Ethics and Equity: Enforcing Ethical Standards in Commercial Relationships

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ABSTRACT. Lawyers and the legal system have been much criticized in recent years. Despite popular perceptions, the legal system contains numerous mechanisms and rules designed to ensure fair results. This paper shows how the legal system tries to implement, in commercial transactions, the ethical principles of truthfulness and fairness. The Anglo-American development of Equity Courts is reviewed briefly. Several examples of the Law's enforcement of ethical principles are presented, in four different legal areas: Contracts, Securities, Goods, and Real Estate. The intent here is to present an overview of the problem, with area-specific illustrations, rather than a comprehenisve examination of the cases in just one area.

Ethical principles

Out of the many ethical principles developed over the centuries, two – Truthfulness and Fairness – seem particularly relevant to legal relationships. Both are also principles of long standing, dating back at least to Aristotle's great work, *Nicomachean Ethics* (Aristotle, 1952).

Truthfulness is required in commercial transactions, and indeed in all human interactions, because we communicate with each other. We exchange information, and then act, at least in part, on the basis of that information. Lying to the other party, in the hopes of gaining a commercial advantage, would generally be defined as unethical conduct. For Aristotle, the truth-teller was "worthy of praise." "[T]he man who loves truth, and is truthful where nothing is at stake, will still more be truthful where something is at stake; he will avoid falsehood as something base, seeing that he avoided it even for its own sake; and such a man is worthy of praise" (Aristotle, 1952).

Fairness, in the context of commercial transactions, implies an exchange of values of approximate equality. At least as of the time of the exchange, each party believes she is receiving value for value given. It is of course often true that our expectations are not fulfilled. Some of the things we receive turn out not to be as useful or as pleasurable as we imagined they would be. To a great extent, that is simply the nature of things. We often desire something intensely, only to be severely disappointed by the post-acquisition actuality. Fairness in the ethical sense does not imply the "complete satisfaction" which is used in so many advertisements. Fairness does mean that each party receive the thing bargained for, and that the thing have a real value. Aristotle also discussed fairness, in the context of what is just: "Both the lawless man and the grasping and unfair man are thought to be unjust, so that evidently both the law-abiding and the fair man will be just. The just, then, is the lawful and the fair, the unjust the unlawful and the unfair (Aristotle, 1952).

The idea of dealing fairly and justly with other persons is "the greatest of virtues" (Aristotle, 1952). "It is complete [virtue] because he who possesses it can exercise his virtue not only in himself but towards his neighbor also; for many men can exercise virtue in their own

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affairs, but not in their relations to their neighbor" (Aristotle, 1952).

How, then, does our modern legal system try to implement these two great ethical princples?

Equity

Systemic need for equity

Appropriately enough, it is also Aristotle who best explains a legal system's need for Equity. Equity's flexibility is required to supplement the rigidity of the general legal rules, to provide for the exceptional case: "Our next subject is equity and the equitable . . . , and their respective relations to justice and the just. . . . What creates the problem is that the equitable is just, but not the legally just but a correction of legal justice. The reason is that all law is universal but about some things it is not possible to make a universal statement which shall be correct. In those cases, then, in which it is necessary to speak universally, but not possible to do so correctly, the law takes the usual case, though it is not ignorant of the possibility of error. . . . When the law speaks universally, then, and a case arises on it which is not covered by the universal statement, then it is right, where the legislator fails us and has erred by over-simplicity, to correct the omission – to say what the legislator himself would have said had he been present, and would have put into his law if he had known" (Aristotle, 1952).

Equity in England

The English legal system responded to its need for equity by developing a second set of courts, using different judges (the chancellors) to administer these supplementary principles. According to Plucknett, however, "many rules which have since become distinctive of chancery make their first appearance in the common law courts" (Plucknett, 1956). Further, he says, "[t]here was, therefore, no fundamental inconsistency between equity and common law; the one was not alien to the other" (Plucknett, 1956). The new Chancery Court "did not originate English Equity, for it simply carried on the work of the older courts by developing in greater fullness and with a different machinery the equity inherent in royal justice" (Plucknett, 1956).

