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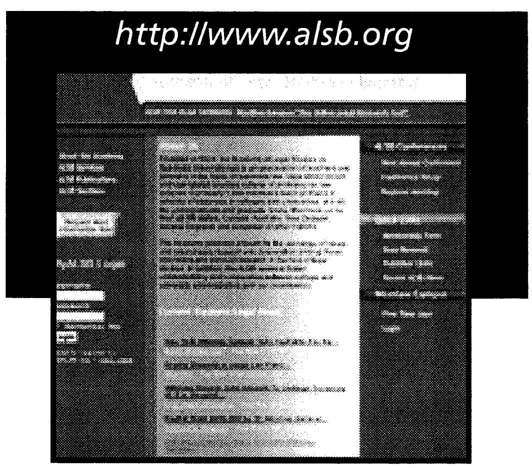

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ARTICLES

TAX ARTICLES

EVOLUTION OF MORAL RIGHTS IN U.S. COPYRIGHT LAW: THE TWIN INHERITANCE OF NATURAL RIGHTS AND STATUTORY CONSTRUCTION+

by

Roy J. Girasa* and Vincent Puma**

I. INTRODUCTION

Monty Python, a well-known comedic group famous for its popular television program, known as *Monty Python's Flying Circus,*[1] and for a number of movies that poke fun at establishment icons, became a litigant in a copyright dispute when the group refused to allow an American distributor to alter its programming. The case raised the issue of the right of an author to prevent mutilation[2] and other distortions of his or her creation. The original agreement between the Monty Python and the BBC had provided that the group would deliver scripts to the BBC for its use in national broadcasts. The agreement further detailed the procedure to be followed in the event of script alterations prior to broadcast. BBC had final approval of the script, although any significant changes had to be made after consultation with the group. No alterations were to be made after the program had been recorded. Subject to the said agreement, the Monty Python group had all rights to the script.

BBC was given the right by the group to license the transmission of the television series globally.[3] In October 1973, Time-Life was given the right to distribute some BBC programs in

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the U.S., including the Monty Python series, with the right to edit the programs for insertion of commercials, matters that violated censorship rules, and other similar type regulations. Monty Python, however, had never granted editing rights to the BBC. When the American Broadcasting Company (ABC) sought permission to broadcast excerpts from various Monty Python series in the spring of 1975, the group refused to permit the disjointed format and sued for injunctive relief.[4]

The central issue in *Gilliam* was not whether the law would protect John Clease and Michael Palin's royalties, but whether it would protect the integrity of their creation. The moral rights claim by Monty Python concerning its programs would appear to depart from the cold realities of law into the ethereal realm of philosophy. Nevertheless, the distinction would be misleading. Modern American law is the culmination of centuries of legal development, stretching back from the initial proclamations of law and equity by English judges through the enactments of Congress and the state legislatures, and the subsequent case law of federal and state courts. Throughout this long evolution, two separate and distinct strains have influenced each other: a belief in inherent transcendental rights and a respect for the stability of the positive law.

The litigation over Monty Python was decided before the U.S. modification of the Copyright Act of 1976, known as the Visual Artists Rights Act of 1990 (VARA).[5] VARA codified the concept of moral rights but limited statutory protection to visual artists. Even before the limited grant of moral rights in VARA, however, U.S. courts had already acknowledged and enforced moral rights of authors and artists, but did so only by advancing such moral rights under the rubric of diverse theories. Despite the codification under VARA, the difficulty created by the lack of statutory uniformity, however, continues to contribute to judicial decision-making that often was and still is discordant and contradictory.

II. MORAL RIGHTS AS NATURAL RIGHTS: THE EVOLUTION OF EUROPEAN AND INTERNATIONAL COPYRIGHT LAW

The United States, as successor to the philosophical developments of Stuart and Hanovarian Britain, long ago diverged from Continental European legal principles. Whereas the United States has evolved a pragmatic legal system emphasizing the rights of property ownership and commercial endeavors, the continental European civil law system has paid greater heed to its natural law roots.[6]

A. Philosophical Duality

Since the Twelfth Century, two separate and distinct legal systems have evolved in Europe: the rise of English common law,[7] based on the statutes of Parliament and the decisions of royal judges, and the development of the continental Civil codes,[8] based on extrapolation of Roman civil law and Catholic canon law. The drafters of the U.S. Constitution, therefore, had imbibed both common law jurisprudence of Coke and the natural rights theory of Locke long before they met in convention in Philadelphia.[9] Discussions of the natural law and rights had dominated legal thinking for many centuries, and, consequently, were at the core of the beliefs of the founding fathers of this country.[10]

American jurists have always had some difficulty reconciling this dual heritage. As the American legal tradition has evolved over the last century, the professional opinions and conceptual understanding of law held by most attorneys are not precedented on abstract theories of rights or justice, but solely on concrete sources, such as statute and case law. That such sources require interpretation, and that such interpretation is often framed in terms of abstract concepts of rights and justice, does not diminish the legal profession's reverential deference to precedent. The American bar argues almost exclusively in terms of tort, contract, and property. Whether arguing statutory construction or past precedent, it attempts to align or distinguish the instant case from those that came before. Even arguments appealing to fairness or the common good are framed in terms of justifying the overturning precedent.

As covered in copyright law, moral rights, or *le droit moral,* are inherently personal in nature. As aspects of the natural law, they are not economic in nature but rather attach to the person.[11] They are based upon a somewhat mystical concept that the unique, creative work of an individual is part of his or her personality. Since continental European law has its philosophical roots in natural law concepts, moreover, it accords individual certain fundamental rights that can never be alienated. Moral rights, therefore, are not related directly to copyright protection but are independent therefrom, and are inherent in the person who engages in the act of creating an artistic work.[12]

Whereas, in contrast to the continental European civil law system which paid greater heed to its natural law roots, the U.S. followed British tradition, and evolved a pragmatic, positivist approach to law, stressing the necessity of settled precedent. The legal system adopted and adapted by American jurists, therefore, emphasizes the rights of property ownership. In the United States, an individual who creates a work of art—whether a painting, a sculpture, a symphony, or a novel— is viewed as possessing rights and obligations in that work in accordance with the law of contracts, torts, and property.[13] Only through those discrete legal categories can the artist seek to ameliorate abuses and violations committed by anyone else who seeks to alter or mutilate their work.[14] In civil law systems, natural law theory holds that works reflect their creator, are intrinsically inseparable from their creator, and, therefore, cannot be altered without their creator's consent. Under common law, a creator's rights are governed by the positivist assertion that any claim against altering a work must fall under the rubric of either an action at contract or an action in tort. The distinctions between these two approaches underlie the continuing chasm between the explicit protection of the French *droit moral* and the reluctant, albeit limited, accord of moral rights in the U.S.[15]

B. The Role of Droit Moral in European Jurisprudence

Continental European law has its roots in natural law concepts which accord the individual certain fundamental rights that can never be taken away. Of the many nations that base their legal systems on natural law principals inherited from Roman civil law, France is the leading national exponent affording the broadest protections and interpretation of moral rights:

> The author has rights regarding his [or her] name, quality, and work. This right is attached to the person. It is perpetual, inalienable, and not subject to limitation of action by lapse of time. It is transmitted upon the author's death to his [or her] heirs. The exercise can be conferred to a third party by virtue of arrangements made in the will.[16]

The text itself stresses several distinct points. First, the author has equal and indivisible rights in his or her name, reputation, and creation; and that these three parallel rights are derived from natural law because of the author's integrity as a person. Therefore, the source of these rights is inherent in the author, and not in the code which enunciates them. Second, since such rights are natural rights, they are inalienable into perpetuity.

The French *droit moral* encompasses four categories of moral rights: the right of disclosure, the right of attribution, the right of integrity, and the right of retraction.[17] The right of disclosure is the right to determine if and when the work will be open to the public.[18] The right of attribution insures that the author will be credited publicly for his or her creation, or for any reference to said work or influence said work has on subsequent works.[19] The right of integrity allows the author to prevent any subsequent alteration or mutilation of a work.[20] The right of withdrawal or retraction refers to the right of an author or artist to remove the work from public view or from publication or to alter said work subsequent to display or publication.[21] There are a number of exceptions to *droit moral* protection, however, including computer programming or computer-generated work, the design of a typeface, work for hire, fair use ("fair dealing"), and other customary exceptions.[22]

The fundamental differences between natural law argumentation and positivist approaches underlie the continuing chasm between the French *droit moral* and the reluctant, albeit limited, accord of moral rights in the United States. Until a decade ago, the United States refused to grant any moral rights protection directly, although it did permit artists to seek protection under a variety of common law and other statutory theories.[23] Moreover, under French law these rights may never be waived, whereas in the U.S., some of these rights, if applicable, may be conveyed to others or even abandoned.[24] French law, therefore, extends *droit moral* to a broader category of artistic works, and grants a greater scope of protection, well beyond the limited protection offered by current U.S. copyright protection.

Although less comprehensive than the protection accorded in France, the United Kingdom also has extensive provisions relating to moral rights. As the original source of common law reasoning and argumentation, Great Britain has a similar dual relationship with natural law theory. Natural law doctrines can be seen as a foreign importation. Because of their unwritten constitution, however, and because of the absolute supremacy of Parliament, the British have adopted a different stance than the Americans, which allows them somewhat greater flexibility in regards to such importation. Among traditional British legal theorists, jurists have long argued that common law reflects natural law, as embodied in the unwritten British constitution and enunciated by Parliament. For modern positivists, the absolute supremacy of Parliament means that any legislation -- whether or not incorporating continental ideas of *droit moral* – is binding precedent and good law. Therefore, as the United Kingdom seeks greater legal conformity with the rest of the European Union, Parliament has sought to reconcile its copyright protection with the greater protections afforded by France and other civil law nations.

In the Copyright, Designs and Patents Act of 1988, Sections 77 *et seq.*, the British Government extended coverage of moral rights to include protection to authors of a copyrighted literary, dramatic, musical or artistic work and to the director of a copyrighted film.[25] All of the said authors have the right to be identified as the author or director of the work subject to the requirement that the right be asserted in the event of an assignment of the copyright with a statement that the author or director be identified with the work. If the work is publicly exhibited, the right may be asserted by the author's identification on the original or authorized copy of the work or by including the statement of assertion of such rights if the work is licensed. The assertion of the right binds the assignees or licensees or persons claiming through them even if such person was not aware of the assertion as by wrongful removal of the statement.[26]

The Act also grants such authors the right to object to derogatory treatment of their works. By "treatment" it is meant "any addition to, deletion from or alteration to or adaptation of the work, other than (i) a translation of a literary or dramatic work, or (ii) an arrangement or transcription of a musical work involving no more than a change of key or register." "Derogatory" treatment is the "distortion or mutilation of the work or is otherwise prejudicial to the honour or reputation of the author or director."[27] There are a number of exceptions to such protection. They include a computer program or computer-generated work, the design of a typeface, work for hire, fair use ("fair dealing"), and other customary exceptions.[28]

C. Moral Rights and the Berne Convention on Copyright

The Berne Convention for the Protection of Literary and Artistic Works ("Berne")[29] clearly sets forth the requirements for member states for adherence to the moral rights of authors and creators of artistic works. The Convention is flexible in nature owing to the need to take account of the diverse philosophies and stages of economic development of member states.[30] The provisions of VARA arises from Article 6 *bis* of Berne, which Article was added in order to accommodate U.S. objections and refusal to previously join the Convention.

Article 6 bis. Moral rights

(1) Independently of the author's economic rights, and even after the transfer of the said rights, the author shall have the right to claim authorship of the work and to object to any distortion, mutilation or other authorship of the work and to object to any distortion, mutilation or other modification of, or other derogatory action in relation to, the said work, which would be prejudicial to his [or her] honour or reputation.

(2) The rights granted to the author in accordance at least until the expiry of the economic rights, and shall be exercisable by the persons or institutions authorized by the legislation of the country where protection is claimed. However, those countries whose legislation, at the moment of their ratification of or accession to this Act, does not provide for the protection after the death of the author of all the rights set out in the preceding paragraph may provide that some of these rights may, after his death, cease to be maintained.

(3) The means of redress for safeguarding the rights the rights granted by this Article shall be governed by the legislation of the country where protection is claimed.

First, moral rights are personal, and not dependent on the economic rights protected by traditional Anglo-American copyright law. Second, the author retains an interest in said rights even after transfer and publication. Third, the protection afforded against subsequent publication or alteration is geared toward protecting the author's reputation, regardless of the economic impact of such publication or alteration. Fourth, in contrast to the French concept of perpetual protection, the minimum time period for protecting these rights is tied to the same time period for protection of economic rights. Finally, the Convention relies on the author seeking redress in national courts for rights acknowledged under its provisions.

The European Union,[31] in its 1995 Green Paper,[32] emphasized that, under the Berne Convention, the author's moral rights remain with the author even after his or her economic rights expire. It leaves to the individual states to make their own determination as to the extent to which beyond Berne that moral rights will be enforced.[33] Noting its judgment in the *Phil Collins* cases,[34] the E.U. leaves the subject matter of moral rights to national legislation but, to the extent that they affect trade in good and services as well as competitive relationships within the E.U., such rights do come within its domain. Nevertheless, it found that moral rights rarely are in issue because almost all such questions are resolved by arrangements between the affected parties before a work is produced.[35]

III. EVOLUTION OF MORAL RIGHTS IN U.S. JURISPRUDENCE: JUDICIAL INTERPOLATIONS BEFORE VARA

U.S. copyright law had always explicitly protected the economic benefits of artistic creation.[36] Prior to 1990, however, the United States did not formally recognize moral rights in the author of a copyrighted work. Although moral rights have been recognized in continental European thought for centuries, before the adoption of VARA such rights were not directly accorded in U.S. jurisprudence because they did not come within the scope of federal copyright statutes. Accordingly, federal courts have applied, or failed to apply, a variety or theories to grant comparable protection to litigants, particularly authors of written and musical works, whose efforts were undermined by users other than the original authors or creators. This reliance in diverse judicial theories lead to a confusing lack of uniformity, and risked uncertainty for authors attempting to protect their works. Moreover, even after subsequent legislation introduced a limited theory of moral rights, the older precedents still remain applicable, especially where VARA does not directly apply.

A. Trademark Theory of Confusion.

One of the earliest efforts to protect the integrity of an author's work centered on the risk of misattribution through confusion. In *Clemens v. Belford, Clark & Co.*,[37] the noted novelist, Samuel L. Clemens, a/k/a Mark Twain, sued the defendant publishers because they had printed large quantities of a book entitled "Sketches by Mark Twain," that were not then protected by U.S. copyright law. Clemens claimed that he had the exclusive right to the use of his *nom de plume*: his trademark name of "Mark Twain." The court held that an author or other artistic person acquires no greater right by the use of an assumed name than by the use of his given name.

In rendering its decision the court discussed what would be characterized as "moral rights" issues affecting the litigation:

> Undoubtedly an author has the right to restrain the publication of any of his literary work which he has never published or given to the public... So too, an author of acquired reputation, and, perhaps, a person who has not obtained any standing before the public as a writer, may restrain another from the publication of literary matter purporting to have been written by him, but which, in fact, was never so written. In other words, no person has the right to hold another out to the world as the author of literary matter which he never wrote; and the same rule would undoubtedly apply in favor of a person known to the public under a *nom de plume*, because no one has the right, either expressly or by implication, falsely or untruly to charge another with the composition or authorship of a literary production which he did not write. Any other rule would permit writers of inferior merit to put their compositions before the public under the names of writers of high standing and authority, thereby perpetrating a fraud not only on the writer whose name is used, but also on the public.[38]

Thus, inasmuch as the publisher did not attribute to Mark Twain the authorship of any work he did not actually write, the court ruled against him.

The three rights of attribution, integrity, and prevention of distortion were recognized by the court in terms of protecting the author and the public on the trademark theory of the prevention of confusion. The central concern of the court appeared not only to protect the name and reputation of the author, but also to guarantee that the publisher was not misleading or confusing the public. That an author wrote under an assumed name did not grant any additional rights, so long as the work attributed was his or her creation.

B. Libel

Libel theory was used in a local New York City court to hold a publishing company responsible for falsely attributing authorship to an article it published in a medical magazine. In *Gershwin v.*

Ethical Pub. Co., Inc.,[39] plaintiff was a medical school professor and medical practitioner whose name was used as the author of an published article concerning therapeutic uses of sulphur. The court decided that it was libelous *per se* to use his name in connection with an article that he did not write or authorize.

