this* inquiry involves, in the instant case at least, factual determinations which are improper on a motion for summary judgment. Resolving whether or not one job is substantially similar to another or whether, on the other hand, it is of a different or inferior kind, will often (as here) require a critical appraisal of the similarities and differences between them in light of the importance of these differences to the employee. This necessitates a weighing of the evidence, and it is precisely this undertaking which is forbidden on summary judgment. . . .

It is not intuitively obvious, to me at least, that the leading female role in a dramatic motion picture is a radically different endeavor from the leading female role in a musical comedy film. Nor is it plain to me that the rather qualified rights of director and screenplay approval contained in the first contract are highly significant matters either in the entertainment industry in general or to this plaintiff in particular. Certainly, none of the declarations introduced by plaintiff in support of her motion shed any light on these issues. Nor do they attempt to explain why she declined the offer of starring in "Big Country, Big Man." Nevertheless, the trial court granted the motion, declaring that these approval rights were "critical" and that their elimination altered "the essential nature of the employment."

I believe that the judgment should be reversed so that the issue of whether or not the offer of the lead role in "Big Country, Big Man" was of employment comparable to that of the lead role in "Bloomer Girl" may be determined at trial.

CALIFORNIA AND HAWAIIAN SUGAR COMPANY, a California Corp., Plaintiff-Appellant v. SUN SHIP, INC., a Pennsylvania Corp., Defendant/Appellant

United States Court of Appeals for the Ninth Circuit

794 F.2d 1433

May 14, 1986, Argued

JUDGES: Nelson, Canby and Noonan, Circuit Judges. Opinion by Noonan

Jurisdiction in this case is based on the diversity of citizenship of California and Hawaiian Sugar company (C and H), a California corporation; and Sun Ship, Inc. (Sun), a Pennsylvania corporation. Interpreting a contract which provides for construction by the law of Pennsylvania, we apply Pennsylvania law. The appeal is from a judgment of the district court in favor of C and H on the main issues. Reviewing the district court's interpretation of the contract anew as a matter of law and respecting the findings of fact of the district court when not clearly erroneous, we affirm the judgment in all respects.

BACKGROUND

C and H is an agricultural cooperative owned by fourteen sugar plantations in Hawaii. Its business consists in transporting raw sugar — the crushed cane in the form of coarse brown crystal — to its refinery in Crockett, California. Roughly one million tons a year of sugar are harvested in Hawaii. A small portion is refined there; the bulk goes to Crockett. The refined sugar — the white stuff — is sold by C and H to groceries for home consumption and to the soft drink and cereal companies that are its industrial customers.

To conduct its business, C and H has an imperative need for assured carriage for the raw sugar from the islands. Sugar is a seasonal crop, with 70 percent of the harvest occurring between April and October, while almost nothing is harvestable during December and January. Consequently, transportation must not only be available, but seasonably available. Storage capacity in Hawaii accommodates not more than a quarter of the crop. Left stored on the ground or left unharvested, sugar suffers the loss of sucrose and goes to waste. Shipping ready and able to carry the raw sugar is a priority for C and H.

In 1979 C and H was notified that Matson Navigation Company, which had been supplying the bulk of the necessary shipping, was withdrawing its services as of January 1981. While C and H had some ships at its disposal, it found a pressing need for a large new vessel, to be in service at the height of the sugar season in 1981. It decided to commission the building of a kind of hybrid — a tug of catamaran design with two hulls and, joined to the tug, a barge with a wedge which would lock between the two pontoons of the tug, producing an "integrated tug barge." In Hawaiian, the barge and the entire vessel were each described as a Mocababoo or push boat.

C and H relied on the architectural advice of the New York firm, J. J. Henry. It solicited bids from shipyards, indicating as an essential term a "preferred delivery date" of June 1981. It decided to accept Sun's offer to build the vessel.

In the fall of 1979 C and H entered into negotiations with Sun on the precise terms of the contract. Each company was represented by a vice-president with managerial responsibility in the area of negotiation; each company had a team of negotiators; each company had the advice of counsel in drafting the agreement that was signed on November 14, 1979. The contract identified C and H as the Purchaser, and Sun as the Contractor; it identified "one non-self-propelled oceangoing barge" as the Vessel that Purchaser was buying from Contractor. Article I provided that Contractor would deliver the Vessel on June 30, 1981. The contract price was $25,405,000.

Under Article I of the agreement, Sun was entitled to an extension of the delivery date for the usual types of force majeure [e.g. war or other acts of God]. . . Article 17 "Delivery" provided that "the Vessel shall be offered for delivery fully and completely connected with the Tug." Article 8, "Liquidated Damages for Delay in Delivery" provided that if "Delivery of the Vessel" was not made on "the Delivery Date" of June 30, 1981, Sun would pay C and H "as per-day liquidated damages, and not as a penalty" a sum described as "a reasonable measure of the damages" — $17,000 per day.

The tug (the "Vessel" of that contract) was to be delivered on April 30, 1981 at Sun's shipyard.

The sub-contractor did not complete the tug until July 15, 1982. Sun did not complete the barge until March 16, 1982. Tug and barge were finally connected under C and H's direction in mid-July 1982 and christened the Moku Pahu. Although Sun paid C and H $17,000 per day from June 30, 1981 until January 10, 1982, it ultimately denied liability for any damages, and this lawsuit resulted.

ANALYSIS

Sun contends that the $17,000 per day is a penalty, not to be enforced by the court. The barge, Sun points out, was useless to C and H without the tug. Unconnected, the barge was worse than useless — it was an expensive liability. C and H did not want the barge by itself. To get $17,000 per day as "damages" for failure to provide an unwanted and unusable craft is, Sun says, to exact a penalty. . . Breach of contract entitles the wronged party only to fair compensation.

Seductive as Sun's argument is, it does not carry the day. Represented by sophisticated representatives, C and H and Sun reached the agreement that $17,000 a day was the reasonable measure of the loss C and H would suffer if the barge was not ready. Of course they assumed that the tug would be ready. But in reasonable anticipation of the damages that would occur if the tug was ready and the barge was not, Article 8 was adopted. As the parties foresaw the situation, C and H would have a tug waiting connection but no barge and so no shipping. The anticipated damages were what might be expected if C and H could not transport the Hawaiian sugar crop at the height of the season. Those damages were clearly before both parties. As Sun's chief negotiator testified, he had "a vision" of a "mountain of sugar piling up in Hawaii" — a vision that C and H conjured up in negotiating the damage clause. Given the anticipated impact on C and H's raw sugar and on C and H's ability to meet the demands of its grocery and industrial customers if the sugar could not be transported, liquidated damages of $17,000 a day were completely reasonable.

The situation as it developed was different from the anticipation. The barge was not ready but neither was the tug. C and H was in fact able to find other shipping. The crop did not rot. The customers were not left sugarless. Sun argues that, measured by the actual damages suffered, the liquidated damages were penal.

We look to Pennsylvania law for guidance. Although no Pennsylvania case is squarely on point, it is probable that Pennsylvania would interpret the contract as a sale of goods governed by the Uniform Commercial Code. . . . The governing statute provides that liquidated damages are considered reasonable "in the light of anticipated or actual harm.". . .

The choice of the disjunctive appears to be deliberate. The language chosen is in harmony with the Restatement (Second) of Contracts § 356 (1979), which permits liquidated damages in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss: "The amount fixed is reasonable to the extent that it approximates the loss anticipated at the time of the making of the contract, even though it may not approximate the actual loss.". . .

Prior to the adoption of the Uniform Commercial Code, Pennsylvania enforced liquidated damage clauses that its courts labeled as nonpenal, but equitable considerations relating to the actual harm incurred were taken into account along with the difficulty of proving damages if a liquidated damage clause was rejected. We do not believe that the *U.C.C.* overrode this line of reasoning. . . .

We conclude, therefore, that in this case of concurrent causation each defaulting contractor is liable for the breach and for the substantial damages which the joint breach occasions. Sun is a substantial cause of the damages flowing from the lack of the integrated tug; Sun cannot be absolved by the absence of the tug. . . .

Sun contends that the actual damages suffered by C and H for lack of the integrated tug boat were slight. Actual damages were found by the district court to consist of "interest on progress payments, unfavorable terms of conversion to long-term financing, and additional labor expense." No dollar amount was determined by the district court in finding that these damages "bore a reasonable relationship to the amount liquidated in the Barge Contract. . . "

The net actual damages suffered by C and H were $368,000. As a matter of law, Sun contends that the liquidated damages are unreasonably disproportionate to the net actual damages.

. . . Promising to pay damages of a fixed amount, the parties normally have a much better sense of what damages can occur. Courts must be reluctant to override their judgment. Where damages are real but difficult to prove, injustice will be done the injured party if the court substitutes the requirements of judicial proof for the parties' own informed agreement as to what is a reasonable measure of damages. Pennsylvania acknowledges that a seller is bound to pay consequential damages if the seller had reason to know of the buyer's special circumstances. The liquidated damage clause here functions in lieu of a court's determination of the consequential damages suffered by C and H. . . .

Proof of its loss is difficult — as difficult, perhaps, as proof of loss would have been if the sugar crop had been delivered late because shipping was missing. Whatever the loss, the parties had promised each other that $17,000 per day was a reasonable measure. The court must decline to substitute the requirements of judicial proof for the parties' own conclusion. The Moku Pahu, available on June 30, 1981, was a great prize, capable of multiple employments and enlarging the uses of the entire C and H fleet. When sophisticated parties with bargaining parity have agreed what lack of this prize would mean, and it is now difficult to measure what the lack did mean, the court will uphold the parties' bargain. C and H is entitled to keep the liquidated damages of $3,298,000 it has already received and to receive additional liquidated damages of $1,105,000 with interest thereon.

AFFIRMED.

MARGUERITE A. O'NEILL, Plaintiff-Appellee, v. GALLANT INSURANCE COMPANY, Defendant-Appellant.

Appellate Court of Illinois, Fifth District

329 Ill. App. 3d 1166; 769 N.E.2d 100

April 23, 2002, Filed

JUDGES: Honorable Clyde L. Kuehn, Justice, delivered the opinion of the court. Honorable Philip J. Rarick, J., and Honorable Thomas M. Welch, J., Concur.

In this case, an insurance company took its small stake in the outcome of a personal-injury claim, $20,000 worth of liability coverage purchased by one of its customers, and transformed it into a multimillion-dollar judgment against the carrier. For reasons that are not entirely clear, John Moss, executive vice president of Warrior Insurance Group, the person primarily responsible for this action, bypassed a chance to settle an insured's obvious liability for catastrophic personal injuries, and to do so within the insurance policy limits. His decision turned $20,000 worth of contractual duty into a $3,010,063 judgment for a bad-faith refusal to settle within the policy limits.

This remarkable wizardry had its origins on October 31, 1996. On that Halloween day, a Gallant Insurance Company customer named Christine Narvaez drove her insured automobile onto the parking lot of a busy Granite City supermarket. Christine had her two-year-old grandchild with her. The youngster was riding, unconstrained, in a booster seat. Christine saw a friend and decided to stop for a brief chat. She parked and exited the car, leaving the keys in the ignition and the motor running. Thus, circumstances awaited the mischief that her unattended two-year-old grandchild could glean from being left alone in a car with its engine running.

Gallant Insurance Company's insured played quite a Halloween trick on shoppers in the vicinity of her car. The trick treated Marguerite O'Neill to lifelong confinement in a nursing home. It only took a moment for Christine's little nipper to crawl behind the wheel, slip the car into gear, and set it into motion. As the car rolled out of control, it collided with two other cars and two pedestrians. Mrs. O'Neill was the most severely damaged victim of Christine's negligence.

Mrs. O'Neill was in her eighties and could not physically evade the slow-moving car as it approached her. The insured's vehicle pinned her between it and another car and slowly crushed her trapped body. Mrs. O'Neill was pried loose and airlifted to St. Louis University Hospital Trauma Center, where she spent the next month in the intensive care unit. Her body suffered a crushed hip, a broken arm, four cracked ribs, and two fractured fingers. She lost more than 40% of her blood supply as a result of internal bleeding. The blood loss triggered respiratory shock. Mrs. O'Neill was given a tracheotomy and was placed on a respirator for 24 days.

The accident had lasting consequences. It deprived Mrs. O'Neill of the ability to live life independently of others. It placed her into a nursing home, where she remains to this day.

Gallant Insurance Company (Gallant) insured Christine with the statutory minimum amount of coverage against liability arising out of the operation of her car. Consequently, there was only$20,000 worth of coverage to address the catastrophic damages that Christine's negligence wrought. Not including her other damages, Mrs. O'Neill's medical bills amounted to $105,000.

Mrs. O'Neill's attorney demanded the policy limits in settlement of her claim. He offered a *complete release from liability for Christine*, provided that Gallant would promptly tender its check for Christine's $20,000 liability coverage. Gallant was given 30 days to decide. Confronted with a case of obvious liability with potential damages far in excess of the policy limits, *Gallant did not dignify the demand with a response*. The 30 days passed and Gallant remained silent. It did not try to negotiate. It did not attempt a counteroffer. It did not even tell Christine that the elderly lady that she hurt was willing to forego a personal judgment for more than the amount with which Christine was insured. Gallant simply ignored the offer to settle, and a window of opportunity to protect its customer from an excess judgment closed. Moss bypassed the chance to authorize the payment of the coverage that Christine had purchased from Gallant. As a result of his decision, Christine suffered a large excess judgment. Gallant's refusal to even respond to an invitation for settlement occurred under baffling circumstances.

Gallant's initial adjuster noted in the claims diary that Christine was clearly negligent and that Gallant was responsible for the damages that she caused. His opinion was reviewed by an immediate supervisor and a claims director, and both concurred in his liability evaluation. Based upon that opinion, Gallant paid the two property-damage claims that stemmed from the accident. When Mrs. O'Neill registered her claim through a lawyer, the claim was forwarded to a more seasoned adjuster. She examined her younger counterpart's work, conducted her own independent investigation of the claim, and *before a demand was even made*, recommended the payment of the $20,000 policy limits. A claims manager reviewed this recommendation. She wrote to Moss and conveyed her opinion that the policy limits should be tendered.

Gallant did not have a claims department. *Only Moss . . . could authorize any Gallant settlement payment in excess of $15,000*.

Warrior's claims manager, someone with a decidedly conservative approach to the settlement of automobile liability claims, wrote and advised Moss that the tender of the policy limits was a necessary step "in order to make sure that the policyholder's interests were treated with equal weight as the company's interests."

Moss also heard from the lawyers Gallant hired to defend against O'Neill's lawsuit. . .   Two weeks prior to the settlement demand's expiration, those lawyers wrote to Moss with an evaluation and a recommendation. Christine's lawyers told him that *liability was clear*. They also told him that the *verdict potential* on that obvious liability rested within a dollar range *15 to 30 times the amount of coverage*. Two weeks before the chance to settle within the policy limits was forever lost, Christine's lawyers urged Moss to tender those limits. In their professional judgment, it was clearly the prudent thing to do.

Moss decided to reject everyone's advice. His decision to disregard the adjusters' opinions, the director's opinion, his claims manager's opinion, and Christine's lawyers' opinions occurred without explanation or notation in the claims diary. . . .

Almost a year after the demand to settle for the policy limits had expired, and only a few days before the trial on the underlying personal-injury action was to begin, Moss decided to authorize an offer of $20,000 in order to settle the case. By that time, Mrs. O'Neill had no interest in accepting such an offer. She had incurred more than $3,000 in costs readying the case for a trial, and there was no offer to defray them. Mrs. O'Neill's economic losses as a result of the accident had nearly doubled since the demand expired, and her contingency-fee structure had also increased. On the eve of trial, Mrs. O'Neill was intent on seeing what kind of an award a jury would return. Hopefully, Christine would personally satisfy the amount by which the jury's award might exceed Christine's insurance coverage.

Moss preferred a last-minute offer of the policy limits to a jury test of his good-faith belief that liability was lacking. Unfortunately, he made the decision to forego his belief too late. The chance to obtain a release in return for $20,000 had come and gone.

A few days after Mrs. O'Neill's refusal of Gallant's offer, a jury found for her and against Christine and awarded $731,063 in damages. The verdict came as no surprise to anyone in Gallant who was ever entrusted with the task of evaluating the claim. We are not even sure that it surprised Moss. Gallant's lawyers asked him to send a $20,000 company check, and he complied, before the verdict was even returned. Christine owed Mrs. O'Neill $711,063. The only reason that she owed it was her carrier's decision not to meet the demand for the policy limits. Moss's good-faith belief that there was no liability on Christine's part proved to be misplaced. The mistake resulted in Christine's financial ruin.

A supplementary action was commenced in order to enforce the judgment against Christine. Her potential claim against Gallant for its failure to settle Mrs. O'Neill's claim within the policy limits was assigned to Mrs. O'Neill, who then brought this lawsuit against Gallant. The case was tried to a jury. The jury found in Mrs. O'Neill's favor and awarded actual damages in the sum of $710,063 and punitive damages in the sum of $2.3 million. Interest was also awarded.

A significant part of the evidence presented against Gallant consisted of the pattern of conduct engaged in by Gallant over the five years leading up to this bad-faith action. Mrs. O'Neill presented 44 known cases where Gallant's Illinois customers suffered excess judgments after Gallant passed up the opportunity to settle within the policy limits. Most of the excess judgments occurred on John Moss's watch. The dollar amount by which the excess judgments exceeded policy limits totaled *$10,849,313*. This staggering total was accumulated through jury awards on automobile accident cases, a class of personal injury generally known for miserly jury verdicts. All but $449,313 of this amount was awarded *after Moss took over* control of the settlement process in June of 1997.

Gallant argues that the jury's verdict, based upon the finding that Gallant acted in bad faith in its handling of Mrs. O'Neill's claim, is contrary to the manifest weight of the evidence. This is a question that we review with deference to the jury. Its findings will not be overturned unless they are "manifestly erroneous."