There was no logical necessity for using different courts to administer the principles of equity. Plucknett remarks on "the abandonment by the common law judges of their ancient powers of discretion" (Plucknett, 1956). Why this happened remains somewhat unclear. Political factors – fear of giving too much power and independence to the common law judges – probably played a part. Philosophically, most common law lawyers and judges preferred the law's certainty to equity's flexibility. Plucknett notes that "the common law was essentially the law of land" (Plucknett, 1956). Land titles and land transactions required certainty, not creativity. "The [common law] lawyers had a maxim that they would tolerate a 'mischief' (a failure of substantial justice in a particular case) rather than an 'inconvenience' (a breach of legal principle)" (Plucknett, 1956).

The chancellors, acting in the king's name, developed a set of equitable remedies for situations where the normal remedies of the common law did not provide complete justice. The injunction was the equity remedy to prevent a continuing wrong. The equity court ordered the offender to cease and desist, in the king's name. Failure to comply with the court order could result in fine and/or imprisonment. Specific performance was the remedy to require performance of a contract for land or for unique goods. Money damages, the usual common law remedy, would not provide adequate relief in such cases, since the plaintiff would still not have the thing bargained for. The chancellors also developed an assortment of other remedies to deal with special situations, including reformation, rescission, restitution, and redemption. They recognized rights created by assignments and trusts. In sum, it was the chancery courts, applying the principles of equity, which provided the rules required by a developing English society.

Transplantation of equity

Many aspects of the English legal system were transplanted to the American colonies. Blackstone's *Commentaries on the Laws of England*, first published in 1765, were widely read and widely used in America. "The *Commentaries* had a tremendous sale there, for not only did they contain some very useful matter on public law, but also served as the principal means of the colonists' information as to the state of English law in general" (Plucknett, 1956).

After independence, guarantees of the right to trial by jury were written into the national Constitution and the constitutions of most, if not all, states. The Seventh Amendment to the U.S. Constitution preserves the right to a trial by jury in civil cases *at common law* involving $20 or more. The key phrase "at common law" thus excludes equity cases, and freezes the law/equity distinction into the Constitution. Later, when most states and the national courts combined legal procedure with equity procedure, these constitutional provisions meant that the statutory combination could not be complete. The law/equity distinction still has to be made to determine whether the parties are entitled to a trial by jury.

Equity today

England reunited Law and Equity, by statute, in 1875 (Curzon, 1968). Similar recombination has taken place in the U.S. courts and in most states. Judges in these "combined" courts have all the powers of the common law judges and all the powers of the equity chancellors. A few states still maintain separate equity courts, most notably Delaware, where many corporate litigations are heard by the Chancery Court.

Whether administered by a separate court or not, the function of Equity remains essentially what it has been for centuries – providing special remedies to do more complete justice between the parties. In this sense, then, Equity continues to serve as "the keeper of the King's [Queen's] conscience" (Rienow, 1952). The "maxims" of Equity developed by the chancellors retain their force and utility: "Equity acts on the conscience;" "Equity looks to the intent rather than to the form;" "He who seeks equity must do equity" (Curzon, 1968). Perhaps the greatest and most basic equitable principle of all is stated as: "Equity will not suffer a wrong to be without a remedy" (Curzon, 1968). Even though no longer separate and independent, Equity operates within our modern legal system as a built-in guarantor of the ethical principle of Fairness.

Ethical standards in legal decisions

A variety of specific legal rules have been developed to ensure Truthfulness and Fairness in commercial transactions. This section examines several of them, taken from Contract Law, Securities Law, Sales of Goods Law, and Landlord/Tenant Law. These examples are not intended to be exhaustive, merely illustrative.

One caveat should be kept in mind during this review of specifics: there are certain systemic constraints on the courts' ability to supervise legal relationships. A major premise of our free, democratic society is the decision-making capacity of the individual citizen. Likewise, our free enterprise system is based on Contract rather than Status – freely made relationships, rather than inherited group membership. There is thus a strong presumption in favor of allowing persons to negotiate their own legal relationships, and then requiring the fulfillment of those relationships. Courts therefore usually feel it necessary to explain why they are modifying the parties' bargain, or refusing to enforce it as negotiated.

Contract enforcement

Adequate consideration

As a rule, the law emphasizes freedom of contract, and permits the parties to set the terms of their own bargain. Usually, the value of the things exchanged is determined by the parties themselves. Once made, their bargain binds both of them to perform it according to its terms. When one party breaches by failing to perform,

the other can get court remedies by showing that there was a bargain for an exchange of "sufficient" considerations. Legal sufficiency does not require proof of equal values, only that some sort of performance was required of each party.