A dismissal of plaintiff's claim based on a libel theory was also made in *Seroff v. Simon & Schuster, Inc.*,[40] another New York court case, which addressed the problems of mistranslation, editorial distortion, and profuse textural errors.[41] The court dismissed the action because the mistranslation was made by an independent publisher who had purchased the French rights to the biography and not by the defendant. It refused to be persuaded by an analogous moral right of an author to object to an alleged deformation, mutilation or alteration of his or her work. The court noted that the Copyright Act did not recognize a moral right of an author to object to such changes.[42]

Another attempt at the use of libel theory was discussed in a New York State court case, *Shostakovich v. Twentieth Century-Fox Film Corp.*[43] Plaintiffs were famous composers and residents of the then USSR. The defendant produced a movie entitled "The Iron Curtain" that showed the division of Europe between free countries in West and the domination of eastern bloc countries by the USSR, and had background music by famed Soviet composers. The movie did contain attribution to the composers although the story line therein was not connected to the music.[44] The court initially noted that the music was in the public domain and had no copyright protection. The Civil Rights Law that protected against invasion of privacy was not applicable to the facts herein because without copyright protection other persons may use the names of the authors in their works. The court also found no libel because there was no indication that the authors had given their approval or endorsement to the use of their music in the film. The court then discussed the moral rights theory in connection with such use:

> ...There is no charge of distortion of the compositions nor any claim that they have not been faithfully reproduced. Conceivably, under the doctrine of moral right the court could in a proper case, prevent the use of a composition or work, in

> the public domain, in such a manner as would be violative of the author's rights. The application of the doctrine presents much difficulty however. With reference to that which is in the public domain there arises a conflict between the moral right and the well-established rights of other to use such works [citing Clemens].... In the present state of our law the very existence of the right is not clear, the relative position of the rights thereunder with reference to the rights of others is not defined nor has the nature of the proper remedy been determined....[45]

Contrast the decision with its subsequent ruling in favor of Shostakovich by a French court that found the artist had suffered moral injury and ordered the seizure of the movie.[46] French courts have upheld the right of an artist, who painted a refrigerator for sale at a charitable auction, to prevent the buyer from dismantling the object for sale as separate pieces, and the right of an artist to withdraw the work and discard it even after its completion pursuant to contract.[47] They also prohibited the display of reproductions that had not conformed to the paintings of the artist, Henri Rousseau, in a famous Parisian department store stating that his heirs had the right to protect the integrity of his works.[48]

C. Contract

In *Rey v. Lafferty*,[49] the plaintiff, the creator of "Curious George" children's books, licensed the work for the production and televising of Curious George episodes. In addition, she entered into an ancillary product agreement permitting the manufacture and sale of tangible goods concerning the character. Rey had the right to disapprove any product and to propose changes so as to make the product acceptable to her.[50] Rey thereafter rejected a number of products that were offered for marketing including a plush toy, pajamas, and educational software. She refused to permit their distribution alleging they were aesthetically in poor taste. The Court of Appeals reversed a finding of damages for breach of contract by the plaintiff:

> [Although] a licensor has no "moral right" to control the quality of licensed depictions [citing *Gilliam*], she may insist [as in the within case], contractually, on approval provisions to

> "assure quality control and high standards in the exploitation" of her creative work....[51]

With respect to moral rights and copyright law, the court held that the plaintiff's withholding of approval was reasonably related to the integrity and commercial value of her artistic creation.[52]

In the United States, authors and artists have the right to enter into contracts that relinquish the ownership of their created works. The copyright of a work vests initially in the author of the work unless the work is one made for hire.[53] Once an author sells or otherwise transfers the work, he or she may lose the rights granted under the copyright Act and under Berne.[54] The problem is particularly acute in the entertainment industry whereby screenwriters, actors, and musicians often convey all of their rights to the production company or studio that retains their services. VARA lends no assistance to them inasmuch as VARA only protects works of visual art. The only U.S. corollary to a true[55] moral right that an author possesses is that of the termination right. A transfer or license of a copyright by an author, other than where the work is one made for hire or bequeathed in a will, may be terminated during a five-year period beginning on the 35th anniversary of the conveyance.[56] Thus, the author has a limited right to rescind the grant of such license or transfer during the five-year window.[57] The difficulty is that struggling artists, anxious to promote their works, agree to studio demands that they sign contracts relegating their works to the work made for hire status. Unfortunately, attempts at protecting moral rights through contract have largely proved ineffective.

D. Contract and Fraud

In *Vargas v. Esquire, Inc.*,[58] an artist sought an injunction to prevent the publication of certain pictures he prepared and delivered to the defendant publisher, alleging that they were wrongfully used without his signature and without accreditation to him. The claim was based on two contracts between the parties, wherein the defendant employed the plaintiff artist, for a period of three years initially starting in June 1940, to produce artwork for publication.[59] The First Circuit upheld the trial court's findings in favor of the defendant, dismissing the complaint based on the grounds of fraud and implied contract. The plaintiff had argued that the publication of works prepared by him without attribution violated an implied agreement with the defendant that it would give such attribution when they were published. The court indicated that the parties had had a contractual relationship between them for many years, and at no time was there any indication that attribution to the plaintiff on the pictures was to be made. Vargas also proposed a moral rights theory as a basis for the complaint. The appellate court readily dismissed the theory on the ground that such theory had not gained acceptance [at that time] in the U.S.:

> What plaintiff in reality seeks is a change in the law of this country to that of certain other countries. We need not stop to inquire whether such a change, if desirable, is a matter for the legislative or judicial branch of the government; in any event, we are not disposed to make any new law in this respect.

The court also dismissed the claim of misrepresentation and unfair competition. Such a theory is premised on pirating or unlawful taking of the property of another. The contract provision above stated precludes such determination.

E. Tort in Connection with Contract

In the oft-cited case of *Granz v. Harris*,[60] the Second Circuit Court of Appeals rendered a decision concerning whether the plaintiff's rights were violated by re-recording of his music from 78 rpm record masters onto smaller records with a shorter playing time. The contract of sale between the plaintiff and the defendant called for the attribution of the music to the plaintiff. The court indicated that such attribution implies a duty that the legend not bear a false designation that would take place if an abbreviated version of the plaintiff's recording were made without his consent. In a concurring opinion by Judge Jerome Frank, he noted that "whether by way of contract or tort, plaintiff (absent his consent to the contrary) is entitled to prevention of the publication, as his, of a garbled version of his uncopyrighted product."[61] An author is entitled to prevent the deception to buyers of works either wrongfully attributed to him or her or a different version of such works:

> Whether the work is copyrighted or not, the established rule is that, even if the contract with the artist expressly authorizes reasonable modifications...it is an actionable wrong to hold out the artist as author of a version which substantially departs from the original....[62]

Such publication would constitute unfair competition thereby meriting an injunction.

F. Lanham Act (Section 43(a))[63]

Increasingly, courts began using the theory of unfair competition under the Lanham Act as the basis for enjoining defendants from violating the rights of authors against mutilation, false attribution, and other indicia of what may be called moral rights. The Lanham Act, section 43(a)[64] provides in relevant part that an author, composer, or artist may have three potential causes of action for protecting the integrity of his or her creation: (1) for misleading advertising, (2) for misidentification of product, or (3) false identification of origin.

1. Misleading Advertising

In *Rich v. RCA Corp.*,[65] the D.C. enjoined RCA from using the current likeness or photo of a famed recording artist, Buddy Rich, on an album of the plaintiff's re-release of music recorded a decade previously. The court decided that such use was likely to deceive the public in believing that the said music contained songs that had been recently recorded by the plaintiff. Similarly, in *Benson v. Paul Winley Record Sales Corp.*,[66] the plaintiff, an internationally acclaimed jazz guitarist, sued the defendant corporation and other parties concerning their re-mixing and sale of an old recording session in which Benson, then an unknown artist, was one of several members of a jazz combo.[67] The District Court issued a preliminary injunction against the defendants enjoining them from releasing the album finding that the defendants clearly misled the public into believing that the album was a new album rather than containing music that was 5-12 years old and that Benson was the principal performer when he was merely an unknown player among several players.

2. *Misidentification of Product*

In *Smith v. Montoro,*[68] the Court of Appeals reversed the District Court's dismissal of the plaintiff's complaint that alleged that the defendant Montoro and others wrongfully failed to give the plaintiff star billing in a motion picture produced by an Italian film company licensed to the defendants. The original agreement between the plaintiff and the film producer called for such star billing in screen credits and advertising for the film. The defendants removed the plaintiff's name from the film credits and advertising and substituted the name of another actor. The court found a violation of Lanham Act, section 43(a), holding that it was an express passing off of a substituted name for that of the plaintiff:

> As a matter of policy, such conduct, like traditional palming off, is wrongful because it involves an attempt to misappropriate or profit from another's talents and workmanship.... [T]he originator of the misidentified product is involuntarily deprived of the advertising value its name and of the goodwill that otherwise would stem from public knowledge of the true source of the satisfactory product....[69]

An actor's performance in the film industry may be an important element in drawing the public to a particular movie. An actor is greatly affected by the appearance of his or her name on a theater's marquee. The failure to receive credit for a performance may be critical to the actor's career.

The same Circuit Court refused to extend its Lanham Act findings in *Halicki v. United Artists Communications, Inc.*[70] Halicki sued under the Lanham Act because the film that he produced and that was distributed by the defendant United Artists and others was wrongfully advertised with an "R" designation instead of a "PG" rating. The "R" designation restricted its viewing to adults and to children if they have parental consent. A "PG" rating would have permitted minors to view the movie without parental consent. The plaintiff said that the film was aimed at a teenage audience and that the wrongful designation caused him significant monetary losses. The Ninth Circuit refused to extend the Lanham Act to the said alleged misuse. It stated that the statute is aimed at unfair competition. Inasmuch as Halicki was not a competitor, the court refused to grant him relief. It is not enough that the conduct be unfair; it must also be anticompetitive. If the court were to extend its meaning, then it would be comparable to moral rights granted under French, German, and Swiss law. Such extension would constitute a "complete dilution of the concept of unfair competition."[71]

Cleary v. News Corp.[72] also concerned a false designation of the origin v. work for hire issue. Cleary assisted in several revisions of *Robert's Rules of Order* for the publisher Scott, Foresman and Co. His name appeared in the 1970 and 1980 editions as having assisted the named author, Sarah Corbin Roberts, and two other persons connected with the work. His contract with the publisher stated his contribution was a work for hire and there was no mention that he was to receive attribution for his work. The title page for the 1990 edition omitted his name although he continued to receive royalties for the new edition and his prior contribution was noted in the preface. He had not participated in preparing any changes in the said edition. Cleary sued the defendant claiming misattribution of his work product by the omission of his name alleging that the changes in the new edition were minor in nature. He also sued alleging state law claims for unfair competition, breach of contract and negligence.

The Court of Appeals for the Ninth Circuit affirmed the grant by the District Court of summary judgment in favor of the defendant on all counts. With respect to the claim of reverse passing off, the court stated that even if the plaintiff were to show that he had not contracted away his right of attribution by contract, he did not meet the statutory and case law standards to warrant relief. It noted that it was not enough to show that the that "the misattributed material is 'substantially similar;' instead, there must be 'bodily appropriation.'.... "Reverse passing off" occurs 'expressly' when the wrongdoer removes the name or trademark on another party's product and sells that product under a name chosen by the wrongdoer. 'Implied' reverse passing off occurs when the wrongdoer simply removes or otherwise obliterates the name of the manufacturer or source and sells the product in an unbranded state."[73] The court noted that the 1990 edition revisions were more than insignificant, offering fourteen important changes thus negating the plaintiff's claim. Moreover, his state law claim was also unproven inasmuch as California's statute is very similar to the Lanham Act, which requires the likelihood that the public would be deceived by the omission of plaintiff's name.[74]

A mixed decision was rendered in *Boosey & Hawkes Music Pub., Ltd. v. Walt Disney Co.*,[75] with respect to alleged alteration of Igor Stravinsky's musical composition entitled "The Rite of Spring." The plaintiff had licensed the composition to the defendant, Walt Disney Enterprises, in 1939 to "record the work in any manner, medium or form" and to distribute copies of the recording worldwide. The plaintiff sued objecting to the release of the work on videocassette and laser disc. The work was in the public domain. The court dismissed the case finding no violation of the Lanham Act. The court did prohibit the distribution of video tapes and laser discs directly to consumers containing the Stravinsky composition due to the limitation in the agreement between Stavinsky and Disney that the work could be performed in theaters having valid licenses from the American Society of Composers, Authors and Publishers. The court further decided that neither the Lanham Act nor the *Gilliam* precedent precludes a person from modifying or mutilating a work.[76]

3. *False Identification of Origin*

It is a violation of the Lanham Act to use a "false designation of origin" in connection with goods or services used in commerce that is likely to confuse the consumer or other user of such goods or services.[77] Courts require a significant factual showing that the plaintiff was likely to be viewed by the public as being connected to a particular product or work. In *New Kids on the Block v. News America Pub. Inc.*,[78] the Court of Appeals affirmed the lower court's dismissal of a ten-count complaint by a then famous musical group wherein the newspaper, USA Today, conducted a poll asking which one of the New Kids was the most popular. The court found the poll to be a fair use exception to the plaintiff's trademark. It stated that the claim that the public would be misled into believing that the plaintiff had sponsored the poll was without merit.[79]

In *King v. Innovation Books*,[80] the famous horror novelist, Stephen King, sued the defendant, Innovation Books and other parties claiming that he was falsely designated as the originator of the motion picture, *The Lawnmower Man*. The plot of the movie allegedly came from King's ten-page short story concerning a homeowner who began to neglect having his lawn mowed after a boy who performed such services for him mowed over the owner's cat. King assigned motion picture and television rights to the defendants for which he received royalties. The rights included the "exclusive right to deal with the [story] as [it] may seem fit," the right to write film treatment and other dialogue versions of the story, and to change the title, plot, theme, and other aspects of the story. A film length motion picture was made of the film, which was advertised as "based upon" the King short story. King objected to both the "possessory credit" in the designation of the movie as *Stephen King's The Lawnmower Man* and to its "based upon" credit. The District Court granted an injunction in favor of King stating that both credits were violative of the Lanham Act.[81]

The Court of Appeals affirmed the District Court's injunction prohibiting the use of the possessory credit but reversed the decision that prohibited the use of the "based upon" credit. The possessory credit is one that infers that King was directly involved in some substantial aspect of the movie, which was not true inasmuch as King had no input into the making of the movie.[82] Nevertheless, the "based upon" credit is broader in scope and permits the movie producers to allege such derivation where the movie was substantially similar to the short story. Unlike *Gilliam*, wherein Monty Python was presented as the creator of the work, the use of a "based upon" designation does not create such inference.[83]

G. Copyright Infringement

The 1976 Monty Python case was cited extensively in later decisions concerning alteration and dilution of the rights of authors. In *Nat. Bank of Commerce v. Shaklee Corp.*,[84] the plaintiff was the executor of the estate of Heloise Bowles, a famed author of columns and books concerning household hints to ease home chores. The author had a policy in all of her works not to refer to any product by its brand name but instead used generic names for all products set forth in her writings. The defendant, in its edition of one of her works, inserted a number of advertisements of brand name products throughout its "Special Edition" without consent of the author. The court decided that the defendant's conduct did constitute unfair competition due to its passing off services as that of the plaintiff. The court then addressed the issue of whether the defendant's acts constituted copyright infringement and whether the author had the right to protect the integrity of her work:

> The rationale for finding infringement when a licensee extends time or media restrictions on his license-the need to allow the proprietor of the underlying copyright to control the method in which his work is presented to the public-applies equally to the situation in which a licensee makes an unauthorized use of the underlying work by publishing in a truncated version. Whether intended to allow greater economic exploitation of the work, as in the media and time cases, or to ensure that the copyright proprietor retains a veto power over revisions desired for the derivative work, the ability of the copyright holder to control his work remains paramount in our copyright law. We find, therefore, that unauthorized editing of the underlying work, if proven, would constitute an infringement of the copyright of that work similar to any other use of a work that exceeded the license granted by the proprietor of the copyright....[85]

Citing the reasoning in *Gilliam*, the District Court held that a copyright infringement exists when the publisher inserted advertising material in Bowles' texts as when ABC edited its Monty Python episodes thereby impairing the integrity of the original work.

Gilliam and *Shaklee* were cited in WGN *Continental Broadcasting Co. v. Albuquerque Cable Television, Inc.*,[86] and in *Paramount Pictures Corp. v. Video Broadcasting Systems, Inc.*[87] In the first action, WGN was an independent television superstation station (transmits program beyond its local area) located in Chicago. It used an intermediate satellite, United Video, in order to transmit beyond its local range. WGN began experimenting with "teletext" (vertical blanking interval that carried material for the television viewer) with news stories and a program schedule in the intervals of its late evening news broadcast. United Video failed to retransmit the teletext with the news program but instead substituted it with teletext of business news furnished by Dow Jones. The issue was whether the substitution violated the Copyright Act by the defendant's secondary transmission deletion and substitution. The Court of Appeals reversed the District Court's denial of relief to WGN, stating that a licensee who transmits a truncated version or exceeds the license of a copyrighted work infringes upon that work.

In *Paramount Pictures*, the defendant, Video Broadcasting Systems, was a company specializing in selling, producing, and placing advertisements on lead-in tapes of videocassettes. The tapes were inserted before the FBI warning that appears before the commencement of almost all videocassettes. In a suit to enjoin the insertion of advertisements, the court, citing *Granz*, *Gilliam*, *WGN*, *Shaklee*, and *Nimmer on Copyright*, denied the preliminary injunction.[88] In so doing, it discussed plaintiff's claim of alleged trademark infringement and unfair competition, as well as copyright infringement. In reviewing the elements of the likelihood of confusion that formulates the basis of both a trademark and unfair competition claim,[89] the court found a lack of evidence to cause it to grant a preliminary injunction prior to a trial on the merits.[90] The court distinguished *Granz* and *Gilliam* by noting that "[t]he occasional overlapping of defendants' advertisements onto the FBI warning or plaintiff's advertisements can hardly be compared to the substantial and material alterations described"[91] in the said cases.