Where an insurer is pursued for its refusal to settle a claim, "bad faith" lies in an insurer's failure to give at least equal consideration to the insured's interests when the insurer arrives at a decision on whether to settle the claim. This is precisely the standard set forth by Donna Hedl, Warrior's claims manager, when she wrote Moss and gave her opinion of how Mrs. O'Neill's claim should be handled. She wrote that the policy limits should be tendered "in order to make sure that the policyholder's interests were treated with equal weight as the company's interests." Her admission, standing alone, provides ample evidence of bad faith. However, there was other evidence of bad faith to support the jury's verdict. . . .

Gallant knew from the lawyers it hired to protect Christine's interests that the verdict potential was, at a minimum, 15 times the amount of insurance protection. The medical bills alone were more than five times that protection. The decision to reject the chance to settle a claim of this magnitude signals bad faith. . . .

The jury's finding of bad faith was not against the manifest weight of the evidence.

We turn to the question of whether punitive damages can be awarded for an insurance company's bad-faith refusal to settle. We hold that they can. . . .

Although punitive damages are not the law's favorite, Illinois has traditionally authorized the recovery of punitive damages in tort cases involving intentional misconduct or a breach of fiduciary duty. . . .

In a case like this one, we think that punitive damages for a bad-faith refusal to settle are appropriate and warranted. After all, punitive damages are designed to deter misconduct. Hopefully, the availability of punitive damages can provide some degree of deterrent against unscrupulous insurers who would otherwise take advantage of customers and abuse their fiduciary relationship in order to promote their own economic self-interest. Gallant needed to be told through the award of punitive damages that it had to stop its common practice of ignoring policy-limit demands in serious cases where liability was clear-cut. It had to be punished for a pattern of misconduct that exposed its policyholders to more than $10 million in excess judgments. . . .

Suffice it to say, there was ample evidence from which a jury could reasonably infer that Gallant *deliberately* chose to gamble with Christine's financial security, in the hope of *merely delaying the payment of minimal policy limits*. It would have been quite reasonable for jurors to conclude that Gallant threw Christine's financial future to the wind for the small amount of revenue it could derive from its $20,000 before a judgment could be rendered. . . .

We find that an award of punitive damages is supported by the evidence. The jury's award is not manifestly erroneous.

For the reasons stated, we affirm.

Affirmed.

RARICK and WELCH, JJ., concur.

Hadley v. Baxendale

(English case)

9 Exch. 141 (1854)

J. CROMPTON

At the trial before…it appeared that the plaintiffs carried on an extensive business as millers at Gloucester; and that, on the 11th of May, their mill was stopped by a breakage of the crank shaft by which the mill was worked. The steamengine was manufactured by Messrs. Joyce & Co., the engineers, at Greenwich, and it became necessary to send the shaft as a pattern for a new one to Greenwich. The facture was discovered on the 12th, and on the 13th the plaintiffs sent one of their servants to the office of the defendants, who are well-known carriers trading under the name of Pickford & Co., for the purpose of having the shaft carried to Greenwich. The plaintiffs' servant told the clerk that the mill was stopped, and that the shaft must be sent immediately; and in answer to the inquiry when the shaft would be taken, the answer was, that if it was sent up by twelve o'clock any day, it would be delivered at Greenwich on the following day. On the following day the shaft was taken by the defendants before noon, for the purpose of being conveyed to Greenwich…; at the same time the defendants' clerk was told that a special entry, if required, should be made to hasten its delivery. The delivery of the shaft at Greenwich was delayed by some neglect; and the consequence was, that the plaintiffs did not receive the new shaft for several days after they would otherwise have done, and the working of their mill was thereby delayed, and they thereby lost the profits they would otherwise have received.

On the part of the defendants, it was objected that these damages were too remote, and that the defendants were not liable with respect to them. The learned Judge left the case generally to the jury, which found a verdict with £25 damages beyond the amount paid into Court….

ALDERSON, B.

We think there ought to be a new trial in this case; but, in so doing, we deem it to be expedient and necessary to state explicitly the rule which the Judge, at the next trial, ought, in our opinion, to direct the jury to be governed by when they estimate the damages.

It is, indeed, of the last importance that we should do this; for, if the jury are left without any definite rule to guide them, it will, in such cases as these, manifestly lead to the greatest injustice….

Now we think the proper rule in such a case as the present is this; — Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract. For, had the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them. Now the above principles are those by which we think the jury ought to be guided in estimating the damages arising out of any breach of contract. It is said, that other cases such as breaches of contract in the non-payment of money, or in the not making a good title to land, are to be treated as exceptions from this, and as governed by a conventional rule. But as, in such cases, both parties must be supposed to be cognizant of that well-known rule, these cases may, we think, be more properly classed under the rule above enunciated as to cases under known special circumstances, because there both parties may reasonably be presumed to contemplate the estimation of the amount of damages according to the conventional rule. Now, in the present case, if we are to apply the principles above laid down, we find that the only circumstances here communicated by the plaintiffs to the defendants at the time the contract was made, were, that the article to be carried was the broken shaft of a mill, and that the plaintiffs were the millers of that mill. But how do these circumstances shew [sic] reasonably that the profits of the mill must be stopped by an unreasonable delay in the delivery of the broken shaft by the carrier to the third person? Suppose the plaintiffs had another shaft in their possession put up or putting up at the time, and that they only wished to send back the broken shaft to the engineer who made it; it is clear that this would be quite consistent with the above circumstances, and yet the unreasonable delay in the delivery would have no effect upon the intermediate profits of the mill. Or, again, suppose that, at the time of the delivery to the carrier, the machinery of the mill had been in other respects defective, then, also, the same results would follow. Here it is true that the shaft was actually sent back to serve as a model for a new one, and that the want of a new one was the only cause of the stoppage of the mill, and that the loss of profits really arose from not sending down the new shaft in proper time, and that this arose from the delay in delivering the broken one to serve as a model. But it is obvious that, in the great multitude of cases of millers sending off broken shafts to third persons by a carrier under ordinary circumstances, such consequences would not, in all probability, have occurred; and these special circumstances were here never communicated by the plaintiffs to the defendants. It follows, therefore, that the loss of profits here cannot reasonably be considered such a consequence of the breach of contract as could have been fairly and reasonably contemplated by both the parties when they made this contract. For such loss would neither have flowed naturally from the breach of this contract in the great multitude of such cases occurring under ordinary circumstances, nor were the special circumstances which, perhaps, would have made it a reasonable and natural consequence of such breach of contract, communicated to or known by the defendants. The Judge ought, therefore, to have told the jury, that, upon the facts then before them, they ought not to take the loss of profits into consideration at all in estimating the damages…

Super Valu Stores, Inc. v. Thomas J. Peterson

Supreme Court of Alabama

506 So. 2d 317

March 27, 1987, Filed

OPINION: MADDOX

. . . Peterson filed a claim against Super Valu in November 1984. That claim arose out of an alleged willful failure by Super Valu to construct and lease to Peterson a discount grocery store, known as the Oxford County Market. Briefly stated, Peterson's substantive claims at trial were twofold: (1) that Super Valu's deliberate decision not to build this store as previously agreed constituted a material breach of an express contract, destroying Peterson's career plans and causing him to lose millions of dollars, and (2) that certain misrepresentations and nondisclosures by Super Valu resulted in enormous damages to him. On August 7, 1985, the jury returned a verdict against Super Valu and in favor of Peterson in the amount of $5,000,000 and a judgment was entered on the same date.

The facts pertinent to this action follow: Super Valu purchased a parcel of property in Oxford, Alabama, in 1981, and eventually made plans for its development as a "County Market." The County Market concept was a new one; the first County Market opened in 1981. The basic concept of the County Market is that it must be the lowest priced store in the market and operate on a high volume, low profit structure; thus, it must draw customers from a larger market area than a traditional supermarket. Since Super Valu was a wholesaler, it planned to have an independent retailer operate the County Market planned for Oxford. Peterson (who at this time was president of the Anniston Division of Super Valu) presented several potential operators to Super Valu for consideration. . .

At least three other prospective retailers other than Peterson considered operating the Oxford County Market; however, none of these men decided to undertake the project. At this point (May 1983), Peterson decided to become a formal applicant for the retailer's position at the proposed County Market. In January 1984, Peterson was approved as the retailer of the proposed Oxford County Market. This approval required Peterson to retire from his job at Super Valu, because Super Valu policy would not allow an employee to own an interest in a retail grocery store. . . .

In the meantime, progress continued for the development of the store with Peterson as the retailer. Peterson retired from Super Valu on February 29, 1984. In March 1984, Super Valu's attorney spoke to Peterson and asked him to hold off on going forward with the store . . . Peterson, through his attorney, made demands upon Super Valu to continue with the building of the proposed County Market. He later withdrew the demands that the development of the store proceed. On November 19, 1984, Peterson filed a cross-claim against Super Valu, alleging that Super Valu had entered into a binding contract with him whereby he would become the retailer of the proposed County Market in Oxford. . . .

The issue presented is whether Peterson presented competent evidence proving with "reasonable certainty" the lost profits that he suffered as a result of Super Valu's conduct.

Super Valu contends that the trial court erroneously allowed "expert" testimony, and other evidence to the effect that the hypothetical County Market would have earned profits of $20,000,000 in fifteen years of operation by Peterson. Super Valu argues that this Court follows the general rule of damages that anticipated profits of a commercial business are too speculative, remote, and uncertain to permit their recovery. Super Valu argues that the "per se" rule of lost profits should apply to this case. The "per se" rule of lost profits is that anticipated profits of a new or hypothetical business can *never* be recovered, because they are inherently too speculative and conjectural.

Super Valu also contends that there are no Alabama cases that have allowed a plaintiff to recover anticipated profits of a hypothetical business that never operates. Super Valu contends that proof of lost profits must satisfy the "reasonable certainty" test. Super Valu argues that under this test a plaintiff must prove a subsequent profit history and that any uncertainty that plaintiff would in fact have made a profit is fatal to the lost profits recovery. Super Valu also argues that the plaintiff must also establish that he has a profitable, substantially similar business in the same geographic area. Finally, Super Valu contends that Peterson's profit projections constitute remote, speculative, and conjectural evidence.

We are of the opinion that the jury's award of compensatory damages to Peterson is completely consistent with the law of Alabama and with the evidence in this case. Current Alabama law, like the law of other states, authorizes recovery of anticipated profits of an unestablished business, if proved with reasonable certainty. [citation omitted] In this case, Peterson's evidence of lost profits is sufficient to meet the "reasonable certainty" standard and supports the jury award. This Court confirmed that the reasonable certainty standard for proving profits of an unestablished business prevails in Alabama in *Morgan v. South Central Bell Telephone Co.*, 466 So.2d 107 (Ala. 1985): "In order that it may be a recoverable element of damages, the loss of profits must be the natural and proximate, or direct, result of the breach complained of and they must also be *capable of ascertainment with reasonable, or sufficient, certainty, or there must be some basis on which a reasonable estimate of the amount of the profit can be made; absolute certainty is not called for or required*. This general rule is applied in most states, and is referred to as the rule of 'reasonable certainty.". . .

This Court's explicit rationale for applying the reasonable certainty rule was its recognition that to disallow damages for loss of reasonably certain future profits "would encourage breach of contract with new businesses." Alabama jury verdicts awarding lost profits will be affirmed if the plaintiff provides a "basis upon which the jury could, with *reasonable* certainty, calculate the amount of profits which were lost as a result of" defendant's wrongful actions. . . .

The weight of modern authority does not predicate recovery of lost profits upon the artificial categorization of a business as "unestablished," "existing," or "new," particularly where the defendant itself has wrongfully prevented the business from coming into existence and generating a track record of profits. Instead, the courts focus on whether the plaintiff has adduced evidence that provides a basis from which the jury could with "reasonable certainty" calculate the amount of lost profits. . .

The fundamental basis for Peterson's evidence as to damages was *Super Valu's own projections of profits*, produced in its normal course of business long before this dispute arose. These projections were the product of an intense, exhaustive process involving many different Super Valu personnel. Super Valu's projections resulted from the application of a scientific methodology that for many years had accurately predicted the future performance of stores associated with Super Valu. These projections were also based upon the prior successful performance of the Super Valu business system, of which the Oxford County Market would have become a standardized part. The jury could have found that Super Valu and Peterson relied upon these profit projections in making their initial decision to go forward with the Oxford County Market store. Super Valu's three-year profit projections were analyzed and extended by Peterson's expert market analyst. Peterson's expert used Super Valu's figures as a base in order to make further profit projections for the 12 subsequent years of the 15-year lease that Super Valu had allegedly agreed to grant Peterson. This evidence was sufficient, in our judgment, to satisfy the "reasonable certainty" standard established in Alabama law for satisfactory proof of lost profits.

In considering claims by unestablished or new businesses for lost profits, courts have consistently given special deference to a party's pre-dispute projections of anticipated profits. . . . The courts have permitted pre-dispute projections to be extrapolated into future years in order to determine the full measure of lost profits. . . . These cases provide strong support for the upholding of the jury verdict for Peterson. Here, Super Valu developed projections as to the anticipated profits that Peterson would earn from the Oxford County Market. . . . Using a methodology embraced by the courts, Peterson's expert used Super Valu's own calculations and extrapolated those projections into future years to determine the full measure of lost profits.

Introduced into evidence was Super Valu's description of the proven accuracy of its sales projections, as follows:

"[Super Valu's team] produces an *extremely accurate* site evaluation report. This team service takes the uncertainty out of expansion, accurately forecasts sales for new or existing supermarkets, [tells] the most profitable store size, estimates the dollar sales that will transfer from existing sister stores, identifies current market position for all supermarkets in an area. . . [and] predicts sales changes for long term. . . . These techniques make it possible for Super Valu market analysts to make accurate forecasts for any site, for any type of supermarket, in any part of the country."

The jury could have found that Super Valu's comments concerning the accuracy of its projections were well-founded in fact, because there was evidence that Super Valu conducted follow-up reports comparing actual performance to the sales projections. Total actual sales as a percentage of projected sales for the category of "stores in new buildings" ranged from 92.1% to 125.6%.

Applying its proven research and analytical techniques to the proposed Oxford County Market, Super Valu concluded that the new store would achieve average weekly sales of $377,160, $433,734, and $471,450 in its first three years of operation. One of Super Valu's employees acknowledged that the analysis was "good, solid" and had been performed in the customary manner. Based on its extensive research and lengthy reports, Super Valu concluded that the "County Market for Anniston/Oxford looks like a winner."

Super Valu's sales projections for the Oxford County Market were incorporated into a *pro forma* profit and loss statement for the proposed store. Before this dispute arose, Super Valu generated its *pro forma* profit and loss statement for the purpose of deciding whether to enter a contract with Peterson. Super Valu's own *pro forma* statement projected profits of $124,684, $619,267 and $750,198 during the first three years of operation of the Oxford County Market. Super Valu's director of market analysis expressly acknowledged that this *pro forma* statement was "reasonable" and saw no reason to challenge its bottom line figures.

As already stated, Peterson's market expert relied on Super Valu's pre-dispute profit projections and extrapolated those figures through the full term of the 15-year lease. The projected profits for the 15-year lease term totaled over $19 million. Peterson's market expert testified that the profit projections provided a "reasonably certain" basis for calculating lost profits for the Oxford County Market. . . .

We are of the opinion that the jury verdict of $5 million was supported by credible evidence. . . .

The judgment of the trial court is due to be, and it hereby is, affirmed.

AFFIRMED.

KEITH M. SHARICK, Appellant, vs. SOUTHEASTERN UNIVERSITY OF THE HEALTH SCIENCES, INC., d/b/a COLLEGE OF OSTEOPATHIC MEDICINE, Appellee.

Court of Appeal of Florida, Third District

780 So. 2d 142
April 4, 2001, Opinion Filed

JUDGES: SCHWARTZ, C.J., and SHEVIN and SORONDO, JJ. SCHWARTZ, C.J., and GODERICH, FLETCHER, SHEVIN, SORONDO and RAMIREZ, JJ., concur. RAMIREZ, J. (concurring). LEVY, Judge (dissenting). JORGENSON, GERSTEN and GREEN, JJ., concur. Judge Cope is recused.

Keith M. Sharick, a fourth-year medical student, was dismissed from the College of Osteopathic Medicine (Southeastern), when he was given a failing grade in the final course he required for graduation, a rural rotation in general medicine at the Clewiston Community Health Center. Following several unsuccessful appeals within the university's review process, Sharick filed a complaint, which was amended several times, alleging multiple tort and contract claims against Southeastern. The only claim that ultimately went before the jury was breach of implied-in-fact contract. The trial court disallowed Sharick's claims for specific performance and past and future lost earning capacity and only permitted the jury to consider damages with respect to tuition expenses. The jury found for Sharick, concluding that Southeastern's decision to dismiss him was arbitrary, capricious, and/or lacking any discernable rational basis, and awarded a partial reimbursement of the tuition paid to Southeastern. Sharick now appeals, claiming that the trial court erred in denying him the right to plead and prove loss of future earning capacity. We reverse. . . .

In this case, the jury found that the university's decision to dismiss Sharick was arbitrary, capricious, and/or lacking any discernable rational basis. This determination is supported by competent, substantial evidence. Southeastern has not challenged the propriety of the adverse jury verdict on cross-appeal. Therefore, the sole issue presently before the court is the appropriate measure of damages for Sharick's wrongful dismissal less than two months prior to when he expected to graduate and obtain his degree as a doctor of osteopathic medicine (DO). . . .

Southeastern's publications at the time of Sharick's enrollment clearly support this conclusion. The preface to the student handbook reflects that the "objective of the University is to offer . . . health care science training and education to its students with the purpose of developing competent physicians . . . who can serve in all areas of our region." The handbook proceeds to identify Southeastern endorsed organizations whose goal is to produce osteopathic physicians. The course of study is outlined as a "four year curriculum ***leading to the DO degree***." (emphasis added). As such, the receipt of a DO degree upon the successful completion of Sharick's studies was reasonably within the contemplation of the parties at the time Sharick and Southeastern entered into their implied-in-fact contract.

In valuing the loss of this degree within the context of an arbitrary, capricious or bad faith deprivation of such, we conclude that it is appropriate to consider the possibility of lost future earnings. We agree with Sharick that the value of a professional degree, particularly to a prospective physician who has successfully completed the overwhelming majority of the academic and clinical requirements, significantly exceeds the tuition cost expended. Southeastern argues that recovery of anything beyond tuition reimbursement when a school dismisses a student from classes is precluded because any other damages would be too remote, contingent, conjectural and speculative and could not be established within a reasonable degree of certainty. . .