Early on, however, courts of equity required a higher standard of a party seeking specific performance. One of the equitable maxims noted above was that "he who seeks equity must do equity." Applying this maxim, equity courts required proof that an "adequate" consideration had been promised in exchange for the land or unique goods which the plaintiff was seeking through specific performance. As stated by the New York appellate court in an early case: "A court of equity must be satisified that the claim for a deed is fair and just, and reasonable, and the contract equal in all its parts, and founded on an adequate consideration, before it will interpose with this extraordinary assistance" (*Seymour*, 1824). "Adequate" in this sense meant at least an approximation of equal values to be exchanged. $5000, for example, would usually be deemed a "sufficient" consideration, but would not be an "adequate" consideration in exchange for a farm worth $50,000, such as to justify specific performance. Persons appealing to "the court of the Queen's conscience" for a special remedy must show the inherent fairness of the contracts they are seeking to enforce.

Gross inadequacy of consideration

A related rule states that a gross disparity in the exchange is some evidence that the transaction was based on fraud or mistake. For instance, in an Illinois case, O'Neill claimed that he owned a valuable painting as the result of a sale of it to him by Mr. Delaney, for $10 and "other good and valuable consideration." The "other good and valuable consideration" turned out to be nothing more than friendly feelings between the two men, while the painting was worth at least $100,000. The Illinois court sustained Mrs. Delaney's objections to the so-called "sale." In the words of the court: "A purchase price of $10 for such a valuable work of art is so grossly inadequate consideration as to shock the conscience of this court, as it did the trial court's. To find $10 valid consideration for this painting would be to reduce the requirement of consideration to a mere formality. This we will not do" (*O'Neill*, 1980). In sum, the purported "sale" was fraudulent, and therefore invalid.

Courts may also find that no contract exists where one party's mistake is so gross that the other party must have known it to be such. In a California case, Kemper sued to rescind a bid it had made on a Los Angeles sewer project. Over 1000 items were involved in preparing the bid; three Kemper employees worked on it until 2 a.m. of the day bids were due. In totalling up the bid, they left out one page of items worth $301,769. Kemper's bid was stated as $780,305. The three competing bids were $1,049,592; $1,183,000; and $1,278,895. The city insisted that Kemper due the work for $780,305, or forfeit the ten percent bond it had posted to guarantee performance. The court held that the city should have been aware of this obvious mistake, and that there was therefore no contract. The city was required to give Kemper back the bond money (*Kemper*, 1951). Clearly, the California court worked out the fair result in this case.

Unconscionability

The drafters of the Uniform Commercial Code included a section (2-302) on unconscionable contracts. Since it was part of Article 2, it therefore applied only to contracts for the sale of goods. The courts, however, were quick to assert that their power to invalidate unconscionable contracts had always been part of the common law.

The leading case on unconscionability is *Williams* (1965). Ms. Williams had signed a credit contract with the furniture store and had purchased several items there, on credit. The form contract stated that the customer was only "leasing" the items until they were fully paid for. Further, the contract said that payments would be applied pro rata to each item bought on credit, and that all items not paid for in full would be collateral for any unpaid balance.

Williams missed a payment, and the store threatened to repossess all the items she had purchased, since none had been paid for in full under the pro rata arrangement. Williams sued to have the pro rata clause and the repossession clause in the contract declared unconscionable. The lower court refused to rule in her favor, since the UCC was not in force in D.C. when she signed the contract. The D.C. Court of Appeals reversed, holding that courts have always had the inherent power to refuse to enforce grossly unfair bargains (*Williams*, 1965).

Courts have made similar rulings in contracts not involving the sale of goods at all. A Michigan court applied the unconscionability principle to invalidate a grossly unfair clause in an employment contract. The employee in question worked as a sales representative and received commissions on sales made. According to his contract, however, if he left the company for any reason, he would receive commissions only for those goods which had actually been delivered to customers as of the date of termination. When he left, he had made a significant sale of merchandise which had not yet been delivered to the customer involved. He sued when the company refused to pay the commission on that sale. The Michigan court held that the "delivery" clause in the employment contract was unconscionable, and that the company did owe the commission on the undelivered merchandise (*Reed*, 1972). It seems clear that most courts today will modify or will refuse to enforce grossly unfair contracts.

Moral obligation as consideration

The general legal rule on a moral obligation as consideration runs counter to the thesis of this paper. Generally, one party's moral obligation to do something is not treated as legally sufficient consideration for her promise to do it. The *Restatement of the Law of Contracts* uses the example of a promise made to a dying partner. On his death-bed, partner A expresses concern about his wife's financial future. Partner B reassures him: "Don't worry; I'll take care of her." The *Restatement* says that B is not legally bound to perform this promise, even though B might have a moral obligation to do so.