Alleged copyright infringement in the *Paramount* case was based on both a claim of violation of its moral right and upon two statutory rights under the Copyright Act, namely the derivative right to prepare works based on the copyrighted work and the distribution right to distribute copies of the work by sale or other transfer of ownership. The court refused to acknowledge the violation of the plaintiff's moral right noting that the Copyright Act (at that time) did not recognize moral rights. The court distinguished the above precedents by noting "that the significant changes made by ABC to the Monty Python programs far exceed in scope and effect the defendants' addition to a local advertisement to the front of a videocassette."[92] The court did not find the defendant's addition to be a "derivative work" because it was merely an addition of a commercial to the front of the videocassette and did not alter the copyrighted materials in any way. Nor was there mutilation of the plaintiff's work inasmuch as there was a dearth of evidence to suggest the alteration. The defendant was protected by the first sale doctrine that states that when "a copyright owner parts with title to a particular copy of his copyrighted work, he divests himself of his exclusive right to vend that particular copy."[93]

The Internet has exacerbated the problem of copyright infringement. A country's laws end at its borders. Cyberspace, by definition, is borderless. A country has little power to protect the works of its authors from being copied and distributed globally. The current intellectual rights regime has been inadequate to address the issues raised by the new technologies due to the constant stream of innovative changes in the marketplace. Criminal and other tortious conduct occur often in countries that have few legal restrictions or lax enforcement. Such laxity has plagued owners of protected works. Until recently, the Peoples Republic of China was accused of intellectual rights privacy and was placed on a "watch list" for possible imposition of sanctions. Prior thereto, other mainstream countries in Asia, such as South Korea and Taiwan, presented serious difficulties for copyright holders. The global community has come to the realization that regulation of copyright protection must be accomplished effectively by the countries acting in concert.

Included among the efforts commenced internationally are those initiated by the World Trade Organization, the Council of Europe, the Organization for Economic Cooperation and Development ("OECD"), the United Nations, and other world bodies. Many international conferences, attended by most of the leading industrial nations, have been convened and are being arranged to address the issues and problems caused by persons using electronic means to circumvent civil and criminal laws protecting intellectual property. Significant discussions of intellectual property rights topics have taken place, especially those arising out of the Uruguay Round of the General Agreement on Tariffs and Trade. All member states of the World Trade Organization are required to adhere to the various intellectual property rights conventions, including Berne. Whether or not the new technologies can or will be controlled by governmental authorities remains an issue for future determinations. Economic sanctions by affected countries may provide incentives for compliance.[94]

H. Joint Work and Moral Rights

In *Seshadri v. Kasraian*,[95] a professor of electrical engineering at the University of Wisconsin sued his graduate student and other persons for copyright infringement and on other grounds.[96] The issue arose whether the professor could prevent the publication of a work prepared jointly with another author, after the professor had already repudiated his participation in that work:

> If a joint work is marred by errors reflecting unfavorably on his co-author, with some quantifiable adverse effects on the co-author's career, the co-author might conceivably have some legal remedy, but it wouldn't be under the Copyright Act. We don't know what it would be under: possibly the law of contracts; in Europe it might be a violation of the author's "moral right" (*droit moral*), the right to the integrity of his work; and there are glimmers of the moral-rights doctrine in contemporary American copyright law [citing *Weinstein, WGN, Carter, and Gilliam* [see moral rights article below]]....But all that matters here is that a joint author does not lose his copyright by being a lousy scholar; were that the rule, rights of joint authorship would be in legal limbo.[97]

In the within case the student co-author had contributed significantly to the article thereby qualifying him as a joint author. His contribution was therefore copyrightable. Just as a sole creator of a work can assign authorship in whole or in part to another person, the same rights apply to joint authors. The court appeared concerned with the potential adverse affects of publication on the reputation of the professor: so long as there was no attribution affecting the professor's professional standing or reputation, to have denied the student co-author the right to publish would have unfairly denied him the right to the benefits of his creative work.

I. Moral Rights in Cyberspace

The advent of the Internet has exacerbated the need for authors and artists to have their rights to created works clarified and protected. Because works utilizing this new medium can be altered, modified, and otherwise mutilated by even the least sophisticated of users, any subsequent user can undermine or alter the integrity of an artist's creation without that artist's consent. Although the passage of VARA introduced the concept of moral rights into American law, the technological challenges presented by the flexibility and mutability of the Internet have seriously challenged further development and protection of those moral rights.

Rather than dealing with the new interface between moral rights and digital manipulation, however, Congress has sought to protect the traditional economic benefits of copyright, as applied to electronic distribution. The ability to violate the copyright ownership and derivative rights of an author has led to a number of Congressional enactments and numerous judicial decisions.[98] In *Tasini,*[99] the U.S. Supreme Court ruled that the plaintiffs, free-lance writers, were entitled to sue and collect damages from the New York Times, Newsday, Time Magazine, and Sports Illustrated for copyright infringement due to the defendants' unauthorized licensing of the plaintiffs' articles for storage in a computerized database possessed by NEXIS. Whereas NEXIS made such articles available for retrieval by persons paying for the service, it provided no further remuneration for the original authors. Under the Copyright Act, the publishers' copyright in the collective work did not extinguish the authors' individual copyright in each separate contribution to the collective work.

The *Tasini* decision and the *Napster*[100] holding wherein Napster was found to be directly and contributorily liable for enabling users of its system to download audio CD recordings, highlight the difficulties experienced by copyright holders by the almost daily technological innovations that elude efforts to protect works from unlawful infringement. It appears that, unless governments are able to formulate global responses to violations of international conventions and national laws, it may be impossible to prevent violations of moral and other legal rights possessed by authors.

IV. U.S. CODIFICATION: THE VISUAL ARTS RIGHTS ACT OF 1990 (VARA)

With the passage of the Visual Arts Rights Act of 1990,[101] the Copyright Act of 1976 was amended so as to add a new visual art section (section 106A) which granted the author of a work coming within the Act the rights stated in the Berne Convention. In its explanation for the adoption of VARA, Congress stated:

> An artist's professional and personal identity is embodied in each work created by that artist. Each work is a part of his or her reputation. Each work is a form of personal expression (oftentimes painstakingly and earnestly recorded). It is a rebuke to the dignity of the visual artist that our copyright laws allow distortion, modification and even outright permanent destruction of such efforts. [102]

By explicitly incorporating the reasoning of the Berne Convention within the text of VARA, Congress acknowledged the impact of a work on an artist's reputation. By making the creation inseparable from its creator, the statute moved away from the economic impact of copyright to acknowledge that certain rights inhering in the creation of a work of art are personal in nature.

As set forth in the Act, there are three protected characteristics: attribution, integrity, and preservation from intentional distortion. The right of attribution allows the author to claim authorship of the work, and prevent use of one's name as author of a work or visual art not created by him or her. The right of integrity prevents the use of one's name of a work or visual art, which was distorted, mutilated or otherwise modified which would injure his or her reputation. The right of preservation from distortion, based in Congress' concern for the reputation of the artist, insures the prevention of intentional distortion, mutilation, destruction or modification prejudicial to one's reputation, and prohibits destruction of any work of recognized stature. [103] Authors of joint work possess the said rights as co-owners. Such rights are also subject to prior consent, or other waiver by the author.[104]

A. "Work of Recognized Stature"

Under VARA, one of the rights set forth is the prevention of destruction of any "work of recognized stature."[105] The phrase is not defined in VARA, but has been interpreted as a method whereby protection is granted only when its value is affirmed by acknowledged artists.[106] The stature need not rise to the level of a work of art by a master, such as Picasso, but does not extend for example to an obviously non-protective work by an unexceptional child. Stature means a "meritorious" work and one that expert witnesses will attest at a trial as having significant merit.[107]

Does a work that had never been displayed to the public preclude a finding that it is a work of "recognized stature?" In *Pollara v. Seymour*,[108] the issue arose whether a painting, which was created by the plaintiff and displayed without a permit on State of New York property and which was torn in its removal by state employees, was protected by VARA. The court denied the defendant's motion for summary judgment to dismiss the claim holding that prior recognition of the stature of the work was not a necessary precondition for a cause of action under VARA. A liberal reading of VARA does not offend the underlying policies of the Act, namely, "(1) the society's interest in the preservation of works of artistic merit; and (2) the artist's economic self-interest in preservation of his or her own works so as to enhance his or her reputation as an artist."[109]

B. Rights Limitations

The work of visual art must not be unlawfully placed onto a location or placed therein without consent of the owner.[110] In *English v. BFC&R East 11th St. LLC*,[111] the plaintiffs are six artists who created certain artwork in a community garden, which work consisted of ten murals and sculptures constituting a thematically interrelated single work of art. The lot wherein the work was located was owned by the City of New York and which was sold to the defendant, N.Y.C. Partnership Housing Development Fund. The Fund wished to develop the lot, which included the removal without destruction or mutilation to another location at no cost to the plaintiffs. The artistic work had been placed on the lot without consent of the City of New York. The court granted summary judgment denying plaintiffs' VARA claim holding that VARA was inapplicable to illegally placed artwork even if it cannot be removed without mutilation.[112]

C. Duration

Works of visual art created on or after the effective date of the Visual Artists Rights Act of 1990 are given protection for the duration of the life of the author or of the last surviving author of a joint work. Comparable rights are also given to authors who created the work before the effective date of then 1990 Act but who had not transferred the work prior to the said effective date.[113] Otherwise, pre-1990 works of visual art do not come within the scope of the Act. For example, the New York Times recently published a front page story concerning a giant (28 by 55 feet) red, white, and black mural created by the artist Josef Albers that was located in the lobby of the MetLife building on Park Avenue in New York City for 37 years. The lobby recently underwent a major renovation and the building owners indicated it would not put back the work so as to give the lobby more light and room. Although the building owners intend to sell or otherwise transfer it, it is possible that the work may be destroyed because it is pealing and contains asbestos. Albers died in 1976. Irrespective of the date the work was created, the owners would be able to ignore the rights of the artist, in the absence of contractual agreement, because of his death and, even if he were alive, the rights would not have been granted him because of the pre-1990 transfer of the work.[114]

D. Transfer and Waiver

The moral rights set forth above may not be transferred but may be waived if expressly done so by the author in a signed written instrument.[115] The instrument must set forth the identity and uses of the work to which a waiver is given. The waiver is strictly limited to the uses specified therein. A waiver by one joint author binds the other joint author. The Act makes it clear that the moral rights set forth by statute are distinct from those rights possessed by the owner of the work or any other exclusive right under the copyright Act. Subject to the waiver, by transferring ownership of a copy of the work, the moral rights are not transferred.[116] Because the rights under the 1990 Act may be waived, it is questionable whether the said rights are truly moral rights. Moral rights by definition are not like economic rights, which may be transferred, assigned, or alienated. Moral rights, as interpreted by European courts (especially in France), are not defeasible.[117] A similar interpretation may be found in the court's dismissal of a claim by the assignee of a copyrighted musical work by a famed composer.[118] Federal courts may adjudicate awards for violation of moral rights granted in other countries provided it has jurisdiction over the parties in the litigation.[119]

The closest economic right equivalent to moral rights for authors, not included within the Visual Arts Rights Act, is found in Section 203 of the Copyright Act. It permits an author who transfers or licenses a copyright work, whether the grant is or is not exclusive, to terminate the transfer or license during a five-year period beginning at the end of thirty-five years from the date of execution of the grant. If the author is deceased, the right is given to his or her surviving widow or widower, children and/or grandchildren. The effect of the termination is to cause all rights to revert to the author provided that the statutory requirements of an advance written notice is rendered.[120]

E. Exceptions: Limitation to Visual Arts, "Strictly Utilitarian Objects", and "Works Made for Hire"

1. Limitation to Visual Arts.

It should be noted that the United States limited its grant of moral rights to "works of visual art" only.[121] A "work of visual art" is defined in Section 101 of the Copyright Act as a single painting, drawing, print, a sculpture, or still photographic image for exhibition purposes and up to 200 signed and consecutively numbered such works. It does not include works made for hire, works of applied art, and strictly utilitarian objects. U.S. Government works, posters, maps, globes, charts, diagrams, models, magazines, newspapers, and the like are not given moral rights protection inasmuch as other provisions of the Copyright Act allegedly cover them.

2. *"Strictly Utilitarian Objects"*

As stated, objects that are strictly utilitarian are not given protection. The meaning of "strictly utilitarian objects" may be easy to define but present factual difficulties for courts to determine. A "useful article" is defined in section 101 of the Copyright Act as "an article having an intrinsic utilitarian function that is not merely to portray the appearance of the article or to convey information." For example in *Kieselstein-Cord v. Accessories by Pearl, Inc.*,[122] the Court of Appeals reversed a finding of the District Court that the plaintiff's belt buckles were utilitarian objects and, therefore, not afforded protection under the Act. In the within case the buckles had risen to the level of creative art due to their separable sculptural elements as distinguished from their purely utilitarian function.

3. *"Work Made for Hire"*[123]

The first case that discusses the moral rights issues under VARA is *Carter v. Helmsley-Spear, Inc.*[124] In *Carter*, an action was brought to prevent the alteration, modification, or destruction of plaintiffs' sculptures and installations in a Queens, New York commercial building.[125] The District Court issued an injunction, with certain modification, ordering the defendants to refrain from "(1) distorting, mutilating, or modifying plaintiffs' art work...installed or located in the Lobby of the Property...; (2) destroying this art work; and/or (3) removing this art work, or any portion there." The District Court initially examined whether the plaintiffs' works were several or one work of art under VARA. The court concluded that, except for several items at the premises, such as the building directory, the entrance steps, the street entrance, and the ceiling and wall lighting, it was one integrated work. It was not applied art that serves a utilitarian purpose but rather was visual art without utilitarian purpose. Even if there were some utilitarian aspects to the visual art, it would not detract from VARA's protection.

The Second Circuit later reversed the decision based on its finding that the work was one made for hire and thus was excluded from the Act's protection.[126] The District Court and the Court of

Appeals differed sharply with respect to the exception to VARA of a "work made for hire." [127] The Court of Appeals reversed the lower court's decision, not on its discussion of the applicable law, but in its application of the cited factors. It stated that "the factors that weigh in favor of finding the artists were employees outweigh those factors supporting the artists' claim that they were independent contractors."[128] At least one commentator[129] noted the contrast in the decision between the emphasis of moral rights under VARA as aspects of economic rights and its contrast with the Berne-type moral rights, which are protective of the artist's personality irrespective of who owns the pecuniary rights.[130]

The exception of "work made for hire" highlights the conflict of ascertaining whether the rights set forth under VARA are "true" moral rights. The joinder of moral and economic rights sets the U.S. apart from the rest of the globe. The creator of a work who does so under the auspices of an employer may forfeit all or part of his or her rights in the work. [131] Whether or not the Congress or the courts will maintain the joinder must be left for future determination.[132]

V. JUDICIAL INTERPRETATIONS OF MORAL RIGHTS: THE IMPACT OF "VARA" ON FEDERAL CASES, ON STATE CASES, AND ON THE BERNE CONVENTION

A. Federal Affirmation of Moral Rights

There are few cases cited in U.S. judicial decisions concerning moral rights. The U.S. Supreme Court discussed the subject briefly in a footnote to its decision in *Quality King Distributors, Inc. v. L'anza Research Intn'l.*[133] In the said case, a California manufacturer, L'anza, sold hair products with copyrighted labels exclusively in the U.S. to distributors subject to limited geographical areas for resale of the products. The said products were sold at a much higher price than to its foreign distributors. The court decided that L'anza could not prevent the purchase of these products by U.S. retailers from the foreign distributors who then later resold the products in the U.S. at lower prices than other U. S. distributors. Section 602(a) of the Copyright Act, which makes it an infringement for a person without authority to import copies of a protected work, acquired outside the U.S. (thus violating section 106(3) stated above concerning the exclusive right to distribute copies of a copyrighted work) is limited by Section 109(a) which expressly permits the owner of a lawfully made copy to resell that copy within the U.S. In other words, the owner of a lawfully acquired copy can do as he or she pleases with that copy. The Act's prohibition in section 602(a) concerns the purchase of pirated copies not lawfully acquired copies.

The court in a footnote indicated that the added section 106A to the Copyright Act encompassing moral rights was not applicable to the facts of the case. The section was limited in scope and subject matter. The rights stated therein were subject to the first sale defense and the other restrictive provisions of sections 107 through 120 of the Act. Presumably, moral rights within the U.S. would not be applicable inasmuch as the copyrighted labels do not come within the definition of "visual art."

There was a much more, albeit limited, discussion of moral rights in *Museum Boutique Intercontinental, Ltd. [MBI] v. Picasso*.[134] The court denied motions for preliminary injunctions to opposing parties, both of whom were given the right to license, manufacture, and sell commercial products and prints that contained images created by Pablo Picasso. It also required the plaintiff to undergo a pre-approval process for use of the license of additional products in order to protect the moral rights of the Picasso Estate. MBI had sued the heirs of Pablo Picasso and their agents for copyright infringement and unfair trade practices. Also sued was the Societe de la Propriete et des Dessins Et Modeles (SPADEM), which is a French organization that seeks to protect the intellectual property rights globally of individual artists. SPADEM was given the right by the defendant Picasso heirs to administer, manage, and exploit the Picasso name, image, and likeness. The parties had previously entered into a "Standstill Agreement" to maintain the status quo pending ultimate determination of the issues in subsequent proceedings.