The record in this case establishes that but for Sharick's dismissal from the university, he would have obtained his DO degree some two months thereafter. As the fact of Sharick's damage as the result of Southeastern's breach of contract can be proved with certainty, we reverse and remand for a new trial on damages. Upon retrial, Sharick must be afforded the opportunity to plead and prove damages in the form of the loss of earning capacity that would reasonably have resulted had he received his DO degree. . . .

Accordingly, the extent or amount of the resulting impairment to Sharick's earning capacity may be determined by a jury based upon reasonable inference. Upon retrial, both parties are free to present evidence as to what impact Sharick's academic and clinical performance may have had upon his ultimate success as an osteopathic physician.

RAMIREZ, J. (concurring).

I concur in the panel opinion in which we reverse and remand for a new trial on damages. I write separately only to address some of the arguments raised by the parties during en banc proceedings.

The judiciary has traditionally deferred to colleges and universities concerning decisions to deny degrees, certificates or academic credit. . . . One of the vestiges of our past judicial deference is the current requirement that a student seeking redress for the denial of a degree or academic credit cannot prevail against a learning institution unless the school's behavior was arbitrary and capricious. Commentators uniformly agree that this is an extremely high burden. In this case, that burden has been met; the jury found that Southeastern University acted arbitrarily and capriciously, and Southeastern University has not challenged that finding. The issue now devolves into a determination of damages.

The panel opinion here does not suggest that we should assume that Sharick would have completed all his degree requirements. Rather, this Court would require Sharick to prove that he would in fact have graduated but for Southeastern University's arbitrary and capricious behavior.

In this case, Sharick did have a contractual relationship with Southeastern University and the University arbitrarily and capriciously breached that contract. Consequently, Sharick should be allowed to recover traditional breach of contract damages. . . . Ordinarily the remedy available in these circumstances would be reinstatement rather than damages. It is, however, apparent that damages arising from a wrongful dismissal could in the proper case be alleged and be shown without an assumption that the academic requirements were met, but these elements would be quite different from the ones here asserted, and would look more like those applied in tort actions.

The best analogy to Sharick's situation can be found in cases where new businesses assert lost profits as consequential damages for breach of contract. Both the panel decision and the dissent discuss the Florida cases in this area, but an analysis of the cases in other jurisdictions indicates that the majority view allows a new business to seek lost profits using its best evidence. . . .

Until recently, the majority rule in this country prohibited a jury's verdict of damages for lost profits of a new business. . . . These cases were generally decided on the basis that loss of profits from a new business was merely speculative and incapable of being ascertained with the requisite degree of certainty. . . Such reasoning is supported by the generally accepted rule of contract law that damages are not recoverable unless they are reasonably certain. . . .

The dissent also speculates on what evidence Sharick will present upon remand, then proceeds to denigrate the evidence as not within a reasonable degree of certainty. The dissent's speculative approach does provide certainty: the certainty that Sharick will be denied his day in court as to what his lost future earnings might be. It would be patently unfair to deny damages to a student after a school has acted arbitrarily and capriciously, provided that the student can prove those damages with reasonable certainty. . . .

Thus, I believe that, as a matter of public policy, the panel opinion is on solid ground. By our decision, we are only requiring that schools not act in an arbitrary and capricious manner, hardly an insurmountable responsibility.

DISSENT: LEVY, Judge (dissenting). JORGENSON, GERSTEN and GREEN, JJ., concur.

I respectfully dissent.

Sharick essentially seeks a lifetime's worth of future income for a potential career in an unknown field from a degree not yet obtained. Under these circumstances and for the following reasons, I do not find it possible for Sharick to establish and prove his loss of future earning capacity within a reasonable degree of certainty. . . .

Before Sharick would even be eligible to practice as a D.O., he would have to successfully complete his final class, pass part two of the state board examinations, successfully complete either an internship or residency program or both, and then meet all licensing requirements of the state D.O. board. Whether or not Sharick would be successful in this endeavor is beyond reasonable conjecture. Neither a jury nor a court should be permitted to excuse a student from completing all of his professional degree requirements in order to award him damages. . . .

However, even if it were proper to assume that Sharick would meet these preconditions to employment, it is still unknown what type of D.O. position Sharick would actually hold and where he would be working. Indeed, should Sharick complete his one year internship after graduation, he would be qualified to serve as either a pathologist, medical administrator, medical examiner or workers compensation hearing officer, and that he would be eligible to get a license to practice as a D.O.. Given this wide array of possibilities, I find it impossible to determine Sharick's loss of future earning capacity within a reasonable degree of certainty. Suffice it to say that, should Sharick go further and complete a residency program, his possibilities for employment would become even more diverse and, consequently, even more undeterminable. Sharick's ultimate goal may be to become a family practitioner, but it is unreasonable to assume that he will do so.[1]

Finally, the majority's analogy to loss of prospective business profits is misplaced. The cases cited by the majority hold that, regardless of whether a business has an established "track record", the business can recover lost prospective profits when damages can be shown to a reasonable certainty by competent proof. . . . Unlike the instant matter, however, those holdings were based on a set of facts and circumstances upon which one could reasonably ascertain, without excessive surmise: (1) the precise scope of the plaintiffs' businesses; (2) exactly where the plaintiffs' were doing business; (3) the specific nature of the plaintiffs' damages suffered due to the defendants' breach of contract; and (4) the "yardstick" by which prospective profits could be measured. . .. As no such certainty exists in the case at bar, I find the "lost profit" line of cases to be inapposite to the instant matter.

In summary, I would find that Sharick is not entitled to recover, as damages, lost future income that he might have earned as a D.O. in an undetermined field only after he might possibly have passed his boards and potentially received a D.O. license. It is wholly speculative whether Sharick would ever practice as a D.O., much less become successful and earn substantial income. The majority opinion requires the jury to utilize a divining rod of conjecture which simply cannot find water. For these reasons, I respectfully dissent.

Fn 1: Although Southeastern has not challenged the determination that it arbitrarily and capriciously dismissed Sharick from medical school, Sharick's inappropriate conduct that led to his dismissal is a factor that the jury should consider when determining whether Sharick would have become employed and in what capacity. . . . Specifically, the record indicates that Sharick was dismissed because he: (1) "was apparently unable to identify very fundamental signs and symptoms of diabetes mellititus"; (2) "failed to examine the abdomen and suprapubic area of a woman complaining of lower abdominal pain and presenting with symptoms of a urinary tract infection"; (3) "raised the skirt of a female patient without informing her that [he was] going to do so"; and (4) "consistently failed to review charts properly prior to interacting with these patients."

V. Securities Law

SECURITIES & EXCHANGE COMMISSION v. W. J. HOWEY CO. ET AL.

Supreme Court of the United States

328 U.S. 293

May 27, 1946, Decided

JUDGES: Stone, Black, Reed, Frankfurter, Douglas, Murphy, Rutledge, Burton; Jackson took no part in the consideration or decision of this case.

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case involves the application of § 2 (1) of the Securities Act of 1933 to an offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor. The Securities and Exchange Commission instituted this action to restrain the respondents from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and non-exempt securities in violation of § 5 (a) of the Act. The District Court denied the injunction. . . . We granted certiorari on a petition alleging that the ruling of the Circuit Court of Appeals conflicted with other federal and state decisions and that it introduced a novel and unwarranted test under the statute which the Commission regarded as administratively impractical.

Most of the facts are stipulated. The respondents, W. J. Howey Company and Howey-in-the-Hills Service, Inc., are Florida corporations under direct common control and management. The Howey Company owns large tracts of citrus acreage in Lake County, Florida. During the past several years it has planted about 500 acres annually, keeping half of the groves itself and offering the other half to the public "to help us finance additional development." Howey-in-the-Hills Service, Inc., is a service company engaged in cultivating and developing many of these groves, including the harvesting and marketing of the crops.

Each prospective customer is offered both a land sales contract and a service contract, after having been told that it is not feasible to invest in a grove unless service arrangements are made. While the purchaser is free to make arrangements with other service companies, the superiority of Howey-in-the-Hills Service, Inc., is stressed. Indeed, 85% of the acreage sold during the 3-year period ending May 31, 1943, was covered by service contracts with Howey-in-the-Hills Service, Inc.

The land sales contract with the Howey Company provides for a uniform purchase price per acre or fraction thereof, varying in amount only in accordance with the number of years the particular plot has been planted with citrus trees. Upon full payment of the purchase price the land is conveyed to the purchaser by warranty deed. Purchases are usually made in narrow strips of land arranged so that an acre consists of a row of 48 trees. During the period between February 1, 1941, and May 31, 1943, 31 of the 42 persons making purchases bought less than 5 acres each. The average holding of these 31 persons was 1.33 acres and sales of as little as 0.65, 0.7 and 0.73 of an acre were made. These tracts are not separately fenced and the sole indication of several ownership is found in small land marks intelligible only through a plat book record.

The service contract, generally of a 10-year duration without option of cancellation, gives Howey-in-the-Hills Service, Inc., a leasehold interest and "full and complete" possession of the acreage. For a specified fee plus the cost of labor and materials, the company is given full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops. The company is well established in the citrus business and maintains a large force of skilled personnel and a great deal of equipment, including 75 tractors, sprayer wagons, fertilizer trucks and the like. Without the consent of the company, the land owner or purchaser has no right of entry to market the crop; thus there is ordinarily no right to specific fruit. The company is accountable only for an allocation of the net profits based upon a check made at the time of picking. All the produce is pooled by the respondent companies, which do business under their own names.

The purchasers for the most part are non-residents of Florida. They are predominantly business and professional people who lack the knowledge, skill and equipment necessary for the care and cultivation of citrus trees. They are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943-1944 season amounted to 20% and that even greater profits might be expected during the 1944-1945 season, although only a 10% annual return was to be expected over a 10-year period. Many of these purchasers are patrons of a resort hotel owned and operated by the Howey Company in a scenic section adjacent to the groves. The hotel's advertising mentions the fine groves in the vicinity and the attention of the patrons is drawn to the groves as they are being escorted about the surrounding countryside. They are told that the groves are for sale; if they indicate an interest in the matter they are then given a sales talk.

It is admitted that the mails and instrumentalities of interstate commerce are used in the sale of the land and service contracts and that no registration statement or letter of notification has ever been filed with the Commission in accordance with the Securities Act of 1933 and the rules and regulations thereunder.

Section 2 (1) of the Act defines the term "security" to include the commonly known documents traded for speculation or investment.[4] This definition also includes "securities" of a more variable character, designated by such descriptive terms as "certificate of interest or participation in any profit-sharing agreement," "investment contract" and "in general, any interest or instrument commonly known as a 'security.'" The legal issue in this case turns upon a determination of whether, under the circumstances, the land sales contract, the warranty deed and the service contract together constitute an "investment contract" within the meaning of § 2 (1). An affirmative answer brings into operation the registration requirements of § 5 (a), unless the security is granted an exemption under § 3 (b). The lower courts, in reaching a negative answer to this problem, treated the contracts and deeds as separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer.

The term "investment contract" is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state "blue sky" laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." . . . . This definition was uniformly applied by state courts to a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves.

By including an investment contract within the scope of § 2 (1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims. In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition necessarily underlies this Court's decision in *S. E. C.* v. *Joiner Corp*., 320 U.S. 344, and has been enunciated and applied many times by lower federal courts. It

[3] "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." H. Rep. No. 85, 73d Cong., 1st Sess., p. 11. It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.

The transactions in this case clearly involve investment contracts as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.

Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts which respondents offer to prospective investors. And respondents' failure to abide by the statutory and administrative rules in making such offerings, even though the failure result from a bona fide mistake as to the law, cannot be sanctioned under the Act.

This conclusion is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract by declining to enter into a service contract with the respondents. The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.

We reject the suggestion of the Circuit Court of Appeals, . . . that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value. The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

DISSENT: MR. JUSTICE FRANKFURTER, dissenting.

"Investment contract" is not a term of art; it is a conception dependent upon the circumstances of a particular situation. If this case came before us on a finding authorized by Congress that the facts disclosed an "investment contract" within the general scope of § 2 (1) of the Securities Act, the Securities and Exchange Commission's finding would govern, unless, on the record, it was wholly unsupported. But that is not the case before us. Here the ascertainment of the existence of an "investment contract" had to be made independently by the District Court and it found against its existence. . . . The Circuit Court of Appeals for the Fifth Circuit sustained that finding. . . . If respect is to be paid to the wise rule of judicial administration under which this Court does not upset concurrent findings of two lower courts in the ascertainment of facts and the relevant inferences to be drawn from them, this case clearly calls for its application. . . . . For the crucial issue in this case turns on whether the contracts for the land and the contracts for the management of the property were in reality separate agreements or merely parts of a single transaction. It is clear from its opinion that the District Court was warranted in its conclusion that the record does not establish the existence of an investment contract:

". . . the record in this case shows that not a single sale of citrus grove property was made by the Howey Company during the period involved in this suit, except to purchasers who actually inspected the property before purchasing the same. The record further discloses that no purchaser is required to engage the Service Company to care for his property and that of the fifty-one purchasers acquiring property during this period, only forty-two entered into contracts with the Service Company for the care of the property." 60 F.Supp. at 442.

Simply because other arrangements may have the appearances of this transaction but are employed as an evasion of the Securities Act does not mean that the present contracts were evasive. I find nothing in the Securities Act to indicate that Congress meant to bring every innocent transaction within the scope of the Act simply because a perversion of them is covered by the Act.

Gerald M. Hocking**,** Plaintiff-Appellant, v. Maylee Dubois and Vitousek & Dick Realtors, Inc., a Hawaii corporation, Defendants-Appellees

United States Court of Appeals for the Ninth Circuit

839 F.2d 560

February 10, 1988, Filed

JUDGES: Alfred T. Goodwin, Procter Hug, Jr. and Stephen Reinhardt, Circuit Judges. Hug, Circuit Judge, dissenting.

OPINION: REINHARDT, Circuit Judge:

This is an action for fraud brought under the federal securities laws against a real estate agent and the broker that employed her. Appellant based federal jurisdiction on the claim that the real estate agent offered a "security" within the meaning of the federal securities laws. He also alleged pendent state causes of action for fraud. . . . We hold that . . . the offer of a condominium with an option to participate in a rental pool arrangement constitutes the offer of an investment contract under the securities laws. Accordingly, we reverse the grant of summary judgment. . . .

I.

Gerald Hocking visited Hawaii and became interested in buying a condominium there as an investment. When he returned to his home in Las Vegas, he made this known to a co-worker whose wife, Maylee Dubois, was a licensed real estate agent in Hawaii. She was employed by Vitousek & Dick Realtors, Inc., a Hawaiian real estate brokerage firm. A meeting was arranged between Hocking and Dubois. Subsequently, Dubois agreed to help Hocking find a suitable unit.

Dubois found a condominium unit owned by Tovik and Yaacov Liberman that was for sale. The unit was located in a resort complex developed by Aetna Life Insurance Company ("Aetna"). As a part of the original development, Aetna had offered purchasers an opportunity to participate in a rental pool arrangement ("RPA"). n2 This was optional and the Libermans had not participated in the rental pool.

- - - - - - - - - - - - - - Footnote - - - - - - - - - - - - - - -
n2 Under an RPA, an agent is responsible for renting and managing the resort project. The rental income from the units is pooled, and after each owner is assessed a pro rata share of the agent's costs, each owner receives a pro rata share of the rental income whether or not the owner's individual unit actually was rented.
- - - - - - - - - - - - End Footnote- - - - - - - - - - - - - -

In arranging the sale of the Libermans' condominium, Dubois advised him of the availability of the rental pool arrangement. . . . Hocking purchased the condominium unit from the Libermans on June 23, 1979. On July 5, 1979, Hocking entered into a rental management agreement with Hotel Corporation of the Pacific ("HCP") and a rental pool agreement that was to take effect six months later. Although the record is not clear on the relationship between HCP and the developer, Aetna, it appears that HCP performed management services at the option of the condominium purchasers.

Hocking subsequently filed suit alleging violations of the antifraud provisions of the Securities Exchange Act of 1934 . . and Rule 10b-5 promulgated thereunder, ... and state law claims of fraud, negligence, and breach of fiduciary duty. He alleged various acts of fraud by Dubois in inducing him to buy the unit and in services she performed or failed to perform thereafter. The district court granted summary judgment for defendants on the securities claim and dismissed the pendent state claims for lack of subject matter jurisdiction.

II.

We review the grant of summary judgment *de novo*. . . . We also review *de novo* the district court's determination whether a transaction is a security.

III.

The term "security" is defined in section 2 of the Securities Act of 1933, and in section 3 of the Securities Exchange Act of 1934. The sections, which are substantially identical, . . . define a security to include any "investment contract." However, the definition is not a static one. Congress cast it "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." It embodies a flexible principle "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

The now classic definition of an investment contract is found in *SEC v. W. J. Howey Co.* In *Howey*, investors purchased portions of a citrus grove in Florida. The seller offered each investor a land sales contract and a service contract under which defendant cultivated, harvested, and marketed the fruit. The service contract was for a ten-year period with no option to cancel. The investors nominally owned the land, but had no right to specific fruit or to enter the land. Their rights were limited to the receipt of profits from the pooling of all the harvested fruit. . . . The Court noted that the buyers lacked the knowledge, skill, and equipment necessary in the citrus fruit business and that the only way they could hope for a return on their investment was by absolute reliance on the efforts and abilities of the Howey Company. The Court, in finding an investment contract, held:

> An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Under *Howey*, then, an investment contract consists of (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits produced by the efforts of others.

Generally, simple transactions in real estate, without more, do not satisfy the *Howey* criteria. . . . When a purchaser is motivated exclusively by a desire to occupy or develop the land personally, no security is involved.

Real estate transactions may involve an offer of securities when an investor is offered both an interest in real estate *and* a collateral expectation of profits. . . . However, drawing the line between the offering of land sales contracts and investment contracts has not been easy. To resolve this difficulty, at least in the area of condominiums, the Securities and Exchange Commission issued guidelines in 1973 on the applicability of federal securities laws to the burgeoning resort condominium market. . . . . We read the *Howey* criteria in light of those guidelines.