Even here, however, there are several notable exceptions, which are consistent with the thrust of this paper. Many states do enforce new promises to pay old debts which have been barred by the running of the statute of limitations, or by a discharge in bankruptcy. Some states may require these new promises to be made in a signed writing to be enforceable, but new consideration is not required. The fairness inherent in these two exceptions is obvious: there was a contract, value was given by one party but not by the other, there is a legal technicality which prevents suit to enforce the debt. If the debtor now promises to pay the previously valid, but now unenforceable debt, why should she not be held to her promise?

Some states also enforce promises made to charitable organizations on the basis of an underlying moral obligation to support "good works." Other states may enforce charitable promises under a different legal theory – promissory estoppel, or may find mutual promises not to revoke implied as between the promisors.

Promissory estoppel

Another fairness issue occurs where a promisee reasonably relies on a non-contractual promise and takes substantial action because of it. The promisor argues that there was no contract, and so she should not be bound by her promise. At least in some of these cases, the courts apply the doctrine of promissory estoppel. The promisor is estopped (prevented) from making the "no consideration = no contract" argument where her promise has induced a promisee to make a substantial change in legal position in reasonable reliance on the promise.

The classic case applying promissory estoppel is *Hoffman* (1964). The Hoffmans wanted a franchise for a Red Owl store. The Red Owl representative told them that they would need to satisfy several requirements to qualify. The Hoffmans sold their home in one city, moved to the designated franchise city, bought a store there to gain the required retail experience, bought a

site there for the proposed Red Owl store, and assembled the capital amount indicated. When they contacted the Red Owl representative about their franchise, he informed them that the capital requirements had been raised. The Hoffmans were unable to raise the additional capital, and sued for breach of contract when their Red Owl franchise was refused. The Wisconsin court said that promisees in this situation should at least be permitted to recover the losses they had sustained by acting in reliance on the promise (*Hoffman*, 1964). Here again, fairness prevails.

Equitable estoppel

The principle of estoppel is also used to produce a fair result where the promisor argues that no contract can be enforced because of the absence of a signed writing, even though substantial values have already been transferred to him. Generally, where a contract is required by the Statute of Frauds to be evidenced by a signed writing and there is no such writing, the contract is indeed unenforceable in court. There is, however, a widely recognized exception which permits the enforcement of oral real estate contracts in certain circumstances.

This exception is most typically applied where the land seller has permitted the buyer to take possession, and to make substantial permanent improvements on the premises. The land seller then claims that the oral contract is unenforceable, and demands return of the (improved) land. In many such cases, the equity court estops the land seller from arguing the Statute of Frauds, and enforces the oral land contract.

A rather unusual case from California shows the scope of the doctrine of equitable estoppel. Annie Porporato's husband was killed in military action in 1943. She had been living in San Francisco in a house owned by her father-in-law, John. When her husband died, Annie returned, with her son, to her family home in Omaha, Nebraska. John said that if she would come back to San Francisco and live there so that he could be near his grandson, she would be given the house when John died. She did so, and lived there for 20 years. When John died, he left the house to Anita DeVincenzi. Even though Annie had nothing in writing, the California court estopped Anita and John's estate from arguing the Statute of Frauds. Annie had given John exactly the value he requested, and there was no way to give her back 20 years of her life. She got the house (*Porporato*, 1968).

Nondisclosure as Fraud

It is true that, as a rule, nondisclosure of material information is not treated as a fraudulent misrepresentation of fact. The reason underlying that rule is that parties usually have no legal duty to make such disclosures. Persons dealing at arm's length with complete strangers normally do not expect those other parties to provide full information voluntarily. We expect to ask questions, to make inspections, to demand verifications.

Even here, however, there are several well-established exceptions which require truthfulness and fairness. First, if one of the parties occupies a fiduciary relationship with respect to the other, full disclosure by the fiduciary is required in any commercial transaction between them. A lawyer buying real estate from a client, for example, would be required to disclose information regarding the value of the land, such as mineral deposits, unknown to the client. Second, the law requires a corrective disclosure where one party has made prior statements to the other, which, although true when made, have since become incorrect. The speaker knows that the other party is still relying on the truth of the original statement in evaluating the transaction. The speaker must now volunteer the correct information.