Among the arguments raised in the proceeding was the claim by SPADEM that, after the Standstill Agreement, MBI had significantly altered the nature of its licensing business by adding low-end products such as men's underwear and baby bibs in violation of the Picasso Estate's moral rights. The court defined "moral right" "as including the right of an artist to have his work attributed to him in the form in which he created it to prevent mutilation or deformation of the work" (citing *Gilliam supra*[135]). The court rejected the claims by SPADEM that it would be irreparably injured if MBI were not enjoined from using certain Picasso trademarks in violation of Picasso moral rights. It left the issue for future determination as to whether such rights were indeed violated by MBI's use of some 200 Picasso images.[136]

B. State Law Expansion: Whether VARA preempts State Attempts to Expand Moral Rights

Moral rights are not necessarily confined to VARA's three-fold enunciation: attribution, integrity, and preservation from intentional distortion. States have also enacted legislation to protect the works of authors and artists.[137] The issue then arises whether such laws that reflect comparable moral and related rights are preempted by VARA.[138] In *Pavia v. 1120 Avenue of the Americas Assoc.*,[139] the District Court addressed the issue of whether the New York Arts and Cultural Affairs Law[140] violated the preemptive provisions of the copyright Act. VARA preempts state laws granting equivalent rights to those conferred by VARA. In *Pavia*, the plaintiff is an artist and sculptor who alleged that the some of the defendants had commissioned him to create a work of art for placement in a mid-town New York City Hilton Hotel. The work consisted of a large bronze sculpture that consisted of three large-diamond-shape standing forms called "The Ides of March." The work was to be permanently and properly displayed in the hotel's lobby. Thereafter, the said defendants entered into an agreement with the Hippodrome Parking Garage to have the work moved to a commercial warehouse at another location. The bronze forms were disassembled, part of which were located at the garage and the remaining parts were displayed in its altered state.

The court determined that there was no conflict between the preemptive provisions of VARA and the New York statute. To be preempted "the state law must create 'legal or equitable rights that are equivalent to any of the exclusive rights within the general scope of copyright as specified in section 106' if it is to be preempted"....[141] It indicated that VARA's focus is on the acts of alternation rather than the work's subsequent display. The VARA provisions were not applicable to the within case inasmuch as the acts took place before the effective date of the Act.[142] State statutes enacted prior to VARA are explicitly not preempted by the Act.[143]

In *Pavia*, the Court cited *Wojnarowicz v. American Family Assoc.*,[144] wherein the court decided that the said New York statute was violated by the defendant, a not-for-profit organization concerned with promoting decency in American society with numerous chapters nationwide, which published and distributed a pamphlet containing reproductions of the plaintiff's works in an effort to stop public funding of the alleged offensive works. The court determined that said New York statute was not preempted by the Copyright Act because the statute is "qualitatively different than federal copyright law in both its aim and elements. The state Act endeavors to protect an artist's reputation from the attribution to him of altered, defaced, mutilated or modified works of art."[145]

In *Brown v. Ames*,[146] the Fifth Circuit reversed the decision of the District Court that had dismissed the plaintiffs' complaint alleging a violation of their rights of publicity due to defendants' misappropriation of their names and likenesses in marketing the plaintiffs' musical performances without their consent on CD's and audio cassettes. Concerning the claim of preemption over Texas' legislation, the court noted that "the tort of misappropriation of name or likeness protects a person's persona. A persona does not fall within the subject matter of copyright--it does not consist of a 'writing' of an 'author' within the meaning of the Copyright Clause of the Constitution."[147]

C. International Implications of U.S. Legislation: Does the U.S. Afford Greater Moral Rights than the Berne Convention?

It may be argued that the U.S. was initially one of the last holdouts among nations agreeing to abide by and enforce moral rights, albeit in its modified VARA format. The Seventh Circuit in *Lee v. A.R.T.Co.*,[148] raised its concern that the Ninth Circuit[149] had given an overbroad expansion of what constitutes "derivative works"[150] protected under the Copyright Act:

> If Lee (and the ninth circuit) are right about what counts as a derivative work, then the United States has established though the back door an extraordinarily broad version of author's moral rights, under which artists may block any modification of their works of which they disapprove. No European version of *droit moral* goes this far.[151]

The *Lee* case raised the question whether the U.S. in fact, if not overtly in statutory enactments, is as protective of moral rights as the most aggressively protective European states. VARA is deliberately limited in scope omitting from its protection works that are not exclusively of visual art. Writings constituting the vast majority of copyrighted works are not given moral rights' statutory protection. Nevertheless, courts have acknowledged for at least a century that such authors and other artists preceding VARA's enactment do have some rights that may deserve judicial protection. From the trademark theory of confusion, to libel, to breach of contract, to tortious fraud, and to the many subcategories of trademark and copyright applications of the Lanham Act, courts have endeavored to render assistance to violations of what a court deems to be wrongful conduct that otherwise would have had protection from an expanded statutory moral rights enactment.[152]

D. The Future of U.S. Moral Rights Legislation

Virtually all commentators agree that the United States should follow the lead of continental Europe and adopt legislation that would extend traditional moral rights to all artists.[153] Accordingly, VARA should be amended to bring the U.S. into line with the standards upheld by the rest of the industrial world. Its limitation to visual artists only does not appear to be appropriate. First, there is no clear ideological or rational distinction for protecting the moral rights of visual artists, but not providing the same protection for the moral rights of other artists, such as musicians and authors. Second, the ability to alter works electronically through use of the Internet means that the creations of all artists—whether or not their medium falls under the limited protection that VARA currently provides visual works—can be altered without the artist's consent. Artists and authors are entitled to prevent alterations of their work and to receive credit for their productions.

Courts have endeavored, under the several theories cited above, to give assistance to authors, but those traditional theories are too diffuse and too inadequate to meet the challenges presented by rapidly changing technology. As illustrated by the *Napster* and the *Tasini* decisions, when faced with the emergence of new technology, courts are barely able to ensure the economic rights traditionally protected by copyright enactments. As the technology comes to allow almost anyone to electronically alter or amend an artist's work, the court's inability to enforce the limited protections of moral rights may make those emerging rights a nullity. The time appears ripe for an amendment to VARA to reflect the new global reality. Its basic provisions should be expanded to include all creative works, and its definition of publication and alteration need to take into account changing technology. VARA should be amended to limit the right of authors to waive their moral rights, and to extend such rights beyond the grave to the extent permitted to holders of copyrights generally.[154]

VII. CONCLUSION

Although the language of *droit moral* appears alien to American jurisprudence, the underlying concepts of protecting an author's name and reputation and of protecting the integrity of that author's work, are not unfamiliar. American attorneys, legislators, and judges have long struggled with the twin inheritance of our revolutionary formation and our common law past: Jefferson's aspiration towards articulating inherent rights and justice, and Lord Acton's[155] adherence to the strict categories of positive law and precedent. U.S. copyright law has long granted strong protection to economic rights, only occasionally affirming moral rights, and then under diverse and discondordant theories.

Lacking a more precise articulation or acknowledgment of moral rights in general, courts have used and will continue to use a variety of other theories to protect persons whose works have been significantly mutilated or otherwise distorted. The Lanham Act bars unfair competition, which covers the wrongful passing off of another's work as one's own. The distortion, alteration, and mutilation of such works may also be protected against under the theory of trademark dilution. Contract, tort, and property rights theories are available and have been used to varying success. Defamation, copyright infringement, misappropriation, breach of contract, and other theories may be used to prevent the wrongful distortion, mutilation and alternation of artistic works.

In 1990, with the passage of VARA, the United States codified the reasoning of the Berne Convention, specifically extending legal protection to moral rights. Such rights, however, are limited, extending only to visual media. Whether the current very limited explicit protection of VARA will subsequently be extended beyond visual works is yet to be determined. Extending moral rights to written works and musical compositions not presently protected by VARA may have profound consequences, particularly in terms of parody and adaptation.[156] Moreover, new technology raises new questions; and these technological advances have presented other challenges for the artist seeking to protect his or her name, his or her reputation, and the integrity of his or her work. For example, it is now possible to download an image of an artist and his or her work and substantially alter such image and work in a manner that totally alters the persona and performance.[157] The Internet only brings with it its own set of difficulties. It is far easier to engage in mutilation and distortion today than in past decades. Such alterations are not now protected under VARA, although other theories may be used to circumscribe such usage as heretofore stated. Thus, some authors have suggested the need for extending moral rights legislation to include the reputation and personality interests of the performer.[158]

It would appear that greater recognition of moral rights should be permitted so as to extend to authors of works other than visual art the same protection now accorded by VARA. Such additional protection, however, raises a whole host of additional issues that must be addressed: the types and categories of works to be afforded protection, the extent to which such additional works should be protected, and the duration of such protection. In extreme cases, it has been suggested that authors who died centuries ago might be protected from abridgment of their works. Moreover a work once considered art cannot now be removed even if considered offensive or outdated.[159]

Many other related issues will have to be addressed by subsequent legislative enactments and judicial decisions. Since the stated purpose of intellectual property rights is to promote the progress of science and useful arts,[160] the degree to which the U.S. comes to acknowledge moral rights may still depend on the economic impact of those rights, on whether protection of those moral rights encourages the creative energies of copyright owners. The enactment of VARA was the first tentative step towards enunciating an author's right towards protecting the integrity of both created work and reputation. When such newly acknowledged moral rights come into conflict with longstanding economic rights, the outcome remains uncertain.

In the past, protection of artistic creations has extended beyond the strict confines of the Copyright Act, although such extensions have had neither a single rationale nor widespread application. As part of the evolving law protecting artistic creation, however, there has always been a conflict between the rights inhering in the individual and the economic exploitation of a creative work. The extent to which the arguments of moral rights will be rationalized, systematized and incorporated into positive law, especially given their underlying acknowledgment of natural law and their relative disregard for economic implications, cannot now be determined. That such evolution reflects the twin inheritance of American law— the natural rights of Jefferson and the *stare decisis* of Coke— only insures that the legislature and the courts will continue to balance the rights of artists to protect their works against the economic needs of society to use those same works.

ENDNOTES

[1] The Program was created for the British Broadcasting System ("BBC"), which was and is owned and controlled by the British Government, and is recognized as a quasi-governmental authority.

[2] "Mutilation" in the context of this paper refers to the alteration or changes made to an author's work without consent of the author. The Monty Python case is an example of such mutilation in the form of deletion of parts of segments of a

show, which destroyed the show's continuity and story flow. An additional example is Ted Turner's colorizing of well-known black and white films.

[3] The recordings were shown on U.S. public television stations, with exceptions in Texas and Nevada where the broadcasts were on commercial stations. Each show was broadcast in its entirety without interruption.

[4] In July 1975, ABC agreed with the BBC to broadcast two ninety-minute uncut segments from three shows, in full conformity with the BBC's original Contract with Monty Python. In September 1975, ABC again wanted to broadcast additional segments, but with certain portions omitted. Monty Python again refused to permit the altered format and sued to enjoin the broadcast. *Gilliam v. American Broadcasting Companies, Inc.*, 538 F.2d 14 (2d Cir. 1976). Monty Python's refusal to allow ABC to edit its work became the focus of a drawn out legal contest. Upon application from Monty Python's attorneys, the District Court granted only limited relief to the group; it provided for the insertion of a disclaimer during a special December 26, 1975 telecast, which stated that the group dissociated itself from the edited program. The District Court, however, denied a preliminary injunction to enjoin the broadcast. The Second Circuit Court of Appeals, not only reversed the decision of the District Court, but granted even broader relief by enjoining the edited broadcasts in their entirety, subject to the findings of fact to be made at a later trial on the merits. The injunction was based on the fact that the telecasts constituted the first exposure to American audiences to the Monty Python works, and that if such works were mutilated, the potential followers of the series could be dissuaded from any future attraction to the series.

[5] Pub. L. No. 101-650, 104 Stat. 5128 (1990). The Act was passed in order to conform to U.S. acceptance of the Berne Convention of 1971 that provided for the almost universally accepted moral rights.

[6] The United States, from a legal perspective, has emphasized the economic rather than the moral rights in its laws, especially in its statutory and judicial law making with respect to intellectual property rights. For a more detailed discussion of the economic versus moral rights dichotomy, see Leslie A. Pettenati, *Moral Rights of Artists in an International Marketplace*, 12 Pace Int'l L. Rev. 425, 435 (Fall, 2000).

[7] For the historical evolution of the English common law, with its emphasis on pleading and form over underlying rights, see John H. Baker, AN INTRODUCTION TO ENGLISH LEGAL HISTORY, (3d ed., 1990); F.S.C. Milsom, HISTORICAL FOUNDATIONS OF THE COMMON LAW (2d ed., 1981). For a detailed discussion of the evolving emphasis and influence of commercial litigation in the eighteenth century, see the introduction to James Oldham, 1 THE MANSFIELD MANUSCRIPTS AND_THE GROWTH OF ENGLISH LAW IN THE EIGHTEENTH CENTURY (Chapel Hill: University of North Carolina Press, 1992).

[8] For the historical evolution of the continental *ius commune* in the middle ages and the early modern era, see Manlio Bellomo, THE COMMON LEGAL PAST OF EUROPE, 1000-1800 (Washington, DC: Catholic University Press, 1995). *See also* O.F. Robinson, et al. AN INTRODUCTION TO EUROPEAN LEGAL HISTORY (Glasgow: Professional Books, 1985).

[9] See James R. Stoner, Jr., COMMON LAW AND LIBERAL THEORY: COKE, HOBBES, & THE ORIGINS OF AMERICAN CONSTITUTIONALISM (U. Kansas Press, 1992), arguing that the American concept of judicial review grew out of both the syllogisms of Coke and the political theories of Hobbes and Locke.

Note that both the Continental Congresses and the Constitution Convention were largely comprised of common law attorneys, and that the main training for such attorneys was study of Coke's commentaries on Littleton on Property. Note that the legal education of John Adams reflects this dual tradition. He concentrated on both Coke's COMMENTARIES and Justinian's INSTITUTES. Note also, that before reading law John Jay, the first Chief Justice of the U.S. Supreme Court, delivered his valedictory address at Columbia (then King's College) on Grotius' *DE IURE BELLI AC PACIS*, and that his later treaty negotiations reflect the strong influence of continental legal theory. For a discussion of the legal training of several of the founding fathers, see Frank L. Dewey, THOMAS JEFFERSON, LAWYER (UNIV. PRESS. OF VA., 1986); Julius Goebel, Jr., ed., THE LAW PRACTICE OF ALEXANDER HAMILTON: DOCUMENTS AND COMMENTARY (5 vols., New York: Columbia University Press, 1980); William R. Castro, THE SUPREME COURT IN THE EARLY REPUBLIC: THE CHIEF JUSTICESHIPS OF JOHN JAY AND OLIVER ELLSWORTH, University of South Carolina Press, 1995.; L.H. Butterfield, ed., DIARY AND AUTOBIOGRAPHY OF JOHN ADAMS, (4 vol., Cambridge, MA: The Belknap Press, 1961); L.H. Butterfield, ed., THE EARLIEST DIARY OF JOHN ADAMS: JUNE 1753- APRIL 1754, SEPTEMBER 1758- JANUARY 1759, (Cambridge, MA: The Belknap Press, 1966).

[10] There are innumerable citations to natural law and natural rights theories and discussions. A sampling of the philosophical discussions may be found in any standard translations of Aristotle, POLITICS, Book I, Ch. 5; Augustine, CITY OF GOD, Book XIX, Ch. 21; Thomas Aquinas, SUMMA THEOLOGICA, Part I-II, Questions 91-96; Thomas Hobbes, LEVIATHAN, Part I; John Locke, CIVIL GOVERNMENT, Ch. II-IX, XI, sections 135-137, Ch. XV, sections 171-172, and Georg Wilhelm Friedrich Hegel, PHILOSOPHY OF HISTORY, Introduction.

The founding fathers were steeped in this intellectual tradition. For a discussion of the philosophical views underlying the American Revolution, see Carl L. Becker, The DECLARATION OF INDEPENDENCE: A STUDY IN

THE HISTORY OF POLITICAL IDEAS (New York, Vintage Books, 1942), esp. Chapter VI. See also, Carl Joachim Friedrich, THE PHILSOPHY OF LAW IN HISTORICAL PERSPECTIVE, 2d ed. (Chicago: Univ. of Chicago Press, 1963), esp. Ch. XIX.

To a large extent, both English and continental legal systems have always sought to reflect justice and, therefore, necessarily focus on natural law. For the continental jurists elaborating on Roman law principles, natural law, with its assertions of the dignity of man, have long been the central focus of political and legal argumentation. For the English, however, the ties between justice and natural law have been obfuscated by two discrete facts. First, English law evolved by procedural innovations in pleadings; therefore British barristers concentrated largely on remedies, and not rights. See John H. Baker, AN INTRODUCTION TO ENGLISH LEGAL HISTORY, 3d ed., (Butterworths, 1990); F.S.C. Milsom, HISTORICAL FOUNDATIONS OF THE COMMON LAW, 2d ed., (Butterworths, 1981). Second, the concentration on formal pleading led to a formal separation of law from equity. What allowed the English system to work is the belief among its practitioners that through its arcane miasma of legal fictions and syllogisms the common law continued to reflect the natural law and natural rights. By crystallizing precedent as a reflection of the natural order in the universe, sixteenth-century common law pleaders raised *stare decisis* from a legal convention to a moral imperative.

See, also, James R. Stoner, Jr., COMMON LAW AND LIBERAL THEORY: COKE, HOBBES, & THE ORIGINS OF AMERICAN CONSTITUTIONALISM (U. Kansas Press, 1992). In arguing against the encroachment of their jurisdiction by Civilians trained in the Roman and Canon law, sixteenth-century English common lawyers did not necessarily deny the natural rights theories of their opponents, but instead argued that the common law incorporated natural law, and that the decisions of King's Bench and Common Pleas represented a codification of natural rights.

[11] *Carter v. Helmsley-Spear, Inc.*, 71 F.3d 77, 81 (2d Cir. 1995):

> The term "moral rights" has its origins in the civil law and is a translation of the French *le droit moral*, which is meant to capture those rights of a spiritual, non-economic and personal nature. The rights spring from a belief that an artist in the process of creation injects his spirit into the work and that the artist's personality, as well as the integrity of the work, should therefore be protected and preserved.

[12] *Id.* at 81.