In Release 5347, the Commission states unequivocally that it will view a condominium as a security if it is offered with any one of three specified rental arrangements. The second of these arrangements, the controlling one here, is "the offering of participation in a rental pool arrangement." 38 Fed. Reg. 1735, 1736 (1973). Unlike a transaction covered under the first arrangement, the offering of a condominium with an RPA *automatically* makes the investment a security. . . .

Release 5347 is controlling here, and compels the conclusion that the offer of the condominium with an RPA option constituted the offer of a security.

IV.

Even apart from the guidelines, we find that under the three *Howey* criteria an offer of a condominium with an RPA constitutes an offer of an investment contract.

1. *Investment of Money*. Defendants do not dispute that the condominium purchase satisfied *Howey's* first requirement. Hocking invested money in the condominium.

2. *Common Enterprise*. There has been some disagreement among the circuit courts of appeals on what satisfies the requirement of a common enterprise. . . .

It is readily apparent that an RPA for condominiums is a common enterprise. Each investor buys one share -- a condominium -- in a common venture that pools the rents from all of the units. The success of each participant's individual investment clearly depends on the entire RPA's success. At least with respect to the common enterprise prong of *Howey*, this is precisely the reason why the SEC felt that an offer of a condominium with an option for RPA *automatically* constitutes the offer of a security.

3. *Expectation of Profits Produced by Others' Efforts*. With respect to the third prong of *Howey*, i.e., the expectation of profits produced by the efforts of others, we conclude that this requisite is met *whenever* a condominium is sold with an RPA option. This is what the Commission has done in its guidelines for condominiums. The rationale of the SEC's *automatic* application of the securities laws to RPAs is not expressly set forth in the Release. . . .

The SEC and its advisory committee recognized the wisdom of having a rule that would make the sale of all the condominiums in a particular condominium development subject to the securities laws or would exclude the sale of all those units -- regardless of the fortuity of the individual economic expectations of the particular buyer. . . . We agree, and believe that the Release's bright line rule reflects the only proper interpretation of *Howey* as applied to condominiums. The purchase of a condominium with an RPA option thus meets the third *Howey* requisite that there be an expectation of profits based upon the entrepreneurial or managerial efforts of others. n8 Not only, then, does the alleged transaction at issue constitute the offer of a security under the SEC guidelines, but it also constitutes a security under the test set forth in *Howey*.

- - - - - - - - - - - - - - Footnote - - - - - - - - - - - - - - -

n8 The third *Howey* criterion originally was that profits from the investment ought to accrue "solely from the efforts of others." However, neither the Court nor this circuit has applied this criterion rigidly. For example, we have found securities to exist when profits are made in part by the efforts of others, and in part through the efforts of the purchaser. . . . Just as the *Howey* test allows us to find the existence of a security when profits are expected from the purchaser's own efforts as well as from the efforts of others, it also allows us to find a security when profits are expected from appreciation of condominium value at time of resale as well as from the efforts of others. This latter situation characterizes the facts here, where profits from the investment in a condominium with an RPA may come from 1) the condominium's pro rata share of net rents from the RPA, which depends upon the efforts of others, and 2) the appreciation on the condominium at the time of resale, which does not depend upon others' efforts. The existence of these two avenues for profit also characterized the facts of *Howey*, where profits came from harvested fruit, but also from the increased value of the land over time. What was important there, as is important here, is that the profits during the period of ownership come from the entrepreneurial or managerial efforts of others, and that the efforts of those other than the investor are the "undeniably significant ones". *Howey*, therefore, does not contemplate that profits must come only from the efforts of others, and not also from increased land values. Our reasoning is consistent with that of the SEC, for the guidelines contemplate that the offer of a condominium with an RPA option necessarily constitutes the offer of a security, irrespective of an expectation of profits from appreciation at the time of resale.

- - - - - - - - - - - - End Footnote- - - - - - - - - - - - - -

V. [omitted]

VI.

. . . . Because the condominium with its RPA is a security, Dubois acted as Hocking's securities broker. Just like any other purchaser of securities, Hocking may sue his own broker for fraudulent representations made in connection with the offer or sale of a security. . . . It is relatively common for securities purchasers to sue their own brokers; often, the sellers of the securities are not even known, let alone the sellers' brokers. A security broker's liability is not dependent on whether the seller is a defendant in the action or whether the broker acted as the seller's agent. Of course, Dubois' liability will depend on whether Hocking can show a fraudulent representation or other violation of a duty owed by Dubois to Hocking. That issue is not before us now.

Accordingly, the judgment below is reversed and the case is remanded for further proceedings consistent with this opinion.

REVERSED AND REMANDED.

DISSENT: HUG, Circuit Judge, dissenting:

I respectfully dissent.

. . . In summary, I submit that, regardless of the validity of the SEC's bright line rule for the purpose of requiring developers to register their projects, it makes no sense to apply that rule to this case. Here we have the Libermans, who bought a unit, rejected the rental pool, and now seek to sell the unit. Dubois notified Hocking that if he bought the unit he could perhaps participate in the developer's rental pool. It is hard to envision either the Libermans or Dubois as promoters offering the kind of package that constitutes an "investment contract," as defined by the Supreme Court.

I would affirm the dismissal for lack of subject matter jurisdiction because no security was involved.

Escott v. Barchris Construction Corp.

United States District Court for the Southern District of New York

283 F. Supp. 643 (1968)

This is an action by purchasers of 5 1/2 per cent convertible subordinated fifteen year debentures of BarChris Construction Corporation (BarChris). Plaintiffs purport to sue on their own behalf and "on behalf of all other and present and former holders" of the debentures. . . . The action is brought under Section 11 of the Securities Act of 1933 (15 U.S.C. § 77k). Plaintiffs allege that the registration statement with respect to these debentures filed with the Securities and Exchange Commission, which became effective on May 16, 1961, contained material false statements and material omissions.

Defendants fall into three categories: (1) the persons who signed the registration statement; (2) the underwriters, consisting of eight investment banking firms, led by Drexel & Co. (Drexel); and (3) BarChris's auditors, Peat, Marwick, Mitchell & Co. (Peat, Marwick).

. . . On the main issue of liability, the questions to be decided are (1) did the registration statement contain false statements of fact, or did it omit to state facts which should have been stated in order to prevent it from being misleading; (2) if so, were the facts which were falsely stated or omitted "material" within the meaning of the Act; (3) if so, have defendants established their affirmative defenses?

Before discussing these questions, some background facts should be mentioned. At the time relevant here, BarChris was engaged primarily in the construction of bowling alleys, somewhat euphemistically referred to as "bowling centers." . . .

BarChris's sales increased dramatically from 1956 to 1960. According to the prospectus, net sales, in round figures, in 1956 were some $800,000, in 1957 $1,300,000, in 1958 $1,700,000. In 1959 they increased to over $3,300,000, and by 1960 they had leaped to over $9,165,000. . . . BarChris was compelled to expend considerable sums in defraying the cost of construction before it received reimbursement. As a consequence, BarChris was in constant need of cash to finance its operations, a need which grew more pressing as operations expanded.

In December 1959, BarChris sold 560,000 shares of common stock to the public at $3.00 per share. This issue was underwritten by Peter Morgan & Company, one of the present defendants. By early 1961, BarChris needed additional working capital. The proceeds of the sale of the debentures involved in this action were to be devoted, in part at least, to fill that need.

The registration statement of the debentures, in preliminary form, was filed with the Securities and Exchange Commission on March 30, 1961. A first amendment was filed on May 11 and a second on May 16. The registration statement became effective on May 16. The closing of the financing took place on May 24. On that day BarChris received the net proceeds of the financing.

By that time BarChris was experiencing difficulties in collecting amounts due from some of its customers. Some of them were in arrears in payments due to factors on their discounted notes. As time went on those difficulties increased. Although BarChris continued to build alleys in 1961 and 1962, it became increasingly apparent that the industry was overbuilt. Operators of alleys, often inadequately financed, began to fail. Precisely when the tide turned is a matter of dispute, but at any rate, it was painfully apparent in 1962.

In May of that year BarChris made an abortive attempt to raise more money by the sale of common stock. It filed with the Securities and Exchange Commission a registration statement for the stock issue which it later withdrew. In October 1962 BarChris came to the end of the road. On October 29, 1962, it filed in this court a petition for an arrangement under Chapter XI of the Bankruptcy Act. BarChris defaulted in the payment of the interest due on November 1, 1962 on the debentures.

The Debenture Registration Statement

. . . . In connection with the sale of common stock, BarChris had issued purchase warrants. In January 1961 a second registration statement was filed in order to update the information pertaining to these warrants. Grant had prepared that statement as well. Some of the basic information needed for the debenture registration statement was contained in the registration statements previously filed with respect to the common stock and warrants. . . .

Peat, Marwick, BarChris's auditors, who had previously audited BarChris's annual balance sheet and earnings figures for 1958 and 1959, did the same for 1960. These figures were set forth in the registration statement. Peat, Marwick undertook a so-called "S-1 review," the proper scope of which is one of the matters debated here. The registration statement in its final form contained a prospectus as well as other information. Plaintiffs' claims of falsities and omissions pertain solely to the prospectus, not to the additional data.

The prospectus contained, among other things, a description of BarChris's business, a description of its real property, some material pertaining to certain of its subsidiaries, and remarks about various other aspects of its affairs. It also contained financial information. It included a consolidated balance sheet as of December 31, 1960, with elaborate explanatory notes. These figures had been audited by Peat, Marwick. It also contained unaudited figures as to net sales, gross profit and net earnings for the first quarter ended March 31, 1961, as compared with the similar quarter for 1960. In addition, it set forth figures as to the company's backlog of unfilled orders as of March 31, 1961, as compared with March 31, 1960, and figures as to BarChris's contingent liability, as of April 30, 1961, on customers' notes discounted and its contingent liability under the so-called alternative method of financing.

Plaintiffs challenge the accuracy of a number of these figures. They also charge that the text of the prospectus, apart from the figures, was false in a number of respects, and that material information was omitted. Each of these contentions, after eliminating duplications, will be separately considered. . . .

Summary

For convenience, the various falsities and omissions which I have discussed in the preceding pages are recapitulated here. They were as follows:

1. 1960 Earnings

(a) Sales	
As per prospectus	$9,165,320
Correct figure	8,511,420
Overstatement	$ 653,900
(b) Net Operating Income	
As per prospectus	$1,742,801
Correct figure	1,496,196
Overstatement	$ 246,605
(c) Earnings per Share	
As per prospectus	$ .75
Correct figure	.65
Overstatement	$ .10

2. 1960 Balance Sheet

Current Assets	
As per prospectus	$4,524,021
Correct figure	3,914,332
Overstatement	$ 609,689

3. Contingent Liabilities as of December 31, 1960 on Alternative

Method of Financing

As per prospectus	$ 750,000
Correct figure	1,125,795
Understatement	$ 375,795
Capitol Lanes should have been shown as a direct liability	$ 325,000

4. Contingent Liabilities as of April 30, 1961

As per prospectus	$ 825,000
Correct figure	1,443,853
Understatement	$ 618,853
Capitol Lanes should have been shown as a direct liability	$ 314,166

5. Earnings Figures for Quarter ending March 31, 1961

(a) Sales	
As per prospectus	$2,138,455
Correct figure	1,618,645
Overstatement	$ 519,810
(b) Gross Profit	
As per prospectus	$ 483,121
Correct figure	252,366
Overstatement	$ 230,755

6. Backlog as of March 31, 1961

As per prospectus	$6,905,000
Correct figure	2,415,000
Overstatement	$4,490,000

7.	Failure to Disclose Officers' Loans Outstanding and Unpaid on May 16, 1961	$ 386,615
8.	Failure to Disclose Use of Proceeds in Manner not Revealed in Prospectus Approximately	$1,160,000
9.	Failure to Disclose Customers' Delinquencies in May 1961 and BarChris's Potential Liability with Respect Thereto Over	$1,350,000
10.	Failure to Disclose the Fact that BarChris was Already Engaged, and was about to be More Heavily Engaged, in the Operation of Bowling Alleys	

Materiality

It is a prerequisite to liability under Section 11 of the Act that the fact which is falsely stated in a registration statement, or the fact that is omitted when it should have been stated to avoid misleading, be "material." . . .

Judged by this test, there is no doubt that many of the misstatements and omissions in this prospectus were material.

The "Due Diligence" Defenses

Section 11(b) of the Act provides that:

> " . . . no person, other than the issuer, shall be liable . . . who shall sustain the burden of proof . . .
>
> (3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; . . . and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) . . . he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."

Section 11(c) defines "reasonable investigation" as follows:

> "In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

Every defendant, except BarChris itself, to whom, as the issuer, these defenses are not available, and except Peat, Marwick, whose position rests on a different statutory provision, has pleaded these affirmative defenses. Each claims that (1) as to the part of the registration statement purporting to be made on the authority of an expert (which, for convenience, I shall refer to as the "expertised portion"), he had no reasonable ground to believe and did not believe that there were any untrue statements or material omissions, and (2) as to the other parts of the registration statement, he made a reasonable investigation, as a result of which he had reasonable ground to believe and did believe that the registration statement was true and that no material fact was omitted. As to each defendant, the question is whether he has sustained the burden of proving these defenses. Surprising enough, there is little or no judicial authority on this question. No decisions directly in point under Section 11 have been found.. . .

The only expert, in the statutory sense, was Peat, Marwick, and the only parts of the registration statement which purported to be made upon the authority of an expert were the portions which purported to be made on Peat, Marwick's authority. . . .

I turn now to the question of whether defendants have proved their due diligence defenses. The position of each defendant will be separately considered.

Russo

Russo was, to all intents and purposes, the chief executive officer of BarChris. He was a member of the executive committee. He was familiar with all aspects of the business. He was personally in charge of dealings with the factors. He acted on BarChris's behalf in making the financing agreements with Talcott and he handled the negotiations with Talcott in the spring of 1961. He talked with customers about their delinquencies.

Russo prepared the list of jobs which went into the backlog figure. He knew the status of those jobs. In addition to being chief executive officer of BarChris, he was a director of T-Bowl International, Inc., and the principals in St. Ann's were his friends.

It was Russo who arranged for the temporary increase in BarChris's cash in banks on December 31, 1960, a transaction which borders on the fraudulent. He was thoroughly aware of BarChris's stringent financial condition in May 1961. He had personally advanced large sums to BarChris of which $175,000 remained unpaid as of May 16.

In short, Russo knew all the relevant facts. He could not have believed that there were no untrue statements or material omissions in the prospectus. Russo has no due diligence defenses.

Vitolo and Pugliese

They were the founders of the business who stuck with it to the end. Vitolo was president and Pugliese was vice president. Despite their titles, their field of responsibility in the administration of BarChris's affairs during the period in question seems to have been less all-embracing than Russo's. Pugliese in particular appears to have limited his activities to supervising the actual construction work.

Vitolo and Pugliese are each men of limited education. It is not hard to believe that for them the prospectus was difficult reading, if indeed they read it at all. But whether it was or not is irrelevant. The liability of a director who signs a registration statement does not depend upon whether or not he read it or, if he did, whether or not he understood what he was reading.

And in any case, Vitolo and Pugliese were not as naive as they claim to be. They were members of BarChris's executive committee. At meetings of that committee BarChris's affairs were discussed at length. They must have known what was going on. Certainly they knew of the inadequacy of cash in 1961. They knew of their own large advances to the company which remained unpaid. They knew that they had agreed not to deposit their checks until the financing proceeds were received. They knew and intended that part of the proceeds were to be used to pay their own loans.

All in all, the position of Vitolo and Pugliese is not significantly different, for present purposes, from Russo's. They could not have believed that the registration statement was wholly true and that no material facts had been omitted. And in any case, there is nothing to show that they made any investigation of anything which they may not have known about or understood. They have not proved their due diligence defenses.

Kircher

Kircher was treasurer of BarChris and its chief financial officer. He is a certified public accountant and an intelligent man. He was thoroughly familiar with BarChris's financial affairs. He knew the terms of BarChris's agreements with Talcott. He knew of the customers' delinquency problem. He participated actively with Russo in May 1961 in the successful effort to hold Talcott off until the financing proceeds came in. He knew how the financing proceeds were to be applied and he saw to it that they were so applied. He arranged the officers' loans and he knew all the facts concerning them. . . .

Kircher's contention is that he had never before dealt with a registration statement, that he did not know what it should contain, and that he relied wholly on Grant, Ballard and Peat, Marwick to guide him. He claims that it was their fault, not his, if there was anything wrong with it. He says that all the facts were recorded in BarChris's books where these "experts" could have seen them if they had looked. He says that he truthfully answered all their questions. In effect, he says that if they did not know enough to ask the right questions and to give him the proper instructions, that is not his responsibility.

There is an issue of credibility here. In fact, Kircher was not frank in dealing with Grant and Ballard. He withheld information from them. But even if he had told them all the facts, this would not have constituted the due diligence contemplated by the statute. Knowing the facts, Kircher had reason to believe that the expertised portion of the prospectus, i.e., the 1960 figures, was in part incorrect. He could not shut his eyes to the facts and rely on Peat, Marwick for that portion.

As to the rest of the prospectus, knowing the facts, he did not have a reasonable ground to believe it to be true. On the contrary, he must have known that in part it was untrue. Under these circumstances, he was not entitled to sit back and place the blame on the lawyers for not advising him about it.

Kircher has not proved his due diligence defenses.

Trilling

Trilling's position is somewhat different from Kircher's. He was BarChris's controller. He signed the registration statement in that capacity, although he was not a director.

Trilling entered BarChris's employ in October 1960. He was Kircher's subordinate. When Kircher asked him for information, he furnished it. On at least one occasion he got it wrong. . . . Trilling may well have been unaware of several of the inaccuracies in the prospectus. But he must have known of some of them. . . . In the light of these facts, I cannot find that Trilling believed the entire prospectus to be true.