A third exception is more difficult to define. The *Restatement of Contracts* also requires disclosure of "essential" information – facts so important that the contract might not have been made had the other party been aware of them. This "exception" has the potential for swallowing up the general rule, since nearly all litigations over undisclosed facts would concern "important" facts. In practice, courts seem to have applied this third exception primarily in cases involving hidden dangerous conditions in buildings or

goods being purchased. *Janinda* (1964) provides one such example.

Harold Janinda was transferred by his employer from Denver, Colorado, to Mountain Home, Idaho. Looking for housing there, Janinda was shown several locations by a realtor. One of these was a complex owned by Mrs. Lanning. On the property were rental spaces for six house trailers, several duplex apartments, and a three-bedroom house. Two wells on the premises furnished the water for the complex. One of the wells was contaminated, a fact known to Mrs. Lanning, but not disclosed to Janinda. He bought the property, and then discovered the contamination. The Idaho court said that Mrs. Lanning's failure to disclose this "dangerous physical condition" was fraudulent, justifying Janinda's rescission of the contract. Her lack of truthfulness required cancellation of the transaction in order to produce a fair result (*Janinda*, 1964).

Securities law

Sales of investment securities are of course contracts, and therefore subject to the general common law rules discussed above. In this area, however, significant extra requirements have been added by statutes and regulations. These "extras" move securities law towards more truthfulness and more fairness.

Uniform Commercial Code

The basic requirements for contracts involving investment securities are set out in Article 8 of the Uniform Commercial Code. However, the general provisions from Article 1 apply to all transactions covered by the UCC. Section 1-203 imposes an obligation of "good faith" in the performance or enforcement of contracts. "Good faith" is defined in Section 1-201(17) as meaning "honesty in fact in the conduct or transaction involved."

The UCC generally permits the parties to negotiate their own terms. Section 1-102(3) states that "[t]he effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act. . . ." There is also a second important exception: "the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement. . . ." To be sure, the parties may by agreement "determine the standards by which the performance of such obligations is to be measured," but such standards themselves must not be "manifestly unreasonable."

Most of the detailed rules in Article 8 cover the technicalities involved in the issuance and transfer of stocks and bonds. One section – that dealing with sellers' warranties – does seem appropriate to this discussion. A person transferring a security represented by a certificate makes three warranties to a purchaser for value. First, the transfer of the security is guaranteed to be effective and rightful. Second, there is a guarantee that the security itself is genuine and that it has not been materially altered. Finally, and most relevant here, the securities seller warrants that "he knows of no fact which might impair the validity of the security." This last statement, in particular, would require disclosure of information in some cases, to avoid liability for breach of warranty.

Securities Act of 1933

Issuers subject to the 1933 Securities Act are also required to make substantial public disclosures. The objective of the 1933 Act was "truth in securities" – to provide sufficient data so that investors could make an informed decision. The general common law rule did not impose an affirmative duty of disclosure on a securities seller (*Strong*, 1919). Prior registration with the Securities and Exchange Commission is now required for stocks and bonds which are to be offered to the public, through interstate commerce.

The registration statement filed with the SEC must contain descriptions of the securities being offered, the issuing company's business, the company's management and their compensation, any pending litigation involving the company, the company's intended use of the proceeds received for the offered securities, the degree of compe-

tition in the company's business, and any special risk factors. Financial statements, certified by a licensed CPA, must also be filed. Violations of the filing requirements can result in both civil and criminal liability, for the company and for the managers involved. Truthfulness is thus mandated at the time of the initial issuance of investment securities.

Securities Exchange Act of 1934

The second major national statute regulating securities transactions, the 1934 Securities Exchange Act, also requires public filing of information. Periodic reports must be filed by companies who have made a registered offering of securities under the 1933 Act, or whose equity securities are traded on a national exchange, or who have assets of more than $5 million and more than 500 shareholders. Such companies must file annual reports and quarterly reports with the SEC. In addition, special reports must be filed within 10 days after the end of any month in which a "material event," such as a merger, occurs.

The 1934 Act, however, goes far beyond mere filing of reports. "Insider" transactions are also strictly regulated, in two different ways. Section 16 of the Act requires that "short-swing" profits made by an "insider" from transactions in the company's securities must be turned over to the company. Section 10(b), which is the general anti-fraud provision, also applies to unfair use of inside information.