[13] In regards to copyright protection, the United States stresses the economic rights of the author. *See* Melissa M. Mathis, *Function, Nonfunction, and Monumental Works of Architecture: An Interpretive Lens in Copyright Law*, 22

Cardozo L. Rev. 595 (January, 2001), for a discussion of copyright protection for architects, including a discussion of moral rights.

[14] The distinction was made clear in an earlier case, *Miller v. Commissioner of Internal Revenue*, 299 F.2d 706 (2d Cir. 1962), in which the plaintiff was the widow of the famous band leader, Glenn Miller. In 1952, she entered into a contract with Universal Pictures concerning the production of the motion picture based on the bandleader's life. She received a substantial sum of money from the venture wherein she granted Universal the exclusive right to produce and exhibit the said picture. She alleged that the income received was for the sale of a capital asset held more than 6 months and thus was taxable at a far lower rate than its treatment as ordinary income. The court decided that the sale of the rights to Miller's life story was for freedom from a possible future lawsuit concerning the abridgment of whatever property right the plaintiff would have and did not pay for "property."

[15] For a summary of the philosophical bases for European moral rights, see Thomas F. Cotter, *Pragmatism, Economics, and the Droit Moral*, 76 N.C.L. Rev. 1 (Nov. 1997). The philosophers most acknowledged to have formulated the *droit moral* bases are Hegel, Kant, and Locke. Hegel, in his PHILOSOPHY OF RIGHT, discussed property in relation to the individual. According to Hegel, property is the product of the exercise of the individual will. "The principle that a thing belongs to the person who happens to be the first in time to take into his possession is immediate explanatory and superfluous, because a second person cannot take into his possession what is already the property of another." Georg Wilhelm Friedrich Hegel, THE PHILOSOPHY OF RIGHT, trans. T. M. Knox, (Chicago: Encyclopaedia Britannica, Inc., 1952), paragraphs 44, 50.

[16] Lois sur les droits d'auteurs (laws concerning the rights of authors), Loi de 1957, art 6 (CPI Arts. L 121-1):

> *Art. L 121-1. L'auteur jouit du droit au respect de son nom, da sa qualite et de son oeuve. Ce droit est attache a sa personne. Il est perpetual, inalienable et imprescriptible. Il est transmissible a cause de mort aux heritiers de l'auteur. L/exercice peut etre confere a un tiers en vertu de dispositions testamentaires.*

[17] Lois sur les droits d'auteurs (laws concerning the rights of authors), Loi de 1957, art 19 (CPI Arts. L 121-2):

> *Art. L 121-2. L'auteur a seul le droit* The author alone has the right to disclose
> *de divuger son oeuvre. Sous reserve* his [or her] work. Under the dispositions of
> *des dispoisitions de l'article L 132-24,* Article L 132-24, [the author] determines

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il determine le procede de divulgation	the procedure for disclosure and determin-
et fixe les conditions de celle-ci. Apres	ation the conditions thereunto. Upon his
sa mort, le droit de divulgation de ses	[or her] death, the right of disclosure of his
oeuvres posthumes est excerce leur vie	[or her] posthumous works is exercised by
durant par le ou les executeurs	the executors during their lifetime [as is
testamentaires par l'auteur. A leur	said executors were] the author. Failing
defaut, ou apres leur deces, et sauf	this, or after their death, and without going
volonte contraire de l'auteur. A leur	against the wishes of the author, this right
defaut, or apres leur deces, et sauf	is exercised in the following order: by the
volonte contraire de l'auteur, ce droit	descendants, by the spouse against whom
est exerce dans l'ordre suivant: par les	there does not exist a judgment of separa-
descendants, par le conjont contre	tion or who has not entered into a new
lequel n'existe pas un jugment passe en	marriage, by the heirs (other than the desc-
force de choe jugee de separation de	endants) who receive all or part of the estate
corps ou qui n's pas contracte un	and by the sole legatees or donatees of all
nouveau mariage, par les heritiers	goods to come. This right can be exercised
autres que les descendants qui	even after the expiration of the exclusive
recueillent tout or partie de la	right of use determined in Article L 123-1.
succession et par les legataires	
universels ou donataires de	
l'universalite des biens a venir. Ce	
droit peut s'exercer meme apres	
l'expiration du droit exclusif	
d'exploitation determine a	
l/article L 123-1.	

Lois sur les droits d'auteurs (laws concerning the rights of authors), Loi de 1957, art 20 (CPI Arts. L 121-3):

Art. L 121-3. En cas d'abus notoire dans In the case of manifest abuse in the use or
l'usage ou le non-usage du droit de non-use of the right of disclosure on the
divulgation de la part des representants part of the deceased author's representatives
de l'auteur decede vise a l'article regarding Article L 121-2, the *tribunal de*
L 121-2, le tribunal de grande instance *grande instance* can order appropriate
peut ordonne toute mesure appropriee. measures. This pertains also if there is a
Il en est de meme s'il y a conflit entre conflict among the representatives, if there
les representants, s'il n'y a pas d'ayant is no known right, or in the case of intestacy
droit connu ou en cas de vacnece ou de or disinheritance. More particularly, an
desherence. Le tribunal peut etre [appropriate] tribunal can be appointed by
notammment par le ministre charge de the Minister of Culture.
la culture.

Lois sur les droits d'auteurs (laws concerning the rights of authors), Loi de 1957, art 21 (CPI Arts. L 121-4):

Art. L 121-4. Nonobstant la cession de Notwithstanding the transfer of his [or her]
son droit d'exploitation, meme right of use, even after the publication of
posterieurement a la publication de son his [or her] work, [the author] enjoys the
oeuvre, jouit d'un droit de repentir ou de right to repent or withdraw *vis-à-vis* his [or
retrait viv-a-vis du cessionaire. Il ne peut her] transferee. He [or she] cannot, in any
toutefois exercer ce droit qu'a charge case, exercise this right to indemnify before-
d'indemniser prealablement le hand the transferee against the detriment
cessionaire du prejudice que ce repentir that this withdrawal might cause. When,
ou ce retrait peut lui causer. Lorsque, prior to exercising his [or her] right to
posterieurement a l'exercice de son droit repent or withdraw, the author decides to

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de repentir ou de retrait, l'auteur decide publish his [or her] work, [the author] must
de faire publier son oeuvre, il est tenu offer by priority his rights of use to the
d'offrir par priorite ses droits transferee who he [or she] had originally
d'exploitation au cessionnaire qu'il avait chosen and under the conditions originally
originairement choisi et aux conditions agreed upon.
originairement determinees.

Note that the French term "*l'auteur*" is more closely akin to the more generic English concept of a "creator," and is not limited to written publications; it applies equally to literary authors, poets, painters, sculptors, etc. For the most current text of the above legislation, consult the French language website: <http://www.multimania.com/calmusac/Txt/Loi/Lois1.html.>

[18] The right of disclosure is akin to the Anglo-American concept of publication, but grants the author greater rights. Every author reserves the right to present his or her work in public, or to withhold any work from public display. For example, a poet retains the right to authorize or prohibit the publication of one of his or her poems. Similarly, a sculptor can permit or prohibit public display of his or her sculpture. This ability to control publication and display, however, goes well beyond the Anglo-American protection of royalties under copyright. In the U.S., copyright holders can only seek to prohibit subsequent publication because of their economic rights in the work, as demonstrated by the protection of royalties. In France, the right to determine display remains with the author, and is separate from the author's right to compensation for use of that work. Moreover, this right is considered so intrinsic to the author, that it survives his or her death, and is inheritable. Unlike in American law, the right to use or display a work does not pass into the public domain by mere passage of time. A discussion of the right of disclosure may be found in Susan P. Liemer, *Understanding Artists' Moral Rights: A Primer*, 7. B.U. Pub. Int. L.J. 41, 47-50 (Winter, 1998).

[19] The right of attribution reflects the twin concerns for acknowledgment of authorship and recognition in derivative works. An author has the right to be recognized as the creator of his or her work. The name, reputation, and work are inseparable. They are personal rights inhering in the author as creator and not as the economic beneficiary of such creation. Therefore, should any work reference another author, that work must acknowledge the source of borrowing or influence. A discussion of the right of attribution may be found in Susan P. Liemer, *Understanding Artists' Moral Rights: A Primer*, 7. B.U. Pub. Int. L.J. 41, 47-50 (Winter, 1998).

[20] A work, like its author, has an acknowledged integrity; under French law, one could no more edit or amend a work against the author's wishes than one could

perform surgery on the author without prior permission and consent. This was the central issue in *Gilliam*. Moreover, the right to protect a work's integrity inheres in the creator, so that no one can alter a work or force publication in an amended or mutilated format without permission of the author.

[21] The right of retraction or withdrawal reinforces the absolute inalienablity of moral rights under the French code. Even after granting use of his or her work, and even after publication, the author retains the right to rescind the original permission. While this right protects authors from abuse at the hands of transferees, it also risks significantly diminishing the economic value of copyrights; assignees and transferees. Transferees may not wish to pay for copyrights without guaranteed protection of their bargain. The possibility that an author might subsequently retract permission would depress the market value of those rights that an author may seek to transfer. The restrictions in Article L 121-4, therefore, appear an attempt to balance the retained rights of original creators and the acquired rights of publishers and publicists.

[22] Section 79.

[23] Under French law, *le droit moral* extends to a broad category of artistic works, unlike the limited scope of protection under VARA. Where the recent statute only covers visual works, the creators of all other works must still seek the haphazard protections afforded by diverse and disconcordant judicial remedies.

[24] See *Mac'Avoy v. The Smithsonian Inst.,* 757 F. Supp. 60, 71 (D.D.C., 1991), where the District Court dismissed a claim by the alleged purchaser of paintings by the French artist, Romaine Brooks, against the Smithsonian museum to which the paintings had been donated. The District Court specifically addressed the issue of moral rights, stating that under French law, "an artist's moral rights to disposition of his or her art can only be passed by will or intestacy."

For a more detailed discussion of similar issues, see Vera Zlatarski, *"Moral" Rights and Other Moral Interests: Public Art Law in France, Russia, and the United States*, 23 Colum.-VLA J.L. & Arts 201 (Spring, 1999).

[25] Section 77. Right to be identified as author or director

> 1. (1) The author of a copyright literary, dramatic, musical or artistic work, and the director of a copyright film, has the right to be identified as the author or director of the work in the circumstances mentioned in this section; but the right is not infringed unless it has been asserted in accordance with section 78.

Compare the broad coverage afforded under British law to the limited scope of the U.S. copyright statute, with its limitation of protection solely to works of visual art.

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[26] Section 78.

[27] Section 80(2)(a)(b).

[28] Section 79. For a discussion, see M. Holderness, *"Moral Rights and Authors' Rights: The Keys to the Information Age,"* The Journal of Information, Law and Technology (JILT) (1998), <http://elj.warwick.ac.uk/jilt/infosoc/98_1hold/>.

[29] Berne Convention for the Protection of Literary and Artistic Works (Paris Text), July 24, 1971.

[30] *See*, for example, Ruth Okediji, *Toward an International Fair Use Doctrine*, 39 Colum. J. Transnat'l L. 75, 97-105 (2000). Among the provisions, in addition to Article 6 bis, that permit alternate forms of national legislation, are Article 7(2) (allowing member states to allow an expiration date of fifty years for cinematographic works); Article 7(3) (permitting member states to refuse protection for anonymous or pseudonymous works); Article 7(4) (member states may extend the term of protection of photographic works and to protect woks of applied art as artistic works); Article 7(6) (member states may extend the term of protection for works in general beyond that stated in the Convention); Article 9(2) (member states may permit the reproduction of literary and artistic works with certain restrictions); Article 10(2) (member states may allow the use of literary or artistic works for purposes of illustration, broadcasts, and for teaching); and Article 10bis (allowing member states to permit reproduction by the press, broadcasting by wire or communication to the public). The Convention is more concerned with setting forth standards of compliance rather than binding rules.

[31]The European Union is composed of fifteen nations, to wit: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

[32] European Commission, COPYRIGHT AND RELATED RIGHTS IN THE INFORMATION SOCIETY (The EU Green Paper) (31 Oct. 1995), www.gn.apc.org/media/eugp.html.

[33] *Id.* at Section VII (2.1-2.2).

[34] Joined Cases C-92/92 and C-326/92 (Oct. 20, 1993).

[35] *Id.* at Section VII (3).

[36] Under U.S. law, as well as in countries adhering to copyright conventions, the copyright holder possesses a five basic economic rights with respect to the protected work: (1) *Reproduction* of copies or phonorecords; (2) *Preparation* of derivative works;[36] (3) *Distribution* of copies or phonorecords to the public by

sale, rental, lease, lending or other transfers; (4) *Performance* in public of a literary, musical, dramatic or choreographic work or by pantomime or by making a motion picture or in the case of sound recordings, by means of a digital audio transmission; and (5) *Display* the said copyrighted work in public (other than motion pictures) including pictorial, graphic, sculptural works or other audiovisual works. See 17 U.S.C. § 106.

Under Section 102 of the Copyright Act, protected works include: (1) literary works; (2) musical works, including the accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic and sculptural works; motion pictures and other audiovisual works; (6) sound recordings; and (7) architectural works. *See*, also, Melissa M. Mathis, *Function, Nonfunction, and Monumental Works of Architecture: An Interpretive Lens in Copyright Law*, 22 Cardozo L. Rev. 595 (January, 2001), for a discussion of copyright protection for architects, including a discussion of moral rights.

[37] 14 F.728 (N.D. Ill. 1883).

[38] *Id.* at 730-731.

[39] 1 N.Y.S.2d 904 (N.Y.C. Civ. Ct. 1937).

[40] 6 Misc.2d 383, 162 N.Y.S.2d 770 (N.Y. Sup. Ct. 1957), aff'd, 210 N.Y.S.2d 479 (1960).

[41] In *Seroff*, the plaintiff was the author of the biography, RACHMANINOFF that was commissioned and published by the defendant. The parties entered into a standard publishing contract that granted the defendant the exclusive right to publish the work and additional rights consisting of an abridgment, translation, and other publication and editorial rights. The book was published in 1950 and was favorably reviewed in the U.S. The defendant sent copies of the work to other countries thereby resulting in a French publication of the work in 1954. The defendant had not participated in the translation, publication or distribution of the translated work. The plaintiff objected to the translations claiming that it was a complete distortion of the English version and was a flagrant falsification thereof. He alleged some 134 errors, mistranslations, distortions and changes, he demanded that all copies of the translated work be recalled including those of the sold copies.

[42] *Id.* at 774. The court held that:

> [N]evertheless, a right analogous to "moral right", though not referred to as such, has been recognized in this country and in the common-law countries of the British commonwealth so that in at least a number of situations the integrity and reputation of an artistic creator have been protected by judicial pronouncements. The express grounds on which common-law

> protection has been given include libel, unfair competition, copyright, and the right of privacy, with some groping toward... "a tort theory of personal *sui generis* nature."

See, also, *Choe v. Fordham Univ. School of Law*, 920 F. Supp. 44 (S.D.N.Y. 1995) wherein the plaintiff, sued his law school for alleged mutilation of his Comment in the Fordham International Law Journal. Specifically he alleged that after he had discussed with the Journal's prior editors and had made several revisions in conformity thereto, the published version under new editors contained numerous substantive and typographical errors. Fordham had agreed to print an errata sheet in the next issue of the journal but the plaintiff rejected the offer. The court dismissed the complaint stating that the plaintiff failed to state a cause of action. The court refused to consider either the libel or the moral rights claim finding that libel did not exist under the facts stated and that federal law did not recognize a moral rights claim. Further, the Lanham Act did not apply inasmuch as the plaintiff failed to establish the claim of mutilation in the form of substantial distortion of the work. Typographical errors and substantive errors did not present the plaintiff as creating a work not his own.

[43] 80 N.Y.S.2d 575 (1948), aff'd, 87 N.Y.S.2d 430 (1949).

[44] Plaintiffs sought to enjoin the use of their names and music in the picture alleging that they constituted libel and violated the NY Civil Rights Law. The court noted also that the claim could also be construed as that of the infliction of injury without just cause and a violation of their moral rights as composers. The court denied the plaintiffs motion for an injunction.

[45] *Id.* at p. 578.

[46] *Soc. Le Chant de Monde v. Soc. Fox Europe et Soc. Fox Americane Twentieth Century*, 1 Gazette du Palais 191 (13 Jan 1953), aff'd D.A. Jur. 16, 80 Cour d'appel Paris. See Brandon G. Williams, *James Brown v. In-Frin-JR: How Moral Rights Can Steal the Groove*, 17 Ariz. J. Int'l & Comp. Law 651, 669 (Fall, 2000) at 669, citing Geri J. Yanover, *The "Dissing" of Da Vinci: The Imaginary Case of Leonardo v. Duchamp: Moral Rights, Parody and Fair Use*, 29 Val. U.L. Rev. 935, 949-50 (2000).

[47] *Buffet v. Fersing*, CA Paris, 1 e ch., May 30, 1962, D. Jur. 1962, 570, 571 and *Eden v. Whistler*, CA Paris, 1898 D.P. II 465, aff'd 1900 D.P. I 497 (Cour de Cassation), cited in Susan P. Liemer, *Understanding Artists' Moral Rights: A Primer*, 7 B.U. Pub. Int. L.J. 41 (Winter, 1998), notes 46 and 58.

[48] Judgment of Mar. 13, 1973, T.G.I., Paris, 1974 J.C.P. IV 224, cited in Vera Zlatarski, *"Moral" Rights and Other Moral Interests: Public Art Law in France, Russia, and the United States*, 23 Colum.-VLA J.L. & Arts 201, 204 (Spring, 1999).