But even if he did, he still did not establish his due diligence defenses. He did not prove that as to the parts of the prospectus expertised by Peat, Marwick he had no reasonable ground to believe that it was untrue. He also failed to prove, as to the parts of the prospectus not expertised by Peat, Marwick, that he made a reasonable investigation which afforded him a reasonable ground to believe that it was true. As far as appears, he made no investigation. He did what was asked of him and assumed that others would properly take care of supplying accurate data as to the other aspects of the company's business. This would have been well enough but for the fact that he signed the registration statement. As a signer, he could not avoid responsibility by leaving it up to others to make it accurate. Trilling did not sustain the burden of proving his due diligence defenses.

Birnbaum

Birnbaum was a young lawyer, admitted to the bar in 1957, who, after brief periods of employment by two different law firms and an equally brief period of practicing in his own firm, was employed by BarChris as house counsel and assistant secretary in October 1960. Unfortunately for him, he became secretary and a director of BarChris on April 17, 1961, after the first version of the registration statement had been filed with the Securities and Exchange Commission. He signed the later amendments, thereby becoming responsible for the accuracy of the prospectus in its final form.

Although the prospectus, in its description of "management," lists Birnbaum among the "executive officers" and devotes several sentences to a recital of his career, the fact seems to be that he was not an executive officer in any real sense. He did not participate in the management of the company. As house counsel, he attended to legal matters of a routine nature. . . .

Birnbaum examined contracts. In that connection he advised BarChris that the T-Bowl contracts were not legally enforceable. He was thus aware of that fact.

One of Birnbaum's more important duties, first as assistant secretary and later as full-fledged secretary, was to keep the corporate minutes of BarChris and its subsidiaries. This necessarily informed him to a considerable extent about the company's affairs. Birnbaum was not initially a member of the executive committee, however, and did not keep its minutes at the outset. According to the minutes, the first meeting which he attended, "upon invitation of the Committee," was on March 22, 1961. He became a member shortly thereafter and kept the minutes beginning with the meeting of April 24, 1961.

It seems probable that Birnbaum did not know of many of the inaccuracies in the prospectus. He must, however, have appreciated some of them. In any case, he made no investigation and relied on the others to get it right. Unlike Trilling, he was entitled to rely upon Peat, Marwick for the 1960 figures, for as far as appears, he had no personal knowledge of the company's books of account or financial transactions. But he was not entitled to rely upon Kircher, Grant and Ballard for the other portions of the prospectus. As a lawyer, he should have known his obligations under the statute. He should have known that he was required to make a reasonable investigation of the truth of all the statements in the unexpertised portion of the document which he signed. Having failed to make such an investigation, he did not have reasonable ground to believe that all these statements were true. Birnbaum has not established his due diligence defenses except as to the audited 1960 figures. . . .

The Underwriters and Coleman

The underwriters other than Drexel made no investigation of the accuracy of the prospectus. . . . Drexel did make an investigation. The work was in charge of Coleman, a partner of the firm, assisted by Casperson, an associate. Drexel's attorneys acted as attorneys for the entire group of underwriters. Ballard did the work, assisted by Stanton.

. . . . Coleman and Ballard asked pertinent questions and received answers which satisfied them. . . . Ballard, without checking, relied on the information which he got from Kircher. He also relied on Grant who, as company counsel, presumably was familiar with its affairs.

The formal opinion which Ballard's firm rendered to the underwriters at the closing on May 24, 1961 made clear that this is what he had done. The opinion stated:

> "In the course of the preparation of the Registration Statement and Prospectus by the Company, we have had numerous conferences with representatives of and counsel for the Company and with its auditors and we have raised many questions regarding the business of the Company. Satisfactory answers to such questions were in each case given us, and all other information and documents we requested have been supplied. We are of the opinion that the *data presented* to us are accurately reflected in the Registration Statement and Prospectus and that there has been omitted from the Registration Statement no material facts *included in such data*. Although *we have not otherwise verified* the completeness or accuracy of the information furnished to us, on the basis of the foregoing and with the exception of the financial statements and schedules (which this opinion does not pass upon), we have no reason to believe that the Registration Statement or Prospectus contains any untrue statement of any material fact or omits to state a material fact required to be stated therein or necessary in order to make the statements therein not misleading."

It is clear that no effectual attempt at verification was made. . . . Are underwriters in a different position, as far as due diligence is concerned?

The underwriters say that the prospectus is the company's prospectus, not theirs. Doubtless this is the way they customarily regard it. But the Securities Act makes no such distinction. The underwriters are just as responsible as the company if the prospectus is false. And prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities. . . .

The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.

It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case. In the present case, the underwriters' counsel made almost no attempt to verify management's representations. I hold that that was insufficient. . . .

The other underwriters, who did nothing and relied solely on Drexel and on the lawyers, are also bound by it. It follows that although Drexel and the other underwriters believed that those portions of the prospectus were true, they had no reasonable ground for that belief, within the meaning of the statute. Hence, they have not established their due diligence defense . . . .

Peat, Marwick

Section 11(b) provides: "Notwithstanding the provisions of subsection (a) no person . . . shall be liable as provided therein who shall sustain the burden of proof —

> "(3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert . . . (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."

This defines the due diligence defense for an expert. Peat, Marwick has pleaded it.

The part of the registration statement purporting to be made upon the authority of Peat, Marwick as an expert was, as we have seen, the 1960 figures. But because the statute requires the court to determine Peat, Marwick's belief, and the grounds thereof, "at the time such part of the registration statement became effective," for the purposes of this affirmative defense, the matter must be viewed as of May 16, 1961, and the question is whether at that time Peat, Marwick, after reasonable investigation, had reasonable ground to believe and did believe that the 1960 figures were true and that no material fact had been omitted from the registration statement which should have been included in order to make the 1960 figures not misleading. In deciding this issue, the court must consider not only what Peat, Marwick did in its 1960 audit, but also what it did in its subsequent "S-1 review." The proper scope of that review must also be determined. . . .

The 1960 Audit

Peat, Marwick's work was in general charge of a member of the firm, Cummings, and more immediately in charge of Peat, Marwick's manager, Logan. Most of the actual work was performed by a senior accountant, Berardi, who had junior assistants, one of whom was Kennedy. Berardi was then about thirty years old. He was not yet a C.P.A. He had had no previous experience with the bowling industry. This was his first job as a senior accountant. He could hardly have been given a more difficult assignment. . . .

In substance, what Berardi did is similar to what Grant and Ballard did. He asked questions, he got answers which he considered satisfactory, and he did nothing to verify them. . . .

Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here. Berardi's review did not come up to that standard. He did not take some of the steps which Peat, Marwick's written program prescribed. He did not spend an adequate amount of time on a task of this magnitude. Most important of all, he was too easily satisfied with glib answers to his inquiries.

This is not to say that he should have made a complete audit. But there were enough danger signals in the materials which he did examine to require some further investigation on his part. Generally accepted accounting standards required such further investigation under these circumstances. It is not always sufficient merely to ask questions.

Here again, the burden of proof is on Peat, Marwick. I find that that burden has not been satisfied. I conclude that Peat, Marwick has not established its due diligence defense. . . .

SECURITIES AND EXCHANGE COMMISSION, Plaintiff-Appellant, v. TEXAS GULF SULPHUR CO., a Texas Corporation, et al., Defendants-Appellants

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

401 F.2d 833

August 13, 1968, Decided

JUDGES: Lumbard, Chief Judge, and Waterman, Moore, Friendly, Smith, Kaufman, Hays, Anderson and Feinberg, Circuit Judges. Friendly, Circuit Judge (concurring). Irving R. Kaufman, Circuit Judge (concurring). Anderson, Circuit Judge (concurring). Hays, Circuit Judge (concurring in part and dissenting in part). Moore, Circuit Judge (dissenting) (with whom Chief Judge Lumbard concurs).

OPINION:

This action was commenced in the United States District Court for the Southern District of New York by the Securities and Exchange Commission (the SEC) against Texas Gulf Sulphur Company (TGS) and several of its officers, directors and employees, to enjoin certain conduct by TGS and the individual defendants said to violate Section 10(b) of the Act, 15 U.S.C. Section 78j(b), and Rule 10b-5 (the Rule), promulgated thereunder, and to compel the rescission by the individual defendants of securities transactions assertedly conducted contrary to law. . . .

THE FACTUAL SETTING

This action derives from the exploratory activities of TGS begun in 1957 on the Canadian Shield in eastern Canada. . . .

On October 29 and 30, 1963, Clayton conducted a ground geophysical survey which confirmed the presence of an anomaly and indicated the necessity of diamond core drilling for further evaluation. Drilling of the initial hole, K-55-1, at the strongest part of the anomaly was commenced on November 8. . . . The results were so remarkable that neither Clayton, an experienced geophysicist, nor four other TGS expert witnesses, had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit. . . . Drilling was resumed on March 31.

From November 12, 1963 to March 31, 1964, certain of the individual defendants, and persons said to have received "tips" from them, purchased TGS stock or calls thereon. Prior to these transactions these persons had owned 1135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8235 shares and possessed 12,300 calls. . . .

Meanwhile, rumors that a major ore strike was in the making had been circulating throughout Canada. . . . The following morning, Sunday, with the aid of a public relations consultant, TGS drafted a press release designed to quell the rumors, which release was issued at 3:00 P.M. on Sunday, April 12, and which appeared in the morning newspapers of general circulation on Monday, April 13. It read in pertinent part as follows:

> NEW YORK, April 12 -- The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:
>
> "During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.
>
> "The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals -- lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.
>
> "Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.
>
> "Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

> "The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

. . . . Meanwhile, drilling operations continued. . . . While drilling activity ensued to completion, TGC officials were taking steps toward ultimate disclosure of the discovery. . . . An official detailed statement, announcing a strike of at least 25 million tons of ore, based on the drilling data set forth above, was read to representatives of American financial media from 10:00 A.M. to 10:10 or 10:15 A.M. on April 16, and appeared over Merrill Lynch's private wire at 10:29 A.M. and, somewhat later than expected, over the Dow Jones ticker tape at 10:54 A.M.

Between the time the first press release was issued on April 12 and the dissemination of the TGS official announcement on the morning of April 16, the only defendants before us on appeal who engaged in market activity were Clayton and Crawford and TGS director Coates. Clayton ordered 200 shares of TGS stock through his Canadian broker on April 15 and the order was executed that day over the Midwest Stock Exchange. Crawford ordered 300 shares at midnight on the 15th and another 300 shares at 8:30 A.M. the next day, and these orders were executed over the Midwest Exchange in Chicago at its opening on April 16. Coates left the TGS press conference and called his broker son-in-law Haemisegger shortly before 10:20 A.M. on the 16th and ordered 2,000 shares of TGS for family trust accounts of which Coates was a trustee but not a beneficiary; Haemisegger executed this order over the New York and Midwest Exchanges, and he and his customers purchased 1500 additional shares.

During the period of drilling in Timmins, the market price of TGS stock fluctuated but steadily gained overall. On Friday, November 8, when the drilling began, the stock closed at 17 3/8. . . The price rose to 20 7/8 by December 13, when the chemical assay results of K-55-1 were received, and closed at a high of 24 1/8 on February 21, the day after the stock options had been issued. It had reached a price of 26 by March 31, after the land acquisition program had been completed and drilling had been resumed, and continued to ascend to 30 1/8 by the close of trading on April 10, at which time the drilling progress up to then was evaluated for the April 12th press release. On April 13, the day on which the April 12 release was disseminated, TGS opened at 30 1/8, rose immediately to a high of 32 and gradually tapered off to close at 30 7/8. It closed at 30 1/4 the next day, and at 29 3/8 on April 15. On April 16, the day of the official announcement of the Timmins discovery, the price climbed to a high of 37 and closed at 36 3/8. By May 15, TGS stock was selling at 58 1/4.

I. THE INDIVIDUAL DEFENDANTS

A. *Introductory*

Rule 10b-5, 17 CFR 240.10b-5, on which this action is predicated, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> > (1) to employ any device, scheme, or artifice to defraud,
> >
> > (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934. By that Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges. The Act and the Rule apply to the transactions here, all of which were consummated on exchanges. . . . The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. *Matter of Cady, Roberts & Co.*, 40 SEC 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act. Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished.

B. *Material Inside Information*

An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. . . . The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders. …

In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Here, notwithstanding the trial court's conclusion that the results of the first drill core, K-55-1, were "too 'remote' to have had any significant impact on the market, i.e., to be deemed material," knowledge of the possibility, which surely was more than marginal, of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (suggesting mineability by the less expensive openpit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold. . . .

Our survey of the facts found conclusively establishes that knowledge of the results of the discovery hole, would have been important to a reasonable investor and might have affected the price of the stock. . . . Testimony revealed that the prices of stocks of other companies, albeit less diversified, smaller firms, had increased substantially solely on the basis of the discovery of good anomalies or even because of the proximity of their lands to the situs of a potentially major strike.

Finally, . . . the timing by those who knew of it of their stock purchases and their purchases of *short-term* calls — purchases in some cases by individuals who had never before purchased calls or even TGS stock — virtually compels the inference that the insiders were influenced by the drilling results. . . .

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks, — which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. . . .

We hold, therefore, that all transactions in TGS stock or calls by individuals apprised of the drilling results were made in violation of Rule 10b-5. The geologist Darke possessed undisclosed material information and traded in TGS securities. Therefore we reverse the dismissal of the action as to him and his personal transactions. . . .

As it is our holding that the information acquired after the drilling of K-55-1 was material, we, on the basis of the findings of direct and circumstantial evidence on the issue that the trial court has already expressed, hold that Darke violated Rule 10b-5 (3) and Section 10(b) by "tipping" and we remand, pursuant to the agreement of the parties, for a determination of the appropriate remedy. As Darke's "tippees" are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible. . . .

C. *When May Insiders Act*?

Appellant Crawford, who ordered the purchase of TGS stock shortly before the TGS April 16 official announcement, and defendant Coates, who placed orders with and communicated the news to his broker immediately after the official announcement was read at the TGS-called press conference, concede that they were in possession of material information. They contend, however, that their purchases were not proscribed purchases for the news had already been effectively disclosed. We disagree.

Crawford telephoned his orders to his Chicago broker about midnight on April 15 and again at 8:30 in the morning of the 16th, with instructions to buy at the opening of the Midwest Stock Exchange that morning. The trial court's finding that "he sought to, and did, 'beat the news,'" is well documented by the record. The rumors of a major ore strike which had been circulated in Canada and, to a lesser extent, in New York, had been disclaimed by the TGS press release of April 12, which significantly promised the public an official detailed announcement when possibilities had ripened into actualities. . . . Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public. Particularly here, where a formal announcement to the entire financial news media had been promised in a prior official release known to the media, all insider activity must await dissemination of the promised official announcement. . . .

Assuming that the contents of the official release could instantaneously be acted upon, at the minimum Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law.

II. THE CORPORATE DEFENDANT

[discussion deleted]

Introductory

The SEC argued below and maintains on this appeal that this release painted a misleading and deceptive picture of the drilling progress at the time of its issuance, and hence violated Rule 10b-5(2). . . . [discussion deleted]

We conclude, then, that, having established that the release was issued in a manner reasonably calculated to affect the market price of TGS stock and to influence the investing public, we must remand to the district court to decide whether the release was misleading to the reasonable investor and if found to be misleading, whether the court in its discretion should issue the injunction the SEC seeks.

CONCLUSION

In summary, therefore, we affirm the finding of the court below that appellants Clayton and Crawford have violated Rule 10b-5; we reverse the judgment order entered below dismissing the complaint against appellees Fogarty, Clayton, Mollison, Holyk, Darke, Huntington, and Coates, as we find that they have violated Rule 10b-5. As to these eight individuals we remand so that in accordance with the agreement between the parties the Commission may notice a hearing before the court below to determine the remedies to be applied against them. . . . We reverse the judgment dismissing the complaint against Texas Gulf Sulphur Company, remand the cause as to it for a further determination below, in the light of the approach explicated by us in the foregoing opinion, as to whether, in the exercise of its discretion, the injunction against it which the Commission seeks should be ordered.

Chiarella v. United States

Supreme Court of the United States

445 U.S. 222

November 5, 1979, Argued
March 18, 1980, Decided

JUDGES**:** POWELL, J., delivered the opinion of the Court, in which STEWART, WHITE, REHNQUIST, and STEVENS, JJ., joined. STEVENS, J., filed a concurring opinion. BRENNAN, J., filed an opinion concurring in the judgment. BURGER, C. J., filed a dissenting opinion. BLACKMUN, J., filed a dissenting opinion, in which MARSHALL, J., joined.

MR. JUSTICE POWELL delivered the opinion of the Court.

The question in this case is whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10 (b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company's securities.

I

Petitioner is a printer by trade. In 1975 and 1976, he worked as a "markup man" in the New York composing room of Pandick Press, a financial printer. Among documents that petitioner handled were five announcements of corporate takeover bids. When these documents were delivered to the printer, the identities of the acquiring and target corporations were concealed by blank spaces or false names. The true names were sent to the printer on the night of the final printing.

The petitioner, however, was able to deduce the names of the target companies before the final printing from other information contained in the documents. Without disclosing his knowledge, petitioner purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public. [1] By this method, petitioner realized a gain of slightly more than $30,000 in the course of 14 months. Subsequently, the Securities and Exchange Commission (Commission or SEC) began an investigation of his trading activities. In May 1977, petitioner entered into a consent decree with the Commission in which he agreed to return his profits to the sellers of the shares. On the same day, he was discharged by Pandick Press.

In January 1978, petitioner was indicted on 17 counts of violating § 10 (b) of the Securities Exchange Act of 1934 (1934 Act) and SEC Rule 10b-5. After petitioner unsuccessfully moved to dismiss the indictment, he was brought to trial and convicted on all counts.

The Court of Appeals for the Second Circuit affirmed petitioner's conviction. 588 F.2d 1358 (1978). We granted certiorari, and we now reverse.

II

Section 10 (b) of the 1934 Act prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Pursuant to this section, the SEC promulgated Rule 10b-5 which provides in pertinent part: [5]

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud, [or] . . .

> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 CFR § 240.10b-5 (1979).