Section 16 defines insiders as including directors, officers, and owners of 10 percent or more of the company's stock. Such statutory insiders must file reports with the SEC disclosing their transactions in the company's stock, within ten days after the end of the month in which such transactions occurred. Where such insiders make profits as a result of pairs of trades occurring within six months of each other, the profits belong to the corporation. Section 16(b) imposes a kind of strict liability on these statutory insiders, since no actual misuse of inside information or intent to do so need be shown.

In contrast, Section 10(b) and implementing SEC Rule 10(b)-5 do require proof of a "manupulative or deceptive device or contrivance," in connection with the purchase or sale of a security. The Supreme Court has ruled that "mere" negligence is not a sufficient basis for this case; a "plan" or "scheme" must be shown (*Ernst*, 1977). Knowing misuse of inside information does meet the statutory definition in 10(b). Other persons besides the statutory insiders may be held liable under section 10(b). Anyone having a "fiduciary relationship" to the other party to the securities transaction has a duty to disclose material information (*Chiarella*, 1980; *Dirks*, 1983). More recently, the U.S. Supreme Court has adopted a "misappropriation" theory, under which persons who use confidential information owned by others may also be prosecuted (*Carpenter*, 1987). Where violations are proved, the securities sale may be rescinded or damages may be awarded, and civil and criminal penalties may be imposed on the wrongdoer.

Securities law thus contains a number of provisions designed to ensure Truthfulness and Fairness.

Sales of goods

The law of sales of goods is now primarily statutory – Article 2 of the Uniform Commercial Code. Several of its provisions promote the ethical values of Truthfulness and Fairness.

Unconscionability

As previously discussed, UCC section 2-302 was the impetus for a new recognition by the courts of the doctrine of unconscionability. Section 2-302 requires the trial judge, rather than the jury, to make the determination of unconscionability. Where a contract provision is found to be unconscionable, the judge is given three options: invalidate the entire contract, invalidate the offending clause and enforce the rest of the contract, or interpret the unconscionable clause so as to avoid any unconscionable result.

Good faith

Since Article 2 is part of the UCC, the general good faith provisions from Article 1 also apply to sales of goods. The good faith requirements imposed by sections 1-203 and 1-102(3) were discussed above, in connection with sales of securities.

Implied warranty of merchantability

Section 2-314 promotes fairness by imposing an implied warranty on sellers who are merchants with respect to the goods being sold. "Merchant" is defined in section 2-104 as being a person who is a dealer in such goods, or who by his occupation holds himself out as having special knowledge with respect to such goods, or who is represented in the transaction by an agent or broker who is held out as having such knowledge.

The implied warranty of merchantability imposes a minimum performance standard on the goods. Section 2-314 contains a six-part definition of "merchantability." The two basic requirements are that the goods must be "fit for the ordinary purposes for which such goods are used" and that they will "pass without objection in the trade under the contract description." Fungible goods, such as sheet steel or crates of apples, must be "of fair, average quality within the description." Multiple units must "run, within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved." The goods must be "adequately contained, packaged and labelled as the agreement may require" and must "conform to the promises or affirmations of fact made on the container or label, if any." Merchant sellers whose goods do not conform to these minimal standards are liable for damages, or for return of the contract price.

Section 2-316 does permit the seller to disclaim the implied warranty of merchantability. To be legally effective, the disclaimer must mention merchantability. If the disclaimer is part of a writing, it must be stated conspicuously – different style or color of type, underlined, or similar attention-getting devices. Merchantability may also be disclaimed by the use of such phrases as "with all faults" or "as is." Even where the statutory phraseology is used, courts may still refuse to enforce a grossly unfair disclaimer, as illustrated by *Henningsen* (1960).

Clause Henningsen bought his wife a new Plymouth as a Mother's Day present. As she was driving the car ten days later, she heard a loud noise under the hood. She said "it felt as if something had cracked." The steering wheel spun in her hands, and the car veered sharply to the right and crashed into a brick wall. The standard written warranty which came with the car disclaimed all liability other than replacement of defective parts. The New Jersey court refused to enforce the disclaimer, and held both seller and manufacturer liable for all damages. The court chastised the industry for using such an unfair form disclaimer: "The terms of the warranty are a sad commentary upon the automobile manufacturers' marketing practices. . . . [W]arranties originated in the law to safeguard the buyer and not to limit the liability of the seller or manufacturer. It seems obvious in this instance that the motive was to avoid the warranty obligations which are normally incidental to such sales. The language gave little and withdrew much. In return for the delusive remedy of replacement of defective parts at the factory, the buyer is said to have accepted the exclusion of the maker's liability for personal injuries arising from the breach of the warranty. An instinctively felt sense of justice cries out against such a sharp bargain" (*Henningsen*, 1960). The court thus produces a fair result by disregarding the non-negotiated form disclaimer.