[49] 990 F.2d 1379 (1st Cir. 1993).

[50] The contract stipulated that all proposed products would be, "subject to [Rey's] prior approval...which prior approval shall not be unreasonably withheld."

[51] *Supra*, note 48, at 1393.

[52] *Id.* at 1394.

[53] Copyright Act, Section 201. a "work made for hire" is defined in Section 101 as one "prepared by an employee within the scope of the person's employment or where it is specially ordered or commissioned."

[54] Section 201(d) "Transfer of Ownership" states:

> (1) The ownership of a copyright may be transferred in whole or in part by any means of conveyance or by operation of law, and may be bequeathed by will or pass by succession by the applicable laws of intestate succession.
> (2) Any of the exclusive rights comprised in a copyright, including any subdivision of any of the rights specified by section 106, may be transferred as provided by clause (1) and owned separately. The owner of any particular exclusive right is entitled, to the extent of that right, to all of the protection and remedies accorded to the copyright owner by this title.

[55] "True" moral rights are rights that may not be conveyed by contract or otherwise by the author. The rights set forth in VARA may be alienated.

[56] Section 203(a)(3) of the Copyright Act. For a discussion of termination rights, see Michael H. Davis, *The Screenwriter's Indestructible Right to Terminate Her Assignment of Copyright: Once a Story is "Pitched," A Studio Can Never Obtain All Copyrights in the Story*, 18 Cardozo Arts & Ent. LJ 93 (2000). For a discussion of moral rights of independent producers, see Stuart K. Kauffman, *Motion Pictures, Moral rights, and the Incentive Theory of Copyright: The Independent Film Producer as "Author,"* 17 Cardozo Arts & Ent. LJ 749 (1999).

[57] In November 1999, an amendment to the Copyright Act was passed by Congress known as The Intellectual Property and Communications Omnibus Reform Act of 1999, Pub. L. No. 106-113 Appendix I, 1011(d), 113 Stat. 1501. The amendment added sound recordings to works eligible for work made for hire status. Had the amendment remained, artists engaged in the said entertainment would not the right to exercise the termination right. The amendment was rescinded in the works Made for Hire and Copyright Corrections Act of 2000, Pub. L. No. 106-379 (2000). For a discussion of the amendment and its rescission, see Kathryn Starshak, *It's the End of the World as*

Musicians Know It, or is It? Artists Battle the Record Industry and Congress to Restore Their Termination Rights in Sound Recordings, 51 DePaul L. Rev. 71 (2001).

[58] 164 F.2d 522 (7th Cir. 1947).

[59] According to the initial contract, the plaintiff, using the *nom de plume* of "A. Varga," was given a monthly salary and a share of the proceeds for commercial use of the works. An annual calendar of "Varga Girls" was also prepared and published by the parties. After the expiration of the contract on June 1943, the plaintiff continued to prepare pictures for the defendant for publication. Although the defendant gave attribution to the plaintiff when it published his pictures, the name did not appear on the pictures when the plaintiff delivered them to Esquire. On May 25, 1943, a second contract was entered into between the parties but on January 14, 1946, the plaintiff told the defendant he no longer wished to be bound by the contract and would no longer furnish any pictures. Defendant had in its possession some twenty pictures of the plaintiff that had not yet been published. In March and May 1946, Esquire published two of the pictures under the title "The Esquire Girl" instead of "The Varga Girl" above the reproduction as well as a calendar of plaintiff's works without attribution. The contract between the parties contained a provision that the pictures and the name "shall forever belong exclusively to Esquire, and Esquire shall have all rights with respect thereto, including ***the right to use*** or otherwise dispose of the same as it shall see fit."

[60] 198 F.2d 585 (2d Cir. 1952).

[61] *Id.* at 589.

[62] *Id.*.

[63] 15 U.S.C. Section 1125(a). For an excellent, albeit dated, review of the Lanham Act in relation to moral rights, see Flore Krigsman, *Section 43(a) of the Lanham Act as a Defender of Author' "Moral Rights,"* 73 TMR 251 (May, 1983 – June, 1983).

[64] Lanham Act, section 43(a):

> (1) Any person who, on or in connection with any goods or services, or any container for goods, uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which-
>
> (A) is likely to cause confusion. or to cause mistake, or to

deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person, or

(B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities,

shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.

[65] 390 F.Supp. 530 (S.D.N.Y. 1975).

[66] 452 F. Supp. 516 (S.D.N.Y. 1978).

[67] The defendants released and marketed the music as *George Benson's Erotic Moods* with Benson's recent photograph and prominent display of his name alone on the album, Under the title of the album was stated "X Rated LP" in which a sexually suggestive moaning of a woman was dubbed on one of the selections. The advertising of the album contained a statement that the album was "XXX Rated new LP and single."

[68] 648 F.2d 602 (9th Cir. 1981).

[69] *Id.* at 607.

[70] 812 F.2d 1213 (9th Cir. 1987).

[71] *Id.* at 1214.

[72] 30 F.3d 1255 (9th Cir. 1993).

[73] *Id.* at 1261.

[74] *See, Lamothe v. Atlantic Recording Corp.* 847 F.2d 1403 (9th Cir. 1988), applying the same stringent requirement for reverse passing off, found in favor of the plaintiffs. Lamothe, Jones and Crosby were co-authors of two songs that were composed when they were members of a band named Mac Meda. After the group was disbanded, Crosby joined another band and with another band member, Croucier, licensed the songs to a music company that then sublicensed it to Atlantic. Atlantic released an album by the new group crediting Crosby with music and lyrics of one of the songs and jointly with Croucier was to the second song. Citing *Smith v. Montoro*, 648 F.2d 602 (9th Cir. 1981), the court said that the attribution of the songs omitting the names of two of the co-authors constituted a violation of Latham 43(a). "Misbranding a product to only partially

identify its source is the economic equivalent of passing off one person's product under the name or mark of another." *Id.* at 1407.

Compare *Rosenfeld v. W.B. Saunders* 728 F. Supp. 236 (S.D.N.Y. 1990), *aff'd*, 923 F.2d 845 (2d Cir. 1990), where the Second Circuit applied a less onerous test to establish "reverse passing off," although the Cleary case would most likely have been decided in the same manner. In *Rosenfeld*, the plaintiff as trustee of the John Marquis Converse Testamentary Trusts sued defendant, a division of Harcourt Brace Jovanovich, Inc., book publisher and Dr. McCarthy for an injunction alleging reverse palming off under Lanham and diverse other claims. The decedent, Dr. Converse, was the principal author and editor of a five-volume treatise, RECONSTRUCTIVE PLASTIC SURGERY that was published in 1964 by Saunders. He then selected his student, Dr. McCarthy, to act as assistant editor for a second, seven-volume edition of the treatise. When a third edition was to be prepared, Dr. Converse told the publisher that Dr. McCarthy was to serve as associate editor and was to be his sole editorial successor for future editions published after his death and was to receive all of the royalties therefrom. In 1981, after the death of Dr. Converse, the changes in medicine were so pronounced that Saunders suggested a totally new work titled PLASTIC SURGERY and not merely a revised edition of the prior treatise. Plaintiff sued to enjoin defendants from publishing and distributing the alleged new work inasmuch as the trusts would lose royalties from the lack of sales due to the competitive work. The Court denied the motion for a preliminary injunction. It stated that: "It is sufficient for the purpose of the instant application for injunctive relief that plaintiff has failed to establish a likelihood of consumer confusion [emphasis supplied] on the part of the ordinary prudent purchaser." *Id.*, at p. 243. The preface to the McCarthy work clarifies the nature of the new work. He noted that the new work is a descendant of the prior Converse work and includes many ideas and principles from the prior treatise. Thus, there is little evidence that consumers would be confused as to the origin of the new treatise, especially in the light that the buyers are highly sophisticated readers of the text. Moreover, the court left the remaining issues of contractual breach and damages if any and any other claims for a trial on the merits.

See, also, *Batiste v. Island Records Inc.*, 179 F.3d 217 (5th Cir. 1999), wherein the plaintiffs sued the defendants for their use of a six and one-half second segment from a purchased recording written by them. The Court found that the plaintiffs had previously transferred all of their rights in the recording to one of the defendants, Bolden, who then obtained a copyright registration identifying one of the plaintiffs as the composer. The recordings were authorized by the defendant, Bolden, to the other defendants. Concerning the claim that the plaintiffs' legal and moral rights were violated by the alleged "mutilation," the Court held that the plaintiffs failed to demonstrate the likelihood of consumer confusion. *Id.*, at 225.

See, also, *Leigh v. Warner Bros., Inc.*, 212 F.3d 1210 (11th Cir. 2000), which decided that the defendant did not possess a trademark with respect to a "Bird

Girl" photograph taken by plaintiff that was commissioned by the publisher of the novel, MIDNIGHT IN THE GARDEN OF GOOD AND EVIL." The plaintiff retained the copyright to the photograph. Warner Brothers produced a film of the novel and made a replica of the Bird Girl statue that had been located in the Savannah, Georgia cemetery. It then took the photograph of the film footage of the replica. The Court of Appeals affirmed the District Court's dismissal of the trademark claim, finding a failure to establish that consumers would likely be confused into believing that the plaintiff was involved with the movie, although it reversed the dismissal of the copyright claim stating as question of fact had been presented and needed to be resolved. *Id.*, at 1218. The Court also found no violation of the artists' moral rights stating it refused to follow the Second Circuit's opinion in *Gilliam*. Moreover, had it so elected to concur with the finding, there was no evidence of alteration or distortion of the plaintiff's photographs inasmuch as the defendant's photograph were of its own replica of the Bird Girl' statute (*Id*).

[75] 934 F. Supp. 119 (S.D.N.Y., 1996).

[76] *Id.* at p. 126.

[77] Lanham Act, Section 43(a)(1).

[78] 971 F.2d 302 (9th Cir. 1992).

[79] Compare *White v. Samsung Electronics America, Inc.*, 971 F.2d 1395 (1992) wherein the plaintiff, Vanna White, a well-known hostess of a television show, was upheld in her claim that the use of a robot that exhibited her likeness in a commercial was not fair use and was likely to cause confusion as to the commercial's origin.

[80] 976 F.2d 824 (2d Cir. 1992).

[81] *King v. Allied Vision, Ltd.,* 877 F. Supp. 185 (S.D.N.Y. 1995).

[82] *Id.* at 829.

[83] *Id.* at 830. The court added: "We think that King would have cause to complain if he were not afforded the "based upon" credit." *See*, also, *Waldman Pub. Corp. v. Landoll, Inc*, 43 F.3d 775 (2d Cir. 1994), a recent case decided after the passage of VARA, where the Court of Appeals addressed the issue concerning the misattribution of a written work. The District Court had granted the plaintiffs a preliminary injunction finding a likelihood of success on their claims for violation of the Lanham Act; *Waldman Pub. Corp. v. Landoll, Inc*, 848 F. Supp. 498 (S.D.N.Y. 1994). Waldman, and the other plaintiff, Playmore Inc., published children's books which were adaptations of literary works in the public domain such as OLIVER TWIST, BLACK BEAUTY, and other classics. The texts were adapted by various authors in simplified language together with

numerous illustrations to make the books appealing to children. They issued a softcover line of books titled ILLUSTRATED CLASSICS and hardcover versions called GREAT ILLUSTRATED CLASSICS. The defendant was also a publisher of children's books and began selling a line of books called FIRST ILLUSTRATED CLASSICS, which also were illustrated adaptations of classic books sold by the plaintiff. The defendant's books were not exact copies as those of the plaintiffs but their arrangements were very similar to those of the plaintiffs. The plaintiffs sued under Lanham Section 43(a). The Court noted that the section prohibits misrepresentations of two types: (1) false advertising; and (2) passing (palming) off wherein A sells its product under B's name and reverse palming off in which A sells B's product under A's name. The Court found that Waldman's books were adaptations and derivative of works in the public domain and were sufficiently original to be deserving of protection. The defendant's books appeared to be similar enough to those of the plaintiffs' so that its failure to credit Waldman constituted false designation of origin. The Court found a likelihood of consumer confusion in this reverse passing off case so that they would be misled into believing the Landoll books were the source of adaptations. The case was remanded to determine whether the plaintiffs were substantially harmed by the defendants' publications.

[84] 503 F.Supp. 533 (W.D.Tx. 1980).

[85] *Id.* at 543 citing *Gilliam v. American Broadcasting Companies, Inc.*, 538 F.2d 14 (2d Cir. 1976) at 21.

[86] 693 F.2d 622 (7th Cir. 1982).

[87] 724 F.Supp. 808 (D.Kan. 1989). Motion to amend court order denied 1989 U.S. Dist. LEXIS 15684 (D.Kan., Dec. 15, 1989).

[88] *Id.* at 819.

[89] The court noted the following factors applied by the 10th Circuit in making such a determination, namely:

(a) the degree of similarity between the designation and the trademark or trade name in
  (i) appearance;
  (ii) pronunciation of the words used;
  (iii) verbal translation of the pictures or designs involved;
  (iv) suggestion;
(b) the intent of the actor in adopting the designation;
(c) the relation in use and manner of marketing between the goods or services marketed by the actor and those marketed by the other;
(d) the degree of care likely to be exercised by purchasers.

[90] *Id.* at p. 817, noting that there was "no evidence of actual confusion and no reason for this evidentiary shortcoming."

[91] *Id.* at p. 818.

[92] Id. at p. 820.

[93] *Id. a*t 821 citing *United States v. Wise*, 550 F.2d 1180, 1187 (9th Cir. 1977). *See,* also, *Weinstein v. University of Illinois*, 811 F.2d 1091 (7th Cir. 1987), where the Court of Appeals affirmed the District Court's dismissal of a lawsuit ruling that the alleged wrongful placement of the order in which the names of three professors appeared in a published article did not constitute a mutilation of the plaintiff's work. The plaintiff, an assistant professor at the defendant university, alleged that he was to be listed as the first author of a work to be published albeit all of the professors did contribute to the study. The Court found the work to be a "work for hire" thereby giving the defendant full rights over the published work. It refused to extend moral rights in favor of the plaintiff noting that only three states at that time had recognized *droit moral* and only as to works of art. "But no jurisdiction has created the sort of moral right Weinstein invokes, let alone created any moral right through judicial decision. A federal court is not about to foist so novel a principle on Illinois. There is no reason to suspect that the courts of Illinois are just about to adopt an approach that no American jurisdiction follows as a general matter" *Id.*, at 1095.

[94] *See* Jane C. Ginsburg, C*opyright and Control over New Technologies of Dissemination*, 101 Colum. L. Rev. 1613 (Nov. 2001).

[95] 130 F.3d 798 (7th Cir. 1997).

[96] In *Seshadri*, the professor and the graduate student had published four prior articles in leading scholarly journals with the graduate student's name appearing first and the professor's name after that of the student. A fifth article was submitted by the professor to the *Journal of Applied Physics* with both names in the same order as the prior articles. The article was withdrawn prior to publication due apparently to a dispute between the professor and the graduate student. After the professor asked that his name not be associated with the article, the student resubmitted the article under his name alone. He assigned the copyright to the article to the journal as had been done previously.

[97] *Id.* at p. 803.

[98] The major enactments are: the 1998 Digital Millennium Copyright Act, 17 U.S.C. Section 1201, which brought the U.S. into conformity with the World Intellectual Property Organization Copyright Treaty and the Performances and Phonograms Treaty and added a new Chapter 12 to the Copyright Act of 1976 by prohibiting the circumvention of technological measures controlling access to a copyright protected work; and the Audio Home Recording Act of 1992, which

added a new Chapter 10 to the Copyright Act of 1976, which prohibited the importation, manufacture, or distribution of any digital audio or interface device that does not conform to the Serial Management System of comparable system that prohibits unauthorized copying. For a discussion of this topic, *see* Jane C. Ginsburg, *Copyright and Control Over New Technologies of Dissemination*, 101 Colum. L. Rev. 1613 (November 2001).

[99] *New York Times Co. Inc. v. Tasini*, 533 U.S. 483 (2001).

[100] *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004 (9th Cir. 2001).

[101] Pub. L. No. 101-650, 104 Stat. 5128 (codified in scattered sections of 17 U.S.C.).

[102] H.R. Rep. No. 101-514, at 15 (1990), reprinted in 1990 U.S.C.C.A.N. 6915, 6925. Quoted in *Martin v. City of Indianapolis*, 192 F.3d 608, 611 (7th Cir. 1999)

[103] *See*, also, Christopher J. Robinson, Note: *The "Recognized Stature" Standard in the Visual Artists Rights Act*, 68 Fordham L. Rev. 1935, 1939 (April, 2000) and Cheryl Swack, *Safeguarding Artistic Creation and the Cultural Heritage: A Comparison of Droit Moral Between France and the United States*, 22 Colum.-VLA J.L. & Arts 361, 370-72 (1998) cited in Robinson.

[104] The right is subject to 17 U.S.C. sections 113(d), 106, and 107. Compare the protection accorded such works in France, which has the greatest expanse of moral rights legislation, where the law also includes the rights of withdrawal, retraction, and disclosure.

[105] 17 U.S.C. Section 106(a)(3)(B).

[106] *Carter, supra* note 11 at 325; cited with approval in *Martin v. City of Indianapolis*, 192 F.3d 608, 612 (7th Cir. 1999). This provision acts as "a gate-keeping mechanism," i.e., granting a work protection only if such work is acknowledged by arts experts or arts community or society to have "stature."