This case concerns the legal effect of the petitioner's silence. The District Court's charge permitted the jury to convict the petitioner if it found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable. In order to decide whether silence in such circumstances violates § 10 (b), it is necessary to review the language and legislative history of that statute as well as its interpretation by the Commission and the federal courts.

Although the starting point of our inquiry is the language of the statute, § 10 (b) does not state whether silence may constitute a manipulative or deceptive device. Section 10 (b) was designed as a catchall clause to prevent fraudulent practices. But neither the legislative history nor the statute itself affords specific guidance for the resolution of this case. When Rule 10b-5 was promulgated in 1942, the SEC did not discuss the possibility that failure to provide information might run afoul of § 10 (b).

The SEC took an important step in the development of § 10 (b) when it held that a broker-dealer and his firm violated that section by selling securities on the basis of undisclosed information obtained from a director of the issuer corporation who was also a registered representative of the brokerage firm. In *Cady, Roberts & Co*., 40 S. E. C. 907 (1961), the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from "[an] affirmative duty to disclose material information."

The Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. [8]

That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law. At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." In its *Cady, Roberts* decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the "necessity of preventing a corporate insider from . . . [taking] unfair advantage of the uninformed minority stockholders."

The federal courts have found violations of § 10 (b) where corporate insiders used undisclosed information for their own benefit. *E. g., SEC* v. *Texas Gulf Sulphur Co*., 401 F.2d 833 (CA2 1968). The cases also have emphasized, in accordance with the common-law rule, that "[the] party charged with failing to disclose market information must be under a duty to disclose it." Accordingly, a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts. . . .

Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10 (b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information. [12]

III

In this case, the petitioner was convicted of violating § 10 (b) although he was not a corporate insider and he received no confidential information from the target company. Moreover, the "market information" upon which he relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company. Petitioner's use of that information was not a fraud under § 10 (b) unless he was subject to an affirmative duty to disclose it before trading. In this case, the jury instructions failed to specify any such duty. In effect, the trial court instructed the jury that petitioner owed a duty to everyone; to all sellers, indeed, to the market as a whole. The jury simply was told to decide whether petitioner used material, nonpublic information at a time when "he knew other people trading in the securities market did not have access to the same information." . . . .

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent. . . .

Indeed, the theory upon which the petitioner was convicted is at odds with the Commission's view of § 10 (b) as applied to activity that has the same effect on sellers as the petitioner's purchases. . . .

We see no basis for applying such a new and different theory of liability in this case. . . . Section 10 (b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10 (b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10 (b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.

IV

In its brief to this Court, the United States offers an alternative theory to support petitioner's conviction. It argues that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation. The breach of this duty is said to support a conviction under § 10 (b) for fraud perpetrated upon both the acquiring corporation and the sellers.

We need not decide whether this theory has merit for it was not submitted to the jury. The jury was instructed that the petitioner employed a scheme to defraud if he "did not disclose . . . material non-public information in connection with the purchases of the stock."

Alternatively, the jury was instructed that it could convict if "Chiarella's alleged conduct of having purchased securities without disclosing material, non-public information would have or did have the effect of operating as a fraud upon a seller." The judge earlier had stated that fraud "embraces all the means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false misrepresentation, suggestions or by suppression of the truth."

The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, non-public information to sellers from whom he bought the stock of target corporations. The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers. Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury, we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10 (b).

The judgment of the Court of Appeals is

Reversed.

MR. JUSTICE STEVENS, concurring.

Before liability, civil or criminal, may be imposed for a Rule 10b-5 violation, it is necessary to identify the duty that the defendant has breached. Arguably, when petitioner bought securities in the open market, he violated (a) a duty to disclose owed to the sellers from whom he purchased target company stock and (b) a duty of silence owed to the acquiring companies. I agree with the Court's determination that petitioner owed no duty of disclosure to the sellers, that his conviction rested on the erroneous premise that he did owe them such a duty, and that the judgment of the Court of Appeals must therefore be reversed. . . .

I write simply to emphasize the fact that we have not necessarily placed any stamp of approval on what this petitioner did, nor have we held that similar actions must be considered lawful in the future. Rather, we have merely held that petitioner's criminal conviction cannot rest on the theory that he breached a duty he did not owe.

Carpenter et al. v. United States

Supreme Court Of The United States

484 U.S. 19

October 7, 1987, Argued
November 16, 1987, Decided

WHITE, J., delivered the opinion for a unanimous Court

JUSTICE WHITE delivered the opinion of the Court.

Petitioners Kenneth Felis and R. Foster Winans were convicted of violating § 10(b) of the Securities Exchange Act of 1934 [1] and Rule 10b-5. [2] They were also found guilty of violating the federal mail and wire fraud statutes, and were convicted for conspiracy. Petitioner David Carpenter, Winans' roommate, was convicted for aiding and abetting. With a minor exception, the Court of Appeals for the Second Circuit affirmed; we granted certiorari.

I

In 1981, Winans became a reporter for the Wall Street Journal (the Journal) and in the summer of 1982 became one of the two writers of a daily column, "Heard on the Street." That column discussed selected stocks or groups of stocks, giving positive and negative information about those stocks and taking "a point of view with respect to investment in the stocks that it reviews." Winans regularly interviewed corporate executives to put together interesting perspectives on the stocks that would be highlighted in upcoming columns, but, at least for the columns at issue here, none contained corporate inside information or any "hold for release" information. Because of the "Heard " column's perceived quality and integrity, it had the potential of affecting the price of the stocks which it examined. The District Court concluded on the basis of testimony presented at trial that the "Heard" column "does have an impact on the market, difficult though it may be to quantify in any particular case."

The official policy and practice at the Journal was that prior to publication, the contents of the column were the Journal's confidential information. Despite the rule, with which Winans was familiar, he entered into a scheme in October 1983 with Peter Brant and petitioner Felis, both connected with the Kidder Peabody brokerage firm in New York City, to give them advance information as to the timing and contents of the "Heard" column. This permitted Brant and Felis and another conspirator, David Clark, a client of Brant, to buy or sell based on the probable impact of the column on the market. Profits were to be shared. The conspirators agreed that the scheme would not affect the journalistic purity of the "Heard" column, and the District Court did not find that the contents of any of the articles were altered to further the profit potential of petitioners' stock-trading scheme. Over a 4-month period, the brokers made prepublication trades on the basis of information given them by Winans about the contents of some 27 "Heard" columns. The net profits from these trades were about $690,000.

In November 1983, correlations between the "Heard" articles and trading in the Clark and Felis accounts were noted at Kidder Peabody and inquiries began. Brant and Felis denied knowing anyone at the Journal and took steps to conceal the trades. Later, the Securities and Exchange Commission began an investigation. Questions were met by denials both by the brokers at Kidder Peabody and by Winans at the Journal. As the investigation progressed, the conspirators quarreled, and on March 29, 1984, Winans and Carpenter went to the SEC and revealed the entire scheme. This indictment and a bench trial followed. Brant, who had pleaded guilty under a plea agreement, was a witness for the Government.

The District Court found, and the Court of Appeals agreed, that Winans had knowingly breached a duty of confidentiality by misappropriating prepublication information regarding the timing and contents of the "Heard" column, information that had been gained in the course of his employment under the understanding that it would not be revealed in advance of publication and that if it were, he would report it to his employer. It was this appropriation of confidential information that underlay both the securities laws and mail and wire fraud counts. With respect to the §10(b) charges, the courts below held that the deliberate breach of Winans' duty of confidentiality and concealment of the scheme was a fraud and deceit on the Journal. Although the victim of the fraud, the Journal, was not a buyer or seller of the stocks traded in or otherwise a market participant, the fraud was nevertheless considered to be "in connection with" a purchase or sale of securities within the meaning of the statute and the rule. The courts reasoned that the scheme's sole purpose was to buy and sell securities at a profit based on advance information of the column's contents. The courts below rejected petitioners' submission, which is one of the two questions presented here, that criminal liability could not be imposed on petitioners under Rule 10b-5 because "the newspaper is the only alleged victim of fraud and has no interest in the securities traded." . . .

The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts. For the reasons that follow, we also affirm the judgment with respect to the mail and wire fraud convictions.

II

Petitioners assert that their activities were not a scheme to defraud the Journal within the meaning of the mail and wire fraud statutes; and that in any event, they did not obtain any "money or property" from the Journal. We are unpersuaded by either submission and address the latter first.

The Journal, as Winans' employer, was defrauded of much more than its contractual right to his honest and faithful service, an interest too ethereal in itself to fall within the protection of the mail fraud statute, which "had its origin in the desire to protect individual property rights." Here, the object of the scheme was to take the Journal's confidential business information — the publication schedule and contents of the "Heard" column — and its intangible nature does not make it any less "property" protected by the mail and wire fraud statutes.

Confidential business information has long been recognized as property. The Journal had a property right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of the "Heard " column. . . . Petitioners' arguments that they did not interfere with the Journal's use of the information or did not publicize it and deprive the Journal of the first public use of it, miss the point. The confidential information was generated from the business, and the business had a right to decide how to use it prior to disclosing it to the public. Petitioners cannot successfully contend that a scheme to defraud requires a monetary loss, such as giving the information to a competitor; it is sufficient that the Journal has been deprived of its right to exclusive use of the information, for exclusivity is an important aspect of confidential business information and most private property for that matter.

We cannot accept petitioners' further argument that Winans' conduct in revealing prepublication information was no more than a violation of workplace rules and did not amount to fraudulent activity. . . . The concept of "fraud" includes the act of embezzlement, which is "'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'" . . . .

We have little trouble in holding that the conspiracy here to trade on the Journal's confidential information is not outside the reach of the mail and wire fraud statutes, provided the other elements of the offenses are satisfied. The Journal's business information that it intended to be kept confidential was its property; the declaration to that effect in the employee manual merely removed any doubts on that score and made the finding of specific intent to defraud that much easier. Winans continued in the employ of the Journal, appropriating its confidential business information for his own use, all the while pretending to perform his duty of safeguarding it. In fact, he told his editors twice about leaks of confidential information not related to the stock-trading scheme, demonstrating both his knowledge that the Journal viewed information concerning the "Heard" column as confidential and his deceit as he played the role of a loyal employee. Furthermore, the District Court's conclusion that each of the petitioners acted with the required specific intent to defraud is strongly supported by the evidence.

Lastly, we reject the submission that using the wires and the mail to print and send the Journal to its customers did not satisfy the requirement that those mediums be used to execute the scheme at issue. The courts below were quite right in observing that circulation of the "Heard" column was not only anticipated but an essential part of the scheme. Had the column not been made available to Journal customers, there would have been no effect on stock prices and no likelihood of profiting from the information leaked by Winans.

The judgment below is *Affirmed*.

STONERIDGE INVESTMENT PARTNERS, LLC, Petitioner v. SCIENTIFIC-ATLANTA, INC., et al.

SUPREME COURT OF THE UNITED STATES

552 U.S. 148; 128 S. Ct. 761

January 15, 2008, Decided

JUDGES: Kennedy, J., delivered the opinion of the Court, in which Roberts, C. J., and Scalia, Thomas, and Alito, JJ., joined. Stevens, J., filed a dissenting opinion, in which Souter and Ginsburg, JJ., joined. Breyer, J., took no part in the consideration or decision of the case.

Justice Kennedy delivered the opinion of the Court.

We consider the reach of the private right of action the Court has found implied in § 10(b) of the Securities Exchange Act of 1934. In this suit investors alleged losses after purchasing common stock. They sought to impose liability on entities who, acting both as customers and suppliers, agreed to arrangements that allowed the investors' company to mislead its auditor and issue a misleading financial statement affecting the stock price. We conclude the implied right of action does not reach the customer/supplier companies because the investors did not rely upon their statements or representations. We affirm the judgment of the Court of Appeals.

I

This class-action suit by investors was filed against Charter Communications, Inc., in the United States District Court for the Eastern District of Missouri. Stoneridge Investment Partners, LLC, a limited liability company organized under the laws of Delaware, was the lead plaintiff and is petitioner here.

Charter issued the financial statements and the securities in question. It was a named defendant along with some of its executives and Arthur Andersen LLP, Charter's independent auditor during the period in question. We are concerned, though, with two other defendants, respondents here. Respondents are Scientific-Atlanta, Inc., and Motorola, Inc. They were suppliers, and later customers, of Charter.

For purposes of this proceeding, we take these facts, alleged by petitioner, to be true. Charter, a cable operator, engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cashflow. The fraud included misclassification of its customer base; delayed reporting of terminated customers; improper capitalization of costs that should have been shown as expenses; and manipulation of the company's billing cutoff dates to inflate reported revenues. In late 2000, Charter executives realized that, despite these efforts, the company would miss projected operating cashflow numbers by $15 to $20 million. To help meet the shortfall, Charter decided to alter its existing arrangements with respondents, Scientific-Atlanta and Motorola. In our decision we assume Arthur Andersen was misled.

Respondents supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents $20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter. The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cashflow numbers. Respondents agreed to the arrangement.

So that Arthur Andersen would not discover the link between Charter's increased payments for the boxes and the advertising purchases, the companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business. Following a request from Charter, Scientific-Atlanta sent documents to Charter stating—falsely—that it had increased production costs. It raised the price for set top boxes for the rest of 2000 by $20 per box. As for Motorola, in a written contract Charter agreed to purchase from Motorola a specific number of set top boxes and pay liquidated damages of $20 for each unit it did not take. The contract was made with the expectation Charter would fail to purchase all the units and pay Motorola the liquidated damages.

To return the additional money from the set top box sales, Scientific-Atlanta and Motorola signed contracts with Charter to purchase advertising time for a price higher than fair value. The new set top box agreements were backdated to make it appear that they were negotiated a month before the advertising agreements. The backdating was important to convey the impression that the negotiations were unconnected, a point Arthur Andersen considered necessary for separate treatment of the transactions. Charter recorded the advertising payments to inflate revenue and operating cashflow by approximately $17 million. The inflated number was shown on financial statements filed with the Securities and Exchange Commission (SEC) and reported to the public.

Respondents [Scientific-Atlanta, Inc., and Motorola, Inc.] had no role in preparing or disseminating Charter's financial statements. And their own financial statements booked the transactions as a wash, under generally accepted accounting principles. It is alleged respondents knew or were in reckless disregard of Charter's intention to use the transactions to inflate its revenues and knew the resulting financial statements issued by Charter would be relied upon by research analysts and investors.

Petitioner filed a securities fraud class action on behalf of purchasers of Charter stock alleging that, by participating in the transactions, respondents violated § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. . . .

Decisions of the Courts of Appeals are in conflict respecting when, if ever, an injured investor may rely upon § 10(b) to recover from a party that neither makes a public misstatement nor violates a duty to disclose but does participate in a scheme to violate § 10(b). We granted certiorari.

II

Section 10(b) of the Securities Exchange Act makes it:

> "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . . . .
>
> "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j.

The SEC, pursuant to this section, promulgated Rule 10b-5, which makes it unlawful:

> "(a) To employ any device, scheme, or artifice to defraud,
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> "in connection with the purchase or sale of any security." 17 CFR § 240.10b-5.

Rule 10b-5 encompasses only conduct already prohibited by § 10(b). Though the text of the Securities Exchange Act does not provide for a private cause of action for § 10(b) violations, the Court has found a right of action implied in the words of the statute and its implementing regulation. In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

In *Central Bank*, the Court determined that § 10(b) liability did not extend to aiders and abettors. The Court found the scope of § 10(b) to be delimited by the text, which makes no mention of aiding and abetting liability. The Court doubted the implied § 10(b) action should extend to aiders and abettors when none of the express causes of action in the securities Acts included that liability. . . .

The decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Securities Exchange Act. Then-SEC Chairman Arthur Levitt, testifying before the Senate Securities Subcommittee, cited *Central Bank* and recommended that aiding and abetting liability in private claims be established. Congress did not follow this course. . . . Instead, it directed prosecution of aiders and abettors by the SEC.

The § 10(b) implied private right of action does not extend to aiders and abettors. The conduct of a secondary actor must satisfy each of the elements or preconditions for liability; and we consider whether the allegations here are sufficient to do so.

III

Reliance by the plaintiff upon the defendant's deceptive acts is an essential element of the § 10(b) private cause of action. It ensures that, for liability to arise, the "requisite causal connection between a defendant's misrepresentation and a plaintiff's injury" exists as a predicate for liability. We have found a rebuttable presumption of reliance in two different circumstances. First, if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance. Second, under the fraud-on-the-market doctrine, reliance is presumed when the statements at issue become public. The public information is reflected in the market price of the security. Then it can be assumed that an investor who buys or sells stock at the market price relies upon the statement.

Neither presumption applies here. Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.

In effect petitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect. Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule.

As stated above, reliance is tied to causation, leading to the inquiry whether respondents' acts were immediate or remote to the injury. In all events we conclude respondents' deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did.

These considerations answer as well the argument that if this were a common-law action for fraud there could be a finding of reliance. Even if the assumption is correct, it is not controlling. Section 10(b) does not incorporate common-law fraud into federal law.

The history of the § 10(b) private right and the careful approach the Court has taken before proceeding without congressional direction provide further reasons to find no liability here.

Concerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us. Though it remains the law, the § 10(b) private right should not be extended beyond its present boundaries.

Secondary actors are subject to criminal penalties. The enforcement power is not toothless. Since 2002, SEC enforcement actions have collected over $10 billion in disgorgement and penalties for distribution to injured investors.

Here respondents were acting in concert with Charter in the ordinary course as suppliers and, as matters then evolved in the not so ordinary course, as customers. Unconventional as the arrangement was, it took place in the marketplace for goods and services, not in the investment sphere. Charter was free to do as it chose in preparing its books, conferring with its auditor, and preparing and then issuing its financial statements. In these circumstances the investors cannot be said to have relied upon any of respondents' deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action. This conclusion is consistent with the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.

The judgment of the Court of Appeals is affirmed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Justice Breyer took no part in the consideration or decision of this case.

DISSENT BY: STEVENS

Justice Stevens, with whom Justice Souter and Justice Ginsburg join, dissenting.