Limitation of remedies

Article 2 also permits the parties to agree on a limitation of remedies and/or a limitation of damages, in the event of a breach of the contract. There are, however, two important limitations on such agreements.

According to section 2-719(3), attempts to limit liability for personal injuries caused by defective consumer goods are prima facie uncon-

scionable. Chrysler and Bloomfield Motors thus could not disclaim liability for Mrs. Henningsen's personal injuries.

As to remedies relating to the defective goods themselves, the parties' limitation is not enforceable where the limited remedy specified "fails of its essential purpose." In that instance, says section 2-719(2), all the normal remedies provided by Article 2 are available to the buyer. Giving Mr. Henningsen the replacement part which was defective would not be an adequate remedy where his wife's brand new Plymouth had been totalled as a result of the defective part.

Thus, while allowing a large measure of freedom of contract in sales transactions, the UCC is very much concerned with the fairness of any bargains made.

Real estate leases

The common law rules regarding sales or leases of real estate were rather harsh, by today's standards. In general, the rule of *caveat emptor* was strictly applied. The buyer or tenant was assumed to take the premises "as is." The seller or landlord could be sued for fraud or for breach of contract where specific promises were made, but otherwise any deficiencies in the premises were borne by the buyer or tenant.

State courts and legislatures have gradually moved the landlord/tenant relationship in the direction of Truthfulness and Fairness.

Statutory warranty of habitability

Many state and local governments have enacted housing codes, which provide for minimum standards of "habitability" for leased dwelling areas. The landlord may have a duty to provide screens for the windows, for instance. Many states also have separate codes regulating the installation of mobile homes on rented spaces in mobile home parks. Typically, both kinds of statutes establish an enforcement agency, which makes inspections and receives complaints. Landlords are thus required by law to provide the statutory minimums of safety and comfort, in exchange for the rental payments.

Exculpatory clauses

Landlords frequently include lease provisions which purport to limit their liability for occurrences on the premises. While freedom of contract still prevails, there are certain outer limits to the legal effectiveness of such exculpatory clauses. One example of such limits appears in *State Farm* (1979).

Ms. Kirsch and her son moved into a ground floor apartment in a building owned by Mendez. Middleton was the building manager. The lease Kirsch signed exempted the landlord from liability for any damages done by plumbing, water, or other pipes. Her apartment and the one immediately above had "sleeves" in the outside walls for air conditioners, but there were no air conditioners in place. Instead, the sleeves were covered with pieces of cardboard. During the winter, the tenants in the apartment above filed some 50 complaints with Middleton about cold air coming in through the cardboard. Middleton did nothing. Finally, a heating pipe froze, burst, and poured water into Kirsch's apartment. Her insurer, State Farm, paid her for the loss, and then sued Mendez and his insurance company (Home). The Wisconsin court held that an exculpatory clause can not be invoked where the landlord or his agent is guilty (as here) of "active or affirmative negligence" (*State Farm*, 1979).

Refusals to lease

Another type of limitation on freedom of contract occurs when the landlord refuses to lease, or terminates an existing lease, on the basis of certain prohibited criteria. State civil rights statutes and local ordinances may prohibit such discrimiantory conduct by landlords. Typically prohibited is discrimination based on race, color, religion, sex, or ancestry. Some such legislation may also prohibit age discrimination in rental housing, such as a prohibition against children (*Marina Point*, 1980). The California civil rights

statute has also been interpreted as prohibiting discrimination against children in the sale of condominium units (*O'Connor*, 1983).

Mitigation of damages

Historically, landlord-tenant law lagged behind general contract law on one important "fairness" rule: the duty to mitigate damages in the event of a breach. The lease was treated as a conveyance of an interest in the land, rather than as a contract, in the case where the tenant moved out before the term of the lease was up. The landlord was generally not required to try to re-rent the premises before suing the tenant for the remaining rentals.

Some courts first said that the landlord *could* re-rent and then sue for the difference (*Stewart*, 1888; *Scott*, 1892). A minority of courts began to require mitigation of damages by the landlord (*Wright*, 1965). The fairness of the mitigation requirement is starkly evident in *Sommer* (1977).