[107] *Id.* In *Martin*, the plaintiff created a large outdoor stainless steel sculpture , which was demolished in the construction of an urban renewal project, the Court of Appeals affirmed the District Court's grant of judgment in favor of the artist and an award of statutory damages in *Martin v. City of Indianapolis*, 982 F. Supp. 625 (S.D. Ind. 1977) and 4 F. Supp.2d 808 (S.D. Ind. 1998). The work had been commissioned by the Indianapolis Development Commission to erect the twenty by forty-foot metal sculpture. Later, the City having taken over the property demolished the work without notice to the artists. The court found that the artist had the requisite stature as evidenced by newspaper article, letters from experts and other evidence of the artist's worth.

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[108] 150 F. Supp.2d 393 (N.D.N.Y. 2001).

[109] *Pollara v. Seymour,* 150 F. Supp.2d 393, 397 (N.D. N.Y. 2991).

[110] The rights extended to visual artists are subject to the limitations found in section 113 (d)(1). The limitations are as follows:

> (d)(1) In a case which—
>
> (A) a work of visual art has been incorporated in or made a part of a building in such a way that removing the work from the building will cause the destruction, distortion, mutilation, or other modification of the work as described in section 106A(a)(3), and
>
> (B) the author consented to the installation of the work in the building either before the effective date set forth in section 610(a) of the Visual Artists Rights Act of 1990, or in a written instrument executed on or after such effective date that is signed by the owner of the building and the author and that specifies that installation of the work may subject the work to destruction, distortion, mutilation, or other modification, by reason of its removal, then the rights conferred by paragraphs (2) and (3) of section 106A(a) shall not apply.
>
> (2) If the owner of a building wishes to remove a work of visual art which is a part of such building and which can be removed from the building without the destruction, distortion, mutilation, or other modification of the work as described in section 106A(a)(3), the author's rights under paragraphs (2) and (3) of section 106A(a) shall apply unless—
>
> (A) the owner has made a diligent, good faith attempt without success to notify the author of the owner's intended action affecting the work of visual art, or
>
> (B) the owner did provide such notice in writing and the person so notified

> failed, within 90 days after receiving such notice, either to remove the work or to pay for its removal."

[111] No. 97 Civ. 7446 (HB), 1997 U.S. Dist. LEXIS 19137 (S.D.N.Y., Dec. 3, 1997).

[112] *Id.* The court also denied plaintiff's claim of estoppel alleging that the City knew or acquiesced in the creation and placement of the artwork on the lot. It rejected the argument stating that a municipality may not be estopped from enforcing its zoning and related laws inasmuch as to hold otherwise would require the City to patrol vigilantly all of its lots to prevent trespass and other unlawful activities. The court would not so mandate.

[113] Section 106A(d) of the Copyright Act.

[114] New York Times, July 9, 2001, pp. 1, B4.

[115] The rights of attribution and integrity are not transferable, while all other exclusive rights under copyright law may be transferred. *The EBT Group, Inc. v. FMC Corp.*, No. 01 C 2768, 2001 U.S. Dist. LEXIS 14646 (N.D.Ill., Sept. 18, 2001).

[116] Section 106A(e) of the Copyright Act.

[117] *See* discussion Michael H. Davis, *The Screenwriter's Indestructible Right to Terminate Her Assignment of Copyright: Once a Story is "Pitched," a Studio Can Never Obtain All Copyrights in the Story,"* 18 Cardozo Arts & Ent. LJ 93, 106 (2000) citing Dano D. Colino, *Moral Rights and Real Obligations: A Property-Law Framework for the Protection of Authors' Moral Rights*, 69 Tul. L. Rev. 935, 941 (1995).

[118] *Boosey & Hawkes Music Pub., Ltd. v. Walt Disney Co.*, No. 93 Civ. 0373 (KTD), 2000 U.S. Dist. LEXIS 1643 (S.D.N.Y., Feb. 18, 2000) wherein the court refused to permit evidence of a violation of moral rights by the assignee of the soundtrack of Igor Stravinsky's, THE RITE OF SPRING Disney reproduced its motion picture, FANTASIA that contained the famed musical score in a video format without alteration. The plaintiff owner of the copyright to the score alleged that the transformation to a video format was a mutilation. The court emphasized the manifold use of the score in the movie and on stage. Moreover, the court stated that the plaintiff had no standing to assert Stravinsky's moral rights because such rights were "inalienable and unassignable."

[119] In *Monroig v. RMM Records & Video Corp.*, No. 97-2764 (SEC)(JA), 2000 U.S. Dist. LEXIS 11248 (D.P.R. 2000), motion for new trial den. at 196 F.R.D. 214 (D.P.R. 2000), the District Court of Puerto Rico sustained a jury's award of monetary damages for infringement of the plaintiffs' moral rights with respect to

the violation of their copyrighted song, *Yo Soy,* under the laws of Puerto Rico, and fourteen other countries.

[120] Section 203(a) of the Copyright Act.

[121] *Id.* Note also, there are exceptions for works that become modified as a result of the passage of time, the inherent nature of the material, the result of conservation, or are due to the lighting or placement of a publicly presented visual artwork.

[122] 632 F.2d 989 (2d Cir. 1980)

[123] The Copyright Act, Section 101 defines "work made for hire" as:

> (1) a work prepared by an employee within the scope of his or her employment; or
> (2) a work specially ordered or commissioned for use as a contribution to a collective work, as a part of a motion picture or other audiovisual work, as a translation, as a supplementary work, as a compilation, as an instructional text, as a trest, as answer material for a test, or as an atlas, if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire....

[124] 861 F. Supp. 303 (S.D.N.Y. 1994), aff'd in part, vacated in part, rev'd in part, 71 F.3d 77 (2d Cir. 1995).

[125] Several artists had agreed, in December 1991, with the managing agent of a Limited Partnership to create and install sculpture and other permanent installations in the lobby of the said premises. The artists were given full authority concerning the design, color, and style of the artwork to be installed but the managing agent, Sig, was given the right to direct where the work was to be installed within the premises. The plaintiffs were to receive full design credit for the work, as well as the copyright to the said sculptures and installations. Sig was to receive one-half of any proceeds earned from the exploitation of the copyright. The agreement was extended for a year in January 1993. Later, in 1993, Corporate Life became the general partner of the Limited Partnership and acted as managing agent for the premises from June 1993 to April 1994. It also extended the agreement with the plaintiffs wherein the plaintiffs were to receive $1,000 weekly for the period ending on April 6, 1994. The Limited Partnership filed for Chapter 7 (liquidation) bankruptcy protection on April 8, 1994. The defendants' agents ordered the plaintiffs to leave the property and allegedly were going to alter or remove the plaintiffs' artwork. Plaintiffs claimed a violation of the Visual Artists Rights Act of 1990 (VARA).

[126] 71 F.3d 77 (2d Cir. 1995).

[127] The District Court had applied the U.S. Supreme Court's factors in making the determination of whether a work falls within the exception. In *Community for Creative Non-Violence v. Reid*, 490 U.S. 730 (1989), the Supreme Court upheld plaintiff's claim that the sculpture prepared by him on behalf of a not-for-profit association for the homeless was not a work made for hire, although it did remand the case for testimony concerning whether the work was a joint work.

[128] *Id.* at 87.

[129] Nenutzka C. Villamar, *Carter v. Helmsley-Spear and the Visual Artists Rights Act of 1990*, 3 U. Balt. Intll. Prop. J. 167 (Spring, 1995).

[130] *Id.* at 181. The author noted that the Court of Appeals' reversal of the District Court's decision on the theory that it was a "work for hire" rather than being the work of an independent contractor highlighted the difference between the Berne and U.S. moral rights perspective. The Berne view of moral rights is one that seeks to protect the personality behind an artist's work. It does not matter who the owner of the work may be. The artist can claim moral rights protection as creator of the work. VARA, as interpreted by the Court of Appeals, emphasizes the economic aspect by ascertaining who owns the work rather than examining its psychological tie.

[131] For a discussion of U.S. moral rights and the "work made for hire" doctrine, *see* Colleen Creamer Fielkow, *Clashing Rights under United States Copyright Law: Harmonizing an Employer's Economic Right with the Artist-Employee's Moral Rights in a Work Made for Hire*, 7 DePaul-LCA J. Art and Ent. L 218 (Spring, 1997).

[132] At least one author believes that VARA was an important first step in the recognition of moral rights but she suggests that moral rights be interpreted in a broader fashion especially in the light of the Supreme Court's Reid formulation. She believes that Carter demonstrated the weaknesses of VARA. See Colleen Creamer Fielkow, *Clashing Rights Under United States Copyright Law: Harmonizing an Employer's Economic right with the Artist-Employee's Moral Rights in a Work Made for Hire*, 7 DePaul-LCA J. Art & Ent. L. 218 (Spring, 1997).

[133] 532 U.S. 135, 150 (1998).

[134] 880 F. Supp. 153 (S.D.N.Y. 1995).

[135] *See Gilliam, supra*, note 4.

[136] *Id.* at p. 166.

[137] *See* Cal. Civ. Code 987(a) (West 1982 & Supp. 2000); Conn. Gen. Stat. Ann. 42-116s-t (West 1992 & Supp. 1999); La. Rev. Stat. Ann. 51:2151-2156 (West

1987 and Supp. 2000); Mass. Ann. Laws ch. 231, 85S (Law. Co-op. 1986 & Supp. 1999); Nev. Stat. Ann. Title 27, 303 (West 1988); Nev. Rev. Stat. Ann. 597.720-.760 (Michie 1999); N.J. Stat. Ann. 2A:24A-1 to -8 (West 1997); N.M. Stat. Ann. 13-4B-1 to -3 (Michie 1997); Pa. Stat. Ann. Title 73, 2101-2110 (West 1993); and R.I. Gen. Laws 5-62-2 to -6 (Michie 1999). Robinson, Id. at 1943.

[138] 17 U.S.C. Section 301(a) states:

> On or after January 1, 1978, all legal and equitable rights that are equivalent to any of the exclusive rights within the general scope of copyright as specified by section 106 in works of authorship that are fixed in a tangible medium of expression and come within the subject matter of copyright as specified by sections 102 and 103, whether created before or after that date and published or unpublished, are governed exclusively by this title....

[139] 901 F. Supp. 620 (S.D.N.Y. 1995).

[140] N.Y. Arts & Cult. Aff. Law Section 14.03 (McKinney Supp. 1993). The section states in part:

> (1) No person other than the artist or a person acting with the artist's consent shall knowingly display in a place accessible to the public or publish a work of fine art or limited edition multiple of not more than three hundred copies of that artist or a reproduction thereof in an altered, defaced, mutilated or modified form if the work is displayed, published or reproduced as being the work of the artist, or under the circumstances which would reasonably be regarded as being the work of the artist, and damage to the artist's reputation is reasonably likely to result therefrom....

[141] *Supra*, note 133 at 627.

[142] VARA provides for an exemption concerning acts committed before the Act's adoption. See VARA Section 610(b)(2), 17 U.S.C. Section 106A note.

[143] The preemption clause states that nothing in the clause "annuls or limits any rights or remedies under the common law or statutes of any State with respect to...any cause of action from undertakings commenced before the effective date" of the Act. VARA Section 605, 17 U.S.C. Section 301(f)(2)(A).

[144] 745 F. Supp. 130 (S.D.N.Y. 1990)

[145] *Id.* at 135.

[146] 201 F.3d 654 (5th Cir. 2000).

[147] *Id.* at 658. The Restatement of Torts, section 652C states:

> *Appropriation of Name or Likeness:*
>
> One who appropriates to his or her own use or benefit the name or likeness of another is subject to liability to the other for invasion of his [or her] privacy.

The court also noted that the legislative history of the Copyright Act supported the court's conclusion. It recited: "The evolving common law rights of 'privacy,' 'publicity,' and trade secrets...would remain unaffected as long as the causes of action contain elements, such as an invasion of personal rights or a breach of trust or confidentiality, that are different in kind from copyright infringement." H.R. Rep. 1476, 94th Cong., 2d Sess. 132 (1976).

New York protects against the wrongful misappropriation of the likeness of a person. McKinney's Consol. Laws of New York Anno., The Civil Rights Law, Section 51 provides:

> Any person whose name, portrait, or picture is used within this state for advertising purposes or for the purposes of trade without the written consent first obtained as above provided may maintain an equitable action in the supreme court of this state against the person, firm or corporation so using his name, portrait or picture, to prevent and restrain the use thereof; and may also sue and recover damages for any injuries sustained by reason of such use and if the defendant shall have knowingly used such person's name, portrait or picture in such manner as is forbidden or declared to be unlawful..., the jury, in its discretion, may award exemplary damages....

[148] 125 F.3d 580 (7th Cir. 1997). In *Lee*, the Court of Appeals had to determine whether the plaintiff's notecards and small lithographs that were sold by one of the buyer's to the defendant and which were mounted on ceramic tiles and sold thereafter without her consent constituted a copyright infringement. Under the first sale doctrine, the defendant believed it had the right of transformation after initial purchase and thus, did not violate the plaintiff's derivative rights. The Court affirmed the District Court's conclusion that the defendant's mounting of Lee's work on tile was not an "original work of authorship" analogizing such mounting to a museum's mounting a work of art in a frame (at p. 581).

For first sale doctrine, *see* 17 U.S.C. Section 109(a), which states in pertinent part:

> (a) Notwithstanding the provisions of section 106(3)

> [owner of copyright has exclusive right to "distribute copies...of the copyrighted work to the public...], the owner of a particular copy or phonorecord lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord....

[149] See *Lone Ranger Television, Inc. v. Program Radio Corp.*, 740 F.2d 718, 722 (9th Cir. 1984). The Court was also concerned about the overbroad interpretation of "derivative works" in academic commentaries; compare Paul Goldstein, COPYRIGHT: PRINCIPLES, LAW AND PRACTICE, Section 5.3.1 (2d ed. 1996).

[150] Section 106(2) defines a "derivative work" as:

> a work based upon one or more preexisting works, such as a translation, musical arrangement, dramatization, fictionalization, motion picture version, sound recording, art reproduction, abridgment, condensation, or any other form in which a work may be recast, transformed, or adapted. A work consisting of editorial revisions, annotations, elaborations, or other modifications which, as a whole, represent an original work of authorship, is a "derivative work."

[151] *Supra*, note 138, at 582.

[152] *See* Alexander A. Caviedes, *International Copyright Law: Should the European Union Dictate Its Development?*, 16 B.U. Int'l L.J. 165, 200 (Spring, 1998) wherein he notes that one of the reasons for the common law's reluctance to adopt moral rights is its requirement of a low level of originality in order to have a copyright whereas the civil law systems require a higher degree of creative output to grant protection. Impliedly, such moral rights that are adopted by common law systems will be more easily enforced because of the *de minimus* creativity requirement. The opinion seems to have been adopted in practice in the U.S.

See, also, *Johnson v. Tuff-N-Rumble Mgmt., Inc.*, No. 99-1374 Section: "R"(3), 2000 U.S. Dist. LEXIS 18299 (E.D.La., Dec. 8, 2000). In *Johnson*, while acknowledging the failure of then U.S. to recognize moral rights, the District Court nevertheless, stated: "Courts tend to recognize such claims in the form of unfair competition, defamation, invasion of privacy or breach of contract." Moreover, such protection is not limited to federal protection in denying plaintiff's claim that a voluntary settlement agreement entered into by the parties violated the plaintiff's moral rights.

[153] *See*, for example, Kauffman, *op. cit.*, pp.784-86; Robert J. Sherman, *The Visual Artists Rights Act of 1990: American Artists Burned Again,* 17 Cardozo L. Rev. 373, 427-431 (Dec. 1995); Colleen Creamer Fielkow, *op. cit.*; Sarah Harding, *Value, Obligation and Cultural Heritage*, 31 Ariz. St. L.J. 291, 346-347 (Summer 1999).

[154] *See Id.* Sherman at 427-429.

[155] Lord Acton was the earliest leading proponent of legal positivism, and his influence has only continued to grow over the past century. By the early twentieth century, for example, when reminded one day by his clerk to "do justice" in determining a case before the Supreme Court, Justice Oliver Wendell Holmes is said to have replied, "Our purpose is not to uphold justice; we uphold the law."

[156] *See Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569 (1994), wherein the U.S. Supreme Court stated that a fair use of copyrighted work may be nullified by an artist claiming that his or her work has been altered or mutilated under an amended VARA.[156] The creativity of an artist rescripting a musical or other artistic composition in a manner that detracts from that of the artist may therefore be circumscribed.

Compare, *Leibovitz v. Paramount Pictures*, 137 F.3d 109 (2d Cir. 1998) wherein the Court of Appeals decided in favor of Paramount for its use in a parodic manner the well-publicized photograph taken by the plaintiff and which appeared on the cover of VANITY FAIR magazine. Leibovitz's photo was that of the nude actress, Demi Moore, in an advanced state of pregnancy, which was altered to reflect the face of the comedic actor, Leslie Nielson.

For a discussion of the cases, see Roy J. Girasa, CYBERLAW: NATIONAL AND INTERNATIONAL PERSPECTIVES, 180-182, Prentice Hall, 2002.

[157] For example, in the movie, *Forest Gump*, the lead actor is shown speaking to or communicating with Presidents Kennedy and Johnson although the movie was made long after the demise of both presidents.

[158] See Roberta Rosenthal Kwall, *Intellectual Property Challenges in the Next Century: Article Preserving Personality and Reputational Interests of Constructed Personas through Moral Rights: A Blueprint for the Twenty-First Century*, 2001 U. Ill. L. Rev. 151, 155-156 (2001).

[159] For example, is a building that contains a work of art forever bound to retain the work albeit it may later constitute an offensive addition?

[160] U.S. Constitution, Article I, Section 8, clause 8.