Charter Communications, Inc., inflated its revenues by $17 million in order to cover up a $15 to $20 million expected cashflow shortfall. It could not have done so absent the knowingly fraudulent actions of Scientific-Atlanta, Inc., and

Motorola, Inc. Investors relied on Charter's revenue statements in deciding whether to invest in Charter and in doing so relied on respondents' fraud, which was itself a "deceptive device" prohibited by § 10(b) of the Securities Exchange Act of 1934. . . .

Even if but-for causation, standing alone, is too weak to establish reliance, petitioner has also alleged that respondents proximately caused Charter's misstatement of income; petitioner has alleged that respondents knew their deceptive acts would be the basis for statements that would influence the market price of Charter stock on which shareholders would rely. . . .

While I would reverse for the reasons stated above, I must also comment on the importance of the private cause of action that Congress implicitly authorized when it enacted the Securities Exchange Act of 1934. . . .

During the first two centuries of this Nation's history much of our law was developed by judges in the common-law tradition. A basic principle animating our jurisprudence was enshrined in state constitution provisions guaranteeing, in substance, that "every wrong shall have a remedy." Fashioning appropriate remedies for the violation of rules of law designed to protect a class of citizens was the routine business of judges. . . .

That context persuaded the majority that Congress had intended the courts to authorize a private remedy for members of the protected class. . . .

In light of the history of court-created remedies and specifically the history of implied causes of action under § 10(b), the Court is simply wrong when it states that Congress did not impliedly authorize this private cause of action "when it first enacted the statute." . . . . Congress enacted § 10(b) with the understanding that federal courts respected the principle that every wrong would have a remedy. Today's decision simply cuts back further on Congress' intended remedy. I respectfully dissent.

IV. Environmental Law

American Trucking Associations, Inc., et al. v. Christine Todd Whitman, Administrator of Environmental Protection Agency, et al.

SUPREME COURT OF THE UNITED STATES

531 U.S. 457; 121 S. Ct. 903

February 27, 2001, Decided

SCALIA, J., delivered the opinion of the Court.

These cases present the following questions: (1) Whether § 109(b)(1) of the Clean Air Act (CAA) delegates legislative power to the Administrator of the Environmental Protection Agency (EPA); (2) Whether the Administrator may consider the costs of implementation in setting national ambient air quality standards (NAAQS) under § 109(b)(1); (3) Whether the Court of Appeals had jurisdiction to review the EPA's interpretation with respect to implementing the revised ozone NAAQS; and (4) If so, whether the EPA's interpretation of that part was permissible.

I

Section 109(a) of the CAA requires the Administrator of the EPA to promulgate NAAQS for each air pollutant for which "air quality criteria" have been issued. Once a NAAQS has been promulgated, the Administrator must review the standard (and the criteria on which it is based) "at five-year intervals" and make "such revisions . . . as may be appropriate." CAA § 109(d)(1), 42 U.S.C. § 7409(d)(1). These cases arose when, on July 18, 1997, the Administrator revised the NAAQS for particulate matter (PM) and ozone. American Trucking Associations, Inc. challenged the new standards in the Court of Appeals for the District of Columbia Circuit.

The District of Columbia Circuit accepted some of the challenges and rejected others. The Administrator and the EPA petitioned this Court for review. We granted certiorari.

II

Section 109(b)(1) instructs the EPA to set primary ambient air quality standards "the attainment and maintenance of which . . . are requisite to protect the public health" with "an adequate margin of safety." Were it not for the hundreds of pages of briefing respondents have submitted on the issue, one would have thought it fairly clear that this text does not permit the EPA to consider costs in setting the standards. . . . The EPA is to identify the maximum airborne concentration of a pollutant that the public health can tolerate, decrease the concentration to provide an "adequate" margin of safety, and set the standard at that level. Nowhere are the costs of achieving such a standard made part of that initial calculation.

Against this most natural of readings, respondents make a lengthy, spirited, but ultimately unsuccessful attack. They begin with the object of § 109(b)(1)'s focus, the "public health."

Respondents argue, many more factors than air pollution affect public health. In particular, the economic cost of implementing a very stringent standard might produce health losses sufficient to offset the health gains achieved in cleaning the air — for example, by closing down whole industries and thereby impoverishing the workers and consumers dependent upon those industries. That is unquestionably true, and Congress was unquestionably aware of it. Thus, Congress had commissioned in the Air Quality Act of 1967 (1967 Act) "a detailed estimate of the cost of carrying out the provisions of this Act; a comprehensive study of the cost of program implementation by affected units of government; and a comprehensive study of the economic impact of air quality standards on the Nation's industries, communities, and other contributing sources of pollution." The 1970 Congress, armed with the results of this study not only anticipated that compliance costs could injure the public health, but provided for that precise exigency. Other provisions explicitly permitted or required economic costs to be taken into account in implementing the air quality standards. Section 111(b)(1)(B), for example, commanded the Administrator to set "standards of performance" for certain new sources of emissions that were to "reflect the degree of emission limitation achievable through the application of the best system of emission reduction which (taking into account the cost of achieving such reduction) the Administrator determines has been adequately demonstrated." Subsequent amendments to the CAA have added many more provisions directing, in explicit language, that the Administrator consider costs in performing various duties. We have therefore refused to find implicit in ambiguous sections of the CAA an authorization to consider costs that has elsewhere, and so often, been expressly granted. . . .

Even if we were to concede those premises, we still would not conclude that one of the unenumerated factors that the agency can consider in developing and applying the criteria is cost of implementation. That factor is *both* so indirectly related to public health *and* so full of potential for canceling the conclusions drawn from direct health effects that it would surely have been expressly mentioned in §§ 108 and 109 had Congress meant it to be considered. Yet while those provisions describe in detail how the health effects of pollutants in the ambient air are to be calculated and given effect, see § 108(a)(2), they say not a word about costs. . . .

The text of § 109(b), interpreted in its statutory and historical context and with appreciation for its importance to the CAA as a whole, unambiguously bars cost considerations from the NAAQS-setting process, and thus ends the matter for us as well as the EPA. We therefore affirm the judgment of the Court of Appeals on this point.

III

[discussion deleted]

IV

[discussion deleted]

To summarize our holdings in these unusually complex cases: The EPA may not consider implementation costs in setting primary and secondary NAAQS under § 109(b) of the CAA.

The judgment of the Court of Appeals is affirmed in part and reversed in part, and the cases are remanded for proceedings consistent with this opinion.

It is so ordered.

JUSTICE BREYER, concurring in part and concurring in the judgment.

I also agree with the Court's determination that the Clean Air Act does not permit the Environmental Protection Agency to consider the economic costs of implementation when setting national ambient air quality standards under § 109(b)(1) of the Act. . . .

The statute's words, then, authorize the Administrator to consider the severity of a pollutant's potential adverse health effects, the number of those likely to be affected, the distribution of the adverse effects, and the uncertainties surrounding each estimate. They permit the Administrator to take account of comparative health consequences. They allow her to take account of context when determining the acceptability of small risks to health. And they give her considerable discretion when she does so.

This discretion would seem sufficient to avoid the extreme results that some of the industry parties fear. After all, the EPA, in setting standards that "protect the public health" with "an adequate margin of safety," retains discretionary authority to avoid regulating risks that it reasonably concludes are trivial in context. Nor need regulation lead to deindustrialization. Preindustrial society was not a very healthy society; hence a standard demanding the return of the Stone Age would not prove "requisite to protect the public health."

Although I rely more heavily than does the Court upon legislative history and alternative sources of statutory flexibility, I reach the same ultimate conclusion. Section 109 does not delegate to the EPA authority to base the national ambient air quality standards, in whole or in part, upon the economic costs of compliance.

SOLID WASTE AGENCY OF NORTHERN COOK COUNTY v. UNITED STATES ARMY CORPS OF ENGINEERS, ET AL.

SUPREME COURT OF THE UNITED STATES

531 U.S. 159

October 31, 2000, Argued
January 9, 2001, Decided

JUDGES: REHNQUIST, C. J., delivered the opinion of the Court, in which O'CONNOR, SCALIA, KENNEDY, and THOMAS, JJ., joined. STEVENS, J., filed a dissenting opinion, in which SOUTER, GINSBURG, and BREYER, JJ., joined.

CHIEF JUSTICE REHNQUIST delivered the opinion of the Court.

Section 404(a) of the Clean Water Act (CWA or Act) regulates the discharge of dredged or fill material into "navigable waters." The United States Army Corps of Engineers (Corps), has interpreted § 404(a) to confer federal authority over an abandoned sand and gravel pit in northern Illinois which provides habitat for migratory birds. We are asked to decide whether the provisions of § 404(a) may be fairly extended to these waters, and, if so, whether Congress could exercise such authority consistent with the Commerce Clause, U.S. Const., Art. I, § 8, cl. 3. We answer the first question in the negative and therefore do not reach the second.

Petitioner, the Solid Waste Agency of Northern Cook County (SWANCC), is a consortium of 23 suburban Chicago cities and villages that united in an effort to locate and develop a disposal site for baled nonhazardous solid waste. The Chicago Gravel Company informed the municipalities of the availability of a 533-acre parcel, bestriding the Illinois counties Cook and Kane, which had been the site of a sand and gravel pit mining operation for three decades up until about 1960. Long since abandoned, the old mining site eventually gave way to a successional stage forest, with its remnant excavation trenches evolving into a scattering of permanent and seasonal ponds of varying size (from under one-tenth of an acre to several acres) and depth (from several inches to several feet).

The municipalities decided to purchase the site for disposal of their baled nonhazardous solid waste. By law, SWANCC was required to file for various permits from Cook County and the State of Illinois before it could begin operation of its balefill project. In addition, because the operation called for the filling of some of the permanent and seasonal ponds, SWANCC contacted federal respondents (hereinafter respondents), including the Corps, to determine if a federal landfill permit was required under § 404(a) of the CWA, 33 U.S.C. § 1344(a).

Section 404(a) grants the Corps authority to issue permits "for the discharge of dredged or fill material into the navigable waters at specified disposal sites." The term "navigable waters" is defined under the Act as "the waters of the United States, including the territorial seas." . . . .

In 1986, in an attempt to "clarify" the reach of its jurisdiction, the Corps stated that § 404(a) extends to intrastate waters:

> "a. Which are or would be used as habitat by birds protected by Migratory Bird Treaties; or
>
> "b. Which are or would be used as habitat by other migratory birds which cross state lines; or
>
> "c. Which are or would be used as habitat for endangered species

This last promulgation has been dubbed the "Migratory Bird Rule."

The Corps initially concluded that it had no jurisdiction over the site because it contained no "wetlands," or areas which support "vegetation typically adapted for life in saturated soil conditions." However, after the Illinois Nature Preserves Commission informed the Corps that a number of migratory bird species had been observed at the site, the Corps reconsidered and ultimately asserted jurisdiction over the balefill site pursuant to subpart (b) of the "Migratory Bird Rule." The Corps found that approximately 121 bird species had been observed at the site, including several known to depend upon aquatic environments for a significant portion of their life requirements. Thus, on November 16, 1987, the Corps formally "determined that the seasonally ponded, abandoned gravel mining depressions located on the project site, while not wetlands, did qualify as 'waters of the United States' . . . based upon the following criteria: (1) the proposed site had been abandoned as a gravel mining operation; (2) the water areas and spoil piles had developed a natural character; and (3) the water areas are used as habitat by migratory bird *[sic]* which cross state lines." U.S. Army Corps of Engineers, Chicago District, Dept. of Army Permit Evaluation and Decision Document, Lodging of Petitioner, Tab No. 1, p. 6.

During the application process, SWANCC made several proposals to mitigate the likely displacement of the migratory birds and to preserve a great blue heron rookery located on the site. Its balefill project ultimately received the necessary local and state approval. By 1993, SWANCC had received a special use planned development permit from the Cook County Board of Appeals, a landfill development permit from the Illinois Environmental Protection Agency, and approval from the Illinois Department of Conservation.

Despite SWANCC's securing the required water quality certification from the Illinois Environmental Protection Agency, the Corps refused to issue a § 404(a) permit. The Corps found that SWANCC had not established that its proposal was the "least environmentally damaging, most practicable alternative" for disposal of nonhazardous solid waste; that SWANCC's failure to set aside sufficient funds to remediate leaks posed an "unacceptable risk to the public's drinking water supply"; and that the impact of the project upon area-sensitive species was "unmitigatable since a landfill surface cannot be redeveloped into a forested habitat."

Petitioner filed suit in the Northern District of Illinois challenging both the Corps' jurisdiction over the site and the merits of its denial of the § 404(a) permit. The District Court granted summary judgment to respondents on the jurisdictional issue, and petitioner abandoned its challenge to the Corps' permit decision. On appeal to the Court of Appeals for the Seventh Circuit, petitioner renewed its attack on respondents' use of the "Migratory Bird Rule" to assert jurisdiction over the site. Petitioner argued that respondents had exceeded their statutory authority in interpreting the CWA to cover nonnavigable, isolated, intrastate waters based upon the presence of migratory birds and, in the alternative, that Congress lacked the power under the Commerce Clause to grant such regulatory jurisdiction.

The Court of Appeals held that the CWA reaches as many waters as the Commerce Clause allows and, given its earlier Commerce Clause ruling, it therefore followed that respondents' "Migratory Bird Rule" was a reasonable interpretation of the Act.

We granted certiorari, 529 U.S. 1129 (2000), and now reverse.

Congress passed the CWA for the stated purpose of "restoring and maintaining the chemical, physical, and biological integrity of the Nation's waters." In so doing, Congress chose to "recognize, preserve, and protect the primary responsibilities and rights of States to prevent, reduce, and eliminate pollution, to plan the development and use (including restoration, preservation, and enhancement) of land and water resources, and to consult with the Administrator in the exercise of his authority under this chapter." Relevant here, § 404(a) authorizes respondents to regulate the discharge of fill material into "navigable waters," . . . which the statute defines as "the waters of the United States, including the territorial seas." Respondents have interpreted these words to cover the abandoned gravel pit at issue here because it is used as habitat for migratory birds. We conclude that the "Migratory Bird Rule" is not fairly supported by the CWA. . . .

Indeed, the Corps' *original* interpretation of the CWA, promulgated two years after its enactment, is inconsistent with that which it espouses here. Its 1974 regulations defined § 404(a)'s "navigable waters" to mean "those waters of the United States which are subject to the ebb and flow of the tide, and/or are presently, or have been in the past, or may be in the future susceptible for use for purposes of interstate or foreign commerce." The Corps emphasized that "it is the water body's capability of use by the public for purposes of transportation or commerce which is the determinative factor." Respondents put forward no persuasive evidence that the Corps mistook Congress' intent in 1974.

Respondents next contend that whatever its original aim in 1972, Congress charted a new course five years later when it approved the more expansive definition of "navigable waters" found in the Corps' 1977 regulations. In July 1977, the Corps formally adopted 33 CFR § 323.2(a)(5) (1978), which defined "waters of the United States" to include "isolated wetlands and lakes, intermittent streams, prairie potholes, and other waters that are not part of a tributary system to interstate waters or to navigable waters of the United States, the degradation or destruction of which could affect interstate commerce." . . .

Where an administrative interpretation of a statute invokes the outer limits of Congress' power, we expect a clear indication that Congress intended that result. This requirement stems from our prudential desire not to needlessly reach constitutional issues and our assumption that Congress does not casually authorize administrative agencies to interpret a statute to push the limit of congressional authority. This concern is heightened where the administrative interpretation alters the federal-state framework by permitting federal encroachment upon a traditional state power. Thus, "where an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress." . . . .

These are significant constitutional questions raised by respondents' application of their regulations, and yet we find nothing approaching a clear statement from Congress that it intended § 404(a) to reach an abandoned sand and gravel pit such as we have here. Permitting respondents to claim federal jurisdiction over ponds and mudflats falling within the "Migratory Bird Rule" would result in a significant impingement of the States' traditional and primary power over land and water use. See, *e.g.*, *Hess* v. *Port Authority Trans-Hudson Corporation*, 513 U.S. 30 (1994) ("Regulation of land use [is] a function traditionally performed by local governments"). Rather than expressing a desire to readjust the federal-state balance in this manner, Congress chose to "recognize, preserve, and protect the primary responsibilities and rights of States . . . to plan the development and use . . . of land and water resources . . . ." We thus read the statute as written to avoid the significant constitutional and federalism questions raised by respondents' interpretation, and therefore reject the request for administrative deference.

We hold that 33 CFR § 328.3(a)(3) (1999), as clarified and applied to petitioner's balefill site pursuant to the "Migratory Bird Rule," exceeds the authority granted to respondents under § 404(a) of the CWA. The judgment of the Court of Appeals for the Seventh Circuit is therefore

Reversed.

DISSENT BY: JUSTICE STEVENS, with whom JUSTICE SOUTER, JUSTICE GINSBURG, and JUSTICE BREYER join, dissenting.

. . . . Today the Court takes an unfortunate step that needlessly weakens our principal safeguard against toxic water.

It is fair to characterize the Clean Water Act as "watershed" legislation. The statute endorsed fundamental changes in both the purpose and the scope of federal regulation of the Nation's waters. In § 13 of the Rivers and Harbors Appropriation Act of 1899 (RHA), Congress had assigned to the Army Corps of Engineers (Corps) the mission of regulating discharges into certain waters in order to protect their use as highways for the transportation of interstate and foreign commerce; the scope of the Corps' jurisdiction under the RHA accordingly extended only to waters that were "navigable." In the CWA, however, Congress broadened the Corps' mission to include the purpose of protecting the quality of our Nation's waters for esthetic, health, recreational, and environmental uses. The scope of its jurisdiction was therefore redefined to encompass all of "the waters of the United States, including the territorial seas." § 1362(7). That definition requires neither actual nor potential navigability.

JAMES E. O'NEIL, Attorney General For the State of Rhode Island, Plaintiff, Appellee, v. WARREN V. PICILLO, SR., ET AL., Defendants, Appellees. AMERICAN CYANAMID COMPANY and ROHM & HAAS COMPANY, Defendants, Appellants

United States Court of Appeals for the First Circuit

883 F.2d 176

(August 21, 1989)

JUDGES: Campbell, Chief Judge, Coffin, Senior Circuit Judge, and Fuste, District Judge.

OPINION BY: COFFIN, Senior Circuit Judge.