James Kridel leased an apartment from Abraham Sommer for two years, May 1, 1972 to April 30, 1974. Rent was not to commence until June 15, 1972, but Kridel paid one month in advance and another month as a security deposit (total $690). Kridel was engaged to be married on June 3. The engagement was broken and the wedding cancelled. James was discharged from the Army in October 1971, and was a student, supported by his step-father. He wrote to Sommer on May 19, 1972, and explained all this. He had never taken possession or been given a key, so he had nothing to return. In his letter, Kridel said: "I beg your understanding and compassion in releasing me from the lease. . . ." He agreed to forfeit the $690. Having neither understanding nor compassion, Sommer waited 15 months and let $4658.50 in unpaid rentals accrue before he finally tried to re-rent the apartment. In the interim, a woman had asked to rent the apartment, but was told that it was already rented to Kridel. Holding that the case "present[ed] a classic example of the unfairness" of the traditional rule, the New Jersey Supreme Court refused to let Sommer collect his alleged damages (*Sommer*, 1977).

Conclusions

Even this brief review, limited to four substantive areas, should indicate the extent to which U.S. legal institutions attempt to enforce the ethical principles of Truthfulness and Fairness. Most courts have tried to produce fair results by relying on the general doctrines of Equity, as well as subject-specific rules. Truthfulness is mandated in many, if not yet all, legal negotiations. Where necessary, legislation has been passed to promote both these ethical precepts, and to prevent overreaching by large, powerful corporations. The individual consumer/debtor thus has a range of legal weapons available, should the need arise, to produce ethical results.

But what does this overview tell us about the relationship between Law and Ethics? Clearly, the ethical sensitivities of judges play a part (often a significant one) in their applications of the legal rules to specific situations. Witness the opinion of the New Jersey Supreme Court in the Henningsen case, discussed earlier: "An instinctively felt sense of justice cries out against such a sharp bargain." The Court tells us that the form disclaimer of warranties at issue in that case was being used by *all* U.S. car manufacturers. The "morals of the marketplace" evidently saw no inconsistency in extensively praising the products' quality, selling the cars for several thousand dollars, and then contractually saying "we don't even guarantee that these cars are reasonably suitable for ordinary use." Even though the marketplace was tolerating such inconsistency, the New Jersey court thought it grossly unfair, and thus refused to enforce the "sharp barghain."

The legal concept of "unconscionability" which the court applied in Henningsen itself originated in the ethical views of the draftsmen of the Uniform Commercial Code. Very much aware of the moral shortcomings of the marketplace, the UCC drafters provided several "contract checkpoints": "good faith," "care," "reasonableness," etc. Courts seeking to work out fair results in commercial transactions are thus encouraged to do so, and have a variety of legal doctrines to justify their interference with the "bargain" made by the parties.

The market's response to these ethical/legal

changes in the rules is unclear – mixed, at best. Carmakers do seem to have recognized some responsibility for the performance of their multi-thousand-dollar products. On the other hand, they continue their attempts to limit liability, by imposing a short time-frame (typically, one or two years) for their express warranties. They also, along with manufacturers in other industries (most notably, consumer electronics), attempt to sell very expensive "extended warranty" packages on their new products. Consumers in many cases thus seem to be paying for redundant warranty coverage. So far, these "extended warranty" practices seem to have escaped judicial notice.

What then is the nature of the Law-Ethics relationship in commercial transactions? One perspecitve might be an analogy to the relationship between Law and Equity. Normally, we leave the parties to their own devices, and enforce the bargains they have made. We also need to recognize, however, that there are still "robber barons" (both large and small) in the marketplace. "Sharp bargains," trickery, fraud, and deception still occur. The Law must contain enough flexibility, enough Equity, to deal with these white-collar robbers. When the terms of a contract offend a judge's "instinctively felt sense of justice," legal doctrine necessary to produce a fair result must be available.

The U.S. trend line over the last 30-plus years seems quite clear – and hopeful. Courts have greatly expanded warranty coverage on products. Courts have applied the doctrine of "unconscionability" to provisions in non-goods contracts. Several courts have found an implied promise of "good faith" in employment contracts and insurance contracts. The Restatement of Contracts now requires disclosure of "essential" facts to the other contracting party. As more and more courts adopt these rulings, we will approach a point of greater symmetry between Ethics and the Law.

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