In July of 1977, the Picillos agreed to allow part of their pig farm in Coventry, Rhode Island to be used as a disposal site for drummed and bulk waste. That decision proved to be disastrous. Thousands of barrels of hazardous waste were dumped on the farm, culminating later that year in a monstrous fire ripping through the site. In 1979, the state and the Environmental Protection Agency (EPA) jointly undertook to clean up the area. What they found, in the words of the district court, were massive trenches and pits "filled with free-flowing, multi-colored, pungent liquid wastes" and thousands of "dented and corroded drums containing a veritable potpourri of toxic fluids." . . .

This case involves the State of Rhode Island's attempt to recover the clean-up costs it incurred between 1979 and 1982 and to hold responsible parties liable for all future costs associated with the site. The state's complaint originally named thirty-five defendants, all but five of whom eventually entered into settlements totaling $5.8 million, the money to be shared by the state and EPA. After a month-long bench trial, the district court, in a thorough and well reasoned opinion, found three of the remaining five companies jointly and severally liable under section 107 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA") for all of the State's past clean-up costs not covered by settlement agreements, as well as for all costs that may become necessary in the future. The other two defendants obtained judgments in their favor, the court concluding that the state had failed to prove that the waste attributed to those companies was "hazardous," as that term is defined under the Act.

Two of the three companies held liable at trial, American Cyanamid and Rohm and Haas, have taken this appeal. Both are so called "generators" of waste, as opposed to transporters or site owners. . . . Neither takes issue with the district court's finding that some of their waste made its way to the Picillo site. Rather, they contend that their contribution to the disaster was insubstantial and that it was, therefore, unfair to hold them jointly and severally liable for all of the state's past expenses not covered by settlements. . . . Finally, they argue that the Act should not be applied retroactively. . . . After a careful review of the record, we conclude that none of these arguments suffices to warrant reversal of the judgment below.

. . . . We confine our discussion to appellants' arguments concerning the unfairness of holding them jointly and severally liable for the government's past and future clean-up costs.

Joint and Several Liability: Statutory Background

It is by now well settled that Congress intended that the federal courts develop a uniform approach governing the use of joint and several liability in CERCLA actions. The rule adopted by the majority of courts, and the one we adopt, is based on the Restatement (Second) of Torts: damages should be apportioned only if the defendant can demonstrate that the harm is divisible. . . .

The practical effect of placing the burden on defendants has been that responsible parties rarely escape joint and several liability, courts regularly finding that where wastes of varying (and unknown) degrees of toxicity and migratory potential commingle, it simply is impossible to determine the amount of environmental harm caused by each party. . . It has not gone unnoticed that holding defendants jointly and severally liable in such situations may often result in defendants paying for more than their share of the harm. . . . Nevertheless, courts have continued to impose joint and several liability on a regular basis, reasoning that where all of the contributing causes cannot fairly be traced, Congress intended for those proven at least partially culpable to bear the cost of the uncertainty. . . .

In enacting the Superfund Amendments and Reauthorization Act of 1986 ("SARA"), Congress had occasion to examine this case law. Rather than add a provision dealing explicitly with joint and several liability, it chose to leave the issue with the courts, to be resolved as it had been — on a case by case basis . . Congress did, however, add two important provisions designed to mitigate the harshness of joint and several liability. First, the 1986 Amendments direct the EPA to offer early settlements to defendants who the Agency believes are responsible for only a small portion of the harm, so-called de minimis settlements. n1 Second, the Amendments provide for a statutory cause of action in Contribution, codifying what most courts had concluded was implicit in the 1980 Act. Under this section, courts "may allocate response costs among liable parties using such equitable factors as the court determines are appropriate." We note that appellants already have initiated a contribution action against seven parties before the same district court judge who heard this case.

While a right of contribution undoubtedly softens the blow where parties cannot prove that the harm is divisible, it is not a complete panacea since it frequently will be difficult for defendants to locate a sufficient number of additional, solvent parties. Moreover, there are significant transaction costs involved in bringing other responsible parties to court. If it were possible to locate all responsible parties and to do so with little cost, the issue of joint and several liability obviously would be of only marginal significance. We, therefore, must examine carefully appellants' claim that they have met their burden of showing that the harm in this case is divisible.

Divisibility

The district court issued two rulings on joint and several liability. First, the court held appellants jointly and severally liable for all of the state's past costs not covered by settlements, roughly $1.4 million including prejudgment interest. According to appellants, this money was spent exclusively on "removal" costs or "surface cleanup" (e.g., sampling the waste, contacting responsible parties, and ultimately, removing the barrels and contaminated soil), and not on remedying the alleged damage to groundwater and other natural resources ("remedial" costs). . . .

I. Past Costs

Appellants begin by stressing that the state's past costs involved only surface cleanup. They then argue that because it was possible to determine how many barrels of waste they contributed to the site, it is also possible to determine what proportion of the state's removal expenses are attributable to each of them simply by estimating the cost of excavating a single barrel. The EPA advances two reasons why this approach is incorrect. First, it claims that it was not possible to determine how many barrels were traceable to appellants, nor was it possible to determine how much of the contaminated soil removed by the state was attributable to each appellant, and therefore, that it is impossible to apportion the state's removal costs. Second, it argues that even if it were possible to determine what proportion of the state's removal costs are attributable to appellants, joint and several liability still would have been proper because the "harm to be apportioned is not the cost but the environmental contamination that prompts the response action.". .

[W]e choose not to resolve the issue in this case. Had appellants met their burden of showing that the costs actually incurred by the state were capable of apportionment, we would have had no choice but to address the EPA's theory. But because we do not believe appellants have done so, we can, and do, choose to leave the question for another day. We turn now to the EPA's first contention that the state's removal costs are not capable of apportionment.

Removal Costs

. . . . In light of the fact that most of the waste could not be identified, and that the appellants, and not the government, had the burden to account for all of this uncertainty, we think it plain that the district court did not err in holding them jointly and severally liable for the state's past removal costs. Perhaps in this situation the only way appellants could have demonstrated that they were limited contributors would have been to present specific evidence documenting the whereabouts of their waste at all times after it left their facilities. But far from doing so, appellants deny all knowledge of how their waste made its way to the site. Moreover, the government presented evidence that much of Rohm and Haas' waste found at the site came from its laboratory in Spring House, Pennsylvania and that during the relevant years, this lab generated over two thousand drums of waste, all of which were consigned to a single transporter. Under these circumstances, where Rohm and Haas was entrusting substantial amounts of waste to a single transporter who ultimately proved unreliable, we simply cannot conclude, absent evidence to the contrary, that only a handful of the 2,000 or more barrels reached the site.

II. Future Liability

. . .   Appellants contend that it was improper to hold them liable for future remedial action because the state has not shown that such work will ever be needed. They do not claim, however, that if remedial action is shown to be necessary, it would be a mistake to assume that their waste contributed to the damage. We see no problem with the court giving the state (and EPA) time to conduct further tests. If after conducting the necessary tests, the government concludes that there was in fact no harm to the area's groundwater, then appellants will have nothing to worry about. Moreover, the district court ruled that under section 107 of the Act, the state may take only such measures as are cost-efficient. Appellants, therefore, will have an opportunity to challenge the state's chosen remedial measures at the appropriate time.

Conclusion

Appellants have argued ably that they should not have been held jointly and severally liable. In the end, however, we think they have not satisfied the stringent burden placed on them by Congress. As to all other issues, we affirm substantially for the reasons set out by the district court. n5 Appellants should now move on to their contribution action where their burden will be reduced and the district court will be free to allocate responsibility according to any combination of equitable factors it deems appropriate. Indeed, there might be no reason for the district court to place any burden on appellants. If the defendants in that action also cannot demonstrate that they were limited contributors, it is not apparent why all of the parties could not be held jointly and severally liable. However, we leave this judgment to the district court. . . .

Affirmed.

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Footnotes:

n1 Appellants apparently were offered settlements, but chose instead to try this case.

n5 One of these other issues concerns the constitutionality of applying CERCLA retroactively. The district court held that CERCLA may be applied to pre-enactment conduct. Appellants contend, however, that even if the statute may be applied to pre-enactment conduct, it may not be applied constitutionally to pre-enactment costs incurred by the government . . . We disagree and find persuasive the Eighth Circuit's reasoning . . . .

United States of America, Plaintiff-Appellee, v. Fleet Factors Corp., Defendant

United States Court of Appeals for the Eleventh Circuit

901 F.2d 1550
(May 23, 1990)

Appeal from the United States District Court for the Southern District of Georgia.

JUDGES: Vance and Kravitch, Circuit Judges, and Lynne, Senior District Judge. Opinion by: Kravitch

Fleet Factors Corporation ("Fleet") brought an appeal from the district court's denial of its motion for summary judgment in this suit by the United States to recover the cost of removing hazardous waste from a bankrupt textile facility. The district court denied summary judgment because it concluded that Fleet's activities at the facility might rise to the level of participation in management sufficient to impose liability under the Comprehensive Environmental Response Compensation and Liability Act ("CERCLA"), 42 U.S.C. §§ 9601, despite the statutory exemption from liability for holders of a security interest. We agree with the district court that material questions of fact remain as to the extent of Fleet's participation in the management of the facility; therefore, we affirm the denial of Fleet's summary judgment motion.

FACTS

In 1976, Swainsboro Print Works ("SPW"), a cloth printing facility, entered into a "factoring" agreement with Fleet in which Fleet agreed to advance funds against the assignment of SPW's accounts receivable. As collateral for these advances, Fleet also obtained a security interest in SPW's textile facility and all of its equipment, inventory, and fixtures. In August, 1979, SPW filed for bankruptcy under Chapter 11. The factoring agreement between SPW and Fleet continued with court approval. In early 1981, Fleet ceased advancing funds to SPW because SPW's debt to Fleet exceeded Fleet's estimate of the value of SPW's accounts receivable. On February 27, 1981, SPW ceased operations and began to liquidate its inventory. Fleet continued to collect on the accounts receivable assigned to it under the Chapter 11 factoring agreement. In December 1981, SPW was adjudicated a bankrupt under Chapter 7 and a trustee assumed title and control of the facility.

In May 1982, Fleet foreclosed on its security interest in some of SPW's inventory and equipment, and contracted with Baldwin Industrial Liquidators ("Baldwin") to conduct an auction of the collateral. Baldwin sold the material "as is" and "in place" on June 22, 1982; the removal of the items was the responsibility of the purchasers. On August 31, 1982, Fleet allegedly contracted with Nix Riggers ("Nix") to remove the unsold equipment in consideration for leaving the premises "broom clean." Nix testified in deposition that he understood that he had been given a "free hand" by Fleet or Baldwin to do whatever was necessary at the facility to remove the machinery and equipment. Nix left the facility by the end of December, 1983.

On January 20, 1984, the Environmental Protection Agency ("EPA") inspected the facility and found 700 fifty-five gallon drums containing toxic chemicals and 44 truckloads of material containing asbestos. The EPA incurred costs of nearly $400,000 in responding to the environmental threat at SPW. On July 7, 1987, the facility was conveyed to Emanuel County, Georgia, at a foreclosure sale resulting from SPW's failure to pay state and county taxes.

The government sued the two principal officers and stockholders of SPW, and Fleet to recover the cost of cleaning up the hazardous waste.

DISCUSSION

The Comprehensive Environmental Response Compensation and Liability Act was enacted by Congress in response to the environmental and public health hazards caused by the improper disposal of hazardous wastes.. . . The essential policy underlying CERCLA is to place the ultimate responsibility for cleaning up hazardous waste on "those responsible for problems caused by the disposal of chemical poison.". . . Accordingly, CERCLA authorizes the federal government to clean up hazardous waste dump sites and recover the cost of the effort from certain categories of responsible parties. . . .

The parties liable for costs incurred by the government in responding to an environmental hazard are: 1) the present owners and operators of a facility where hazardous wastes were released or are in danger of being released; 2) the owners or operators of a facility at the time the hazardous wastes were disposed; 3) the person or entity that arranged for the treatment or disposal of substances at the facility; and 4) the person or entity that transported the substances to the facility. . . . The government contends that Fleet is liable for the response costs associated with the waste at the SPW facility as either a present owner and operator of the facility, or the owner or operator of the facility at the time the wastes were disposed. . .

The district court, as a matter of law, rejected the government's claim that Fleet was a present owner of the facility. The court, however, found a sufficient issue of fact as to whether Fleet was an owner or operator of the SPW facility at the time the wastes were disposed to warrant the denial of Fleet's motion for summary judgment. On appeal each party contests that portion of the district court's order adverse to their respective interests.

A. Fleet's Liability

. . . . CERCLA imposes liability on "any person who at the time of disposal of any hazardous substance owned or operated any . . . facility at which such hazardous substances were disposed of. . . ." . . . CERCLA excludes from the definition of "owner or operator" any "person, who, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility." . . . . Fleet has the burden of establishing its entitlement to this exemption. There is no dispute that Fleet held an "indicia of ownership" in the facility through its deed of trust to SPW, and that this interest was held primarily to protect its security interest in the facility. The critical issue is whether Fleet participated in management sufficiently to incur liability under the statute.

The construction of the secured creditor exemption is an issue of first impression in the federal appellate courts. The government urges us to adopt a narrow and strictly literal interpretation of the exemption that excludes from its protection any secured creditor that participates in any manner in the management of a facility. We decline the government's suggestion because it would largely eviscerate the exemption Congress intended to afford to secured creditors. Secured lenders frequently have some involvement in the financial affairs of their debtors in order to insure that their interests are being adequately protected. To adopt the government's interpretation of the secured creditor exemption could expose all such lenders to CERCLA liability for engaging in their normal course of business.

Fleet, in turn, suggests that we adopt the distinction delineated by some district courts between permissible participation in the financial management of the facility and impermissible participation in the day-to-day or operational management of a facility. . . .

The court, however, determined that the facts alleged by the government with respect to Fleet's involvement after Baldwin entered the facility were sufficient to preclude the granting of summary judgment in favor of Fleet on this issue. . . . It is not necessary for the secured creditor actually to involve itself in the day-to-day operations of the facility in order to be liable — although such conduct will certainly lead to the loss of the protection of the statutory exemption. Nor is it necessary for the secured creditor to participate in management decisions relating to hazardous waste. Rather, a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose. . . .

This construction of the secured creditor exemption, while less permissive than that of the trial court, is broader than that urged by the government and, therefore, should give lenders some latitude in their dealings with debtors without exposing themselves to potential liability. Nothing in our discussion should preclude a secured creditor from monitoring any aspect of a debtor's business. Likewise, a secured creditor can become involved in occasional and discrete financial decisions relating to the protection of its security interest without incurring liability.

Our interpretation of the exemption may be challenged as creating disincentives for lenders to extend financial assistance to businesses with potential hazardous waste problems and encouraging secured creditors to distance themselves from the management actions, particularly those related to hazardous wastes, of their debtors. . . . As a result, the improper treatment of hazardous wastes could be perpetuated rather than resolved. These concerns are unfounded.

Our ruling today should encourage potential creditors to investigate thoroughly the waste treatment systems and policies of potential debtors. If the treatment systems seem inadequate, the risk of CERCLA liability will be weighed into the terms of the loan agreement. Creditors, therefore, will incur no greater risk than they bargained for and debtors, aware that inadequate hazardous waste treatment will have a significant adverse impact on their loan terms, will have powerful incentives to improve their handling of hazardous wastes.

Similarly, creditors' awareness that they are potentially liable under CERCLA will encourage them to monitor the hazardous waste treatment systems and policies of their debtors and insist upon compliance with acceptable treatment standards as a prerequisite to continued and future financial support. . . . Once a secured creditor's involvement with a facility becomes sufficiently broad that it can anticipate losing its exemption from CERCLA liability, it will have a strong incentive to address hazardous waste problems at the facility rather than studiously avoiding the investigation and amelioration of the hazard. . . . .

We agree with the court below that the government has alleged sufficient facts to hold Fleet liable. . . . From 1976 until SPW ceased printing operations on February 27, 1981, Fleet's involvement with the facility was within the parameters of the secured creditor exemption to liability. During this period, Fleet regularly advanced funds to SPW against the assignment of SPW's accounts receivable, paid and arranged for security deposits for SPW's Georgia utility services, and informed SPW that it would not advance any more money when it determined that its advanced sums exceeded the value of SPW's accounts receivable.

Fleet's involvement with SPW, according to the government, increased substantially after SPW ceased printing operations at the Georgia plant on February 27, 1981, and began to wind down its affairs. Fleet required SPW to seek its approval before shipping its goods to customers, established the price for excess inventory, dictated when and to whom the finished goods should be shipped, determined when employees should be laid off, supervised the activity of the office administrator at the site, received and processed SPW's employment and tax forms, controlled access to the facility, and contracted with Baldwin to dispose of the fixtures and equipment at SPW. These facts, if proved, are sufficient to remove Fleet from the protection of the secured creditor exemption. Fleet's involvement in the financial management of the facility was pervasive, if not complete. Furthermore, the government's allegations indicate that Fleet was also involved in the operational management of the facility. Either of these allegations is sufficient as a matter of law to impose CERCLA liability on a secured creditor. The district court's finding to the contrary is erroneous.

With respect to Fleet's involvement at the facility from the time it contracted with Baldwin in May 1982 until Nix left the facility in December 1983, we share the district court's conclusion that Fleet's alleged conduct brought it outside the statutory exemption for secured creditors. Indeed, Fleet's involvement would pass the threshold for operator liability. . . . The scope of the secured creditor exemption is not determined by whether the creditor's activity was taken to protect its security interest. What is relevant is the nature and extent of the creditor's involvement with the facility, not its motive. To hold otherwise would enable secured creditors to take indifferent and irresponsible actions toward their debtors' hazardous wastes with impunity by incanting that they were protecting their security interests. Congress did not intend CERCLA to sanction such abdication of responsibility.

CONCLUSION

. . . Although the court erred in construing the secured creditor exemption to insulate Fleet from CERCLA liability for its conduct prior to June 22, 1982, it correctly ruled that Fleet was liable for its subsequent activities if the government could establish its allegations. Because there remain disputed issues of material fact, the case is remanded for further proceedings consistent with this opinion.

AFFIRMED and REMANDED.