COLLEGE AND UNIVERSITY LIABILITY FOR STUDENT SUICIDES

by

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Introduction

During the past decade, colleges and universities have had to face the grim reality that student suicides are increasing at institutions of higher learning. When the International Association of Counseling Services surveyed 274 campus counseling centers, it found that 89 percent of colleges and universities reported hospitalizing students for mental illness and 30 percent had at least one student who had committed suicide.[1] Anecdotal reports indicate caseloads at college and university mental health centers have risen more than 50 percent in the past five years. Perhaps the suicide of Elizabeth Shin at the Massachusetts Institute of Technology best highlights the problem. While she was one of 12 students to commit suicide at MIT since 1990, unlike the other suicides, her parents filed a lawsuit blaming the university for their daughter's death. The Shins' suit named numerous MIT administrators, medical personnel and campus police officers and sought damages of $27 million. Other lawsuits involving student suicides have also included faculty, advisors and residence hall staff.

This is a troubling trend for colleges and universities if in tandem with the rising rates of troubled students, courts increase institutional liability. Few other acts compare to the randomness and unpredictability of suicide. Historically, the act of suicide has

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been considered "a deliberate, intentional and intervening act that precludes another's responsibility for the harm."[2] To find liability for such an event appears to defy the basic tenets of negligence theory. Yet, liability has been established in a number of cases.

The purpose of this paper, therefore, is to discuss when a college or university is liable for the suicide of a student. We will address the legal theories behind a wrongful death lawsuit against a college or university for the death of a student[3] and look at the college counseling center's liability for inadequate mental health services as well as other campus employees. We will also discuss how the archaic doctrine *in loco parentis* still influences some courts' evaluation of college and university liability and ask what colleges and universities can do to limit their exposure and reduce their liability for student suicides.

Historical Aspects of College and University Liability

From In Loco Parentis to Questions of Duty

At the heart of a lawsuit against a college or university for the death of a student lies the question: exactly what is the legal relationship between the student and the institution? Perhaps no other relationship has remained so ill defined, if defined at all. Until the 1960's, the doctrine of *in loco parentis* seemed, in part, to answer the question. This doctrine imposed a duty on colleges and universities to protect the physical welfare of students. Institutions of higher learning stood in the place of the parents: in that sense they had the responsibility for controlling the behavior of their "children." Thus, "as college administrators governed students with parental authority, courts began to recognize a correlative legal duty to protect the students over whom such authority was exercised."[4] Along with this duty to protect students, however, came the insulation from lawsuits by the children against the university. As a result, the general rule today is that, "colleges and universities do not stand *in loco parentis* to their students. Colleges are not insurers of the safety of their students, much less their guests."[5] During the politically turbulent 1960's, the theory eroded, as students demanded more rights and more freedom, with less interference from the college administration over their lives.

With the demise of *in loco parentis*, the institution may not be in a position where it has a legal duty to protect students. But concomitant with this lowered duty, the college is no longer insulated from lawsuits by the student against the institution. In the cases that followed the "demise" of *in loco parentis*, courts searched for appropriate legal theories by which they could now impose liability. If the college no longer stood *in loco parentis*, then what *was* its relationship toward the student? Some likened the relationship to that of a landlord and tenant[6] when determining the liability of colleges and universities for assaults on their students[7] but that relationship fails to deal with a host of other problems that might arise in the unique setting of a college or university.

Underlying Theories of College and University Liability

There is no doubt that the liability of colleges and universities toward their students is an evolving one. And while we have established that colleges are not insurers of the safety of their students[8] it is possible to state with some predictability that liability will exist when the event that caused the injury is foreseeable, or a "special relationship" exists between the student and the institution.

- *If the Injury is Foreseeable*

It is a generally understood aspect of negligence law that if a dangerous situation exists on a campus, the institution may be liable for resulting death or injuries. Once the institution is "on notice" of occurrences, the duty to protect rises to a higher level than the "reasonable person standard" For example in *Williams v. State*,[9] a student brought a negligence action against a state university for failing to provide adequate safety measures after he was assaulted at gunpoint and robbed in his dormitory room. In comparing the college to a business, the court stated that, "...although business owners are not the insurers of their patrons' safety, they do have a duty to implement reasonable measures to protect their patrons from criminal acts when those acts are foreseeable."[10]

Similarly, when the college knows that one of its students has a prior criminal record, the school may be on notice and have an increased duty to protect and/or warn other students of the danger. In *Nero,*[11] a fellow student in a common area of their dorm assaulted a university student.[12] The court held that "a university has a duty of reasonable care to protect [or warn] a student against certain dangers, including criminal actions against a student by another student or third party if the criminal act is reasonably foreseeable and within the university's control."[13] Because the university knew the assailant had been charged with rape three weeks earlier, and because it placed the assailant in a coed dorm with the victim, the court concluded that the foreseeability of the attack was a factual issue.[14]

The duty to protect students has even extended to students off campus on internships. In *Nova Southeastern University, Inc. v. Gross,*[15] the University provided students with a list of possible intern sites that were approved by the program. The plaintiff was accosted, abducted, robbed and sexually assaulted while on her internship in a city off campus. Because the university had been made aware of prior criminal incidents at that particular location, the jury could be instructed on whether the university breached its duty of care to the student. Given the number of mandatory and/or sponsored internships that colleges and universities offer to thousands of students in large cities, this decision has broad ramifications.

How then do these cases relate to suicide? One argument is that when the college or university is on notice that a problem exists, its duty of care increases. When a student exhibits mental problems, or seeks counseling, the college or university may then be on notice that the student has mental problems. Once the institution is on notice that the student has problems, the Courts may be convinced that the institution has a heightened duty and therefore, increased liability toward that student and others with whom the student interacts.

In *Klein v. Solomon*[16] the deceased enrolled at Brown University and immediately sought psychological help from Ferdinand Jones (Jones), a psychologist and a professor of psychology at Brown. During Daniel's initial and subsequent appointments with Jones, Jones took a psychological history of Daniel and discovered that Daniel was suffering from "anxiety and dread" and that "he was depressed" and "also had some suicidal fantasies."[17] Brown had a policy of making its psychological services available for only three visits. As a result, Daniel was referred out to four people, none of whom "were psychiatrists, and in fact only three were psychologists. None specialized in suicide prevention."[18] After treatment for over two years with one of the four counselors to whom he was referred, Daniel stopped going to therapy and committed suicide. The court held that:

> legally sufficient evidence existed in the record on the issue of Jones's alleged negligent referral. Jones wrote in his notes from his scheduled appointments with Daniel that Daniel had suicidal fantasies and that he was depressed and anxious. That evidence would be enough to put Jones on notice of Daniel's potential for suicide. A jury certainly could have reasonably concluded that Jones was negligent in failing to refer Daniel to someone qualified in suicide prevention or to someone who could prescribe medication for Daniel that would reduce his suicidal inclinations."[19]

When the university provides medication to students in a negligent manner, and the student uses the drugs to overdose, there may also be liability for the student's suicide. In *Wallace v. Broyles*[20] the deceased played football for the University of Arkansas. As the result of a shoulder injury, the team physician prescribed pain pills to him prior to his suicide. However, it was disclosed at trial that:

> The University athletic department had purchased 13,079 dosage units of controlled substances, but that records could be found accounting

> for only 3,352 units. The fifteen-month audit showed that while the University training room bought 8,500 dosage units of Darvocet, appropriate records had accounted for only 1,025 of the units. The investigators determined that athletic trainers would place orders with Harp's pharmacy department, and the drugs would be delivered to the athletic department. Defendant Woodell related that he filled prescriptions for the University athletic training room two or three times a week, nothing was in writing, and some drugs bore no labels or names. Defendant Dr. Park admitted giving trainers authorization to dispense drugs and said that he, individually, never dispensed medication to the athletes.

The deceased had suffered a shoulder injury playing football and had been prescribed pain pills. The fact that appropriate records were not kept and that students had access to the drugs were significant factors to the court. Additionally, there was evidence that University personnel were also on notice that the deceased was despondent. The combination of the availability of drugs with the student's despondency could "be said to have (created) an appreciable risk of harm to others," and thus questions of liability were submitted to the jury.

Even if the student does not seek counseling, nevertheless, when the college is aware that the student has severe mental problems that may include hurting one's self, the college may still have an increased duty of care. For example, in *Schieszler v. Ferrum College*[21] the police found the student alone in his room with bruises on his head, claiming the bruises were self-inflicted. They required him to sign a statement that he would not hurt himself. After the police left, the student shot and killed himself. Because the defendants were 'on notice' of the students' proclivities to harm himself, "a trier of fact could conclude that there was "an imminent probability" that he would try to hurt himself. Thus, the death of the student was foreseeable; giving rise to a duty to protect the student from the danger that he would hurt himself.[22]

Newspaper reports concerning the Shin case at MIT case may be an indication of future suits. There the parents complained that, "There wasn't even one phone call" from the school...despite the family having since learned that Elizabeth's problems were well-known to a large number of personnel at the school and that she had been treated frequently by MIT's mental health services." Family members also blamed the school for mental health services that failed to "diagnose, treat and coordinate Elizabeth's mental health care."[23]

- *If a Special Relationship Exists*

Even if there is not a foreseeable danger, some cases find the college or university liable if a special relationship exists. Several situations exist where colleges and universities have been found liable based on such things as athletics, internship or outings sanctioned by the institution.[24] In *Kleinknecht v. Gettysburg College*,[25] a student died of cardiac arrest during a practice session of its intercollegiate lacrosse team. Since "he was participating in a scheduled athletic practice for an intercollegiate team sponsored by the College under the supervision of College employees...a special relationship existed between the College and (the student) that was sufficient to impose a duty of reasonable care on the College."[26]

Institutions may also incur liability for activities at organizations under the aegis of the institution. In *Furek v. University of Delaware*[27] a pledge in a fraternity was injured when his compatriots poured lye on him. The fraternity system at the University of Delaware had previously been under the scrutiny of the administration and there was evidence of prior warnings about behavior. The court held that:

> While we acknowledge the apparent weight of decisional authority that there is no duty on the part of a

> college or university to control its students based merely on the university-student relationship, where there is direct university involvement in, and knowledge of, certain dangerous practices of its students, the university cannot abandon its residual duty of control.[28]

This pivotal ruling lead to a first-of-its-kind settlement. The Virginia College agreed to an undisclosed case settlement, a one-time scholarship in the boy's name and an agreement to revamp and enhance the college's mental hearth crisis policies and procedures.[29]

As noted, *infra*, off campus internships may be covered under standard negligence theories of foreseeability. In *Beach v. University of Utah*[30] the plaintiff fell from a cliff at night during a field trip sponsored by the University. The court held that she "was obligated to prove that she had a special relationship with the University. The question, then, is whether the facts in the record establish some basis for imposing an affirmative duty upon the University to protect Beach from her own intoxication and disorientation on the night in question. Because no special relationship existed, the University had no affirmative obligation to protect or supervise her and no duty was breached."[31]

One way to attain a higher standard of care is when the college or university provides supervision for organized extracurricular activities that are inherently dangerous.[32] For example, a freshman was injured during a state university freshman orientation when he engaged in a game of punch ball. The college was not required to provide supervision "for organized extracurricular activities of students on or off school grounds, unless such activities are so inherently dangerous that the College authorities are under actual or constructive notice that injuries may result to students." As a result, the College was not held liable for his injuries. This is the more common result in cases involving students and alcohol related injuries.[33]

College Or University Not Held Liable For Suicide Of Student

If however, there is no "special relationship" and the student was not under the care of campus mental health services, then it is unlikely that parents could sustain a cause of action for their child's suicide. Even stating a cause of action is challenging.[34] Often the courts find that the institution did all that is reasonable to assist troubled students. Commonly, institutions of higher education have extensive counseling and or psychological services available on campus.

When campus police, and/or residence hall personnel intervene, it is difficult to sustain the argument that the institution did not take adequate steps to protect the student who committed suicide. After all, suicide is an act with much data to support its randomness. In many cases, the record suggests that numerous people on the campus tried to intervene before the student's suicide occurred. In the case *White v. University of Wyoming*[35] many college personnel rendered assistance: first the hall director called the University police because the student was so intoxicated she feared he might asphyxiate. After being released from the hospital, the student met with residence hall staff that referred him to a crisis intervention team. A member of the team met with the student who denied that he had attempted to commit suicide and made assurances that he was not suicidal.

> Johnstone determined that White did not have a plan, or access to a means, to commit suicide and that he had a good support system of friends. Johnstone talked to White about counseling and the UW Counseling Center, and White told Johnstone he was willing to seek counseling. Johnstone concluded that White was at low risk at that time to do further harm to himself, which ended the crisis intervention...Two years later...Chauncey White committed suicide.[36]

In spite of all the actions undertaken to prevent the suicide, and in spite of the intervening two years, the mother sued the University alleging that its actions were negligent in the treatment of her son. The court found, however, that under a Wyoming statute, the only way that the dormitory staff or advisors could be liable is if they were classified as health providers, which they were not. Therefore the claims were barred.

Similarly, in *Jain v. State*[37] a father brought an action against the University of Iowa for the suicide of his son. First, he claimed that if the university had followed its policy of notifying parents of a student's self-destructive behavior, the suicide could have been prevented.[38] When this argument failed, he claimed that the university had a duty to take affirmative action to prevent the son from killing or injuring himself. Contrary to this contention however, as in the *White* case, the record was replete with many actions taken by the university to help the student.

> It is undisputed that the RAs appropriately intervened in an emotionally charged situation, offered Sanjay support and encouragement, and referred him to counseling. Beth Merritt likewise counseled Sanjay to talk things over with his parents, seek professional help, and call her at any time, even when she was not at work. She sought Sanjay's permission to contact his parents but he refused. In short, no action by university personnel prevented Sanjay from taking advantage of the help and encouragement being offered, nor did they do anything to prevent him from seeking help on his own accord.[39]

In establishing that the University had not acted negligently, the court concluded that suicide is a unique act. As such, "the act of suicide is considered a deliberate, intentional and intervening act that precludes another's responsibility for the harm."[40]

Conclusion And Recommendations For Colleges And Universities

Given the potential for liability, many colleges and universities undertake behaviors to decrease their liability. The National Mental Health Association and the Jed Foundation, a suicide prevention group, recently issued a report to 3000 college presidents about the need to do more to prevent student suicides. The reports recommendations for college administrators include:

(1.) Setting up screening programs to identify at risk students;
(2.) Running educational programs for professors, coaches, members of the clergy, and resident advisers on detecting depression.
(3.) Develop campus wide suicide prevention education; and
(4.) Making sure that adequate medical and counseling services are available on campuses.

To guide administrators through reviewing their current programs, the report includes a checklist with questions like, "Do we have a mental health management plan in writing?" and "Have we educated our students so that they are able to identify at risk behaviors within themselves and among their peers?"

These are all non-controversial and positive recommendations that will enhance mental health services and their visibility on college campuses. Certainly, colleges and universities should reevaluate whether they have made adequate resource commitments to such programs. More difficult is implementing effective crisis intervention programs and monitoring outside referrals.

In light of the tragedy and uniqueness of each suicide case, there is no sure way to completely insulate the college from liability. Colleges and universities should, nonetheless, consider adopting a clear written policy statement to explain that their provision of campus counseling services does not extend the institutions' duty as a custodian of its students. Recipients of mental health services should acknowledge this understanding in writing, and where confidentiality has been waived, parents should likewise be asked to sign. Though in recent years many colleges have marketed themselves as "nurturing" environments, from a liability perspective, academic institutions should instead stress their role in fostering student autonomy and independence.

ENDNOTES

[1] Salwen, Sara, Study Finds Increase in Mental Health Issues," *The Cavalier Daily Online,* October 15, 2002, http://www.cavalierdaily.com/CVArticle.asp?ID=9658&pid=767 (last visited on April 22, 2003).

[2] "In Iowa and elsewhere, it is the general rule that unless the possibility of accident or innocence can be reasonably determined, the act of suicide is considered a deliberate, intentional and intervening act that precludes another's responsibility for the harm." *Jain v. State 617 N.W.2d 293 (Iowa, 2000) citing: Cutler v. Klass, Whicher & Mishne 473 N. W.2d 178 (Iowa, 1991).*

[3] See Note 2, *infra*

[4] Stamatakos, Theodore C., *The Doctrine Of In Loco Parentis, Tort Liability And The Student-College Relationship*, 65 Ind. L.J. 471 (Spring, 1990).

[5] Tribbensee, Nancy, "Tort Litigation In Higher Education: A Review Of Cases Decided In The Yar 2001," 29 J Coll. & Univ. L. 249, *Citing Rabel v. Illinois Wesleyan University*, 524 N.E.2d 522, 560-61 (stating it would be unreaslistic to impose upon a university the responsibility for assuring the safety of its adult students and the safety of others). "A college is an educational institution, not a custodian of the lives of each adult, both student and non-student, who happens to enter the boundaries of its campus" *Id.* At fn 66. A contrary result "would directly contravene the competing social policy of fostering an educational environment of student autonomy and independence." *Univ. of Denver v. Whitlock,* 744 P.2d 54, 62 (Colo. 1987).

[6] In *Miller v. State*, 62 NY2d 506, 478 NYS 2d 829, 467 NE2d 493 (1984) the Court of Appeals equated the liability of the State University with that of a landlord, finding negligence because the State had a policy of having all entrances to the dormitory unlocked at all times.

[7] *Savannah College of Art and Design v. Ore,* 409 S.E.2d 848 (Ga. 1991) *Vangeli v. Schneider and Cornell University* 598 N.Y.S.2d 837 (3rd Dep't 1993).

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[8] *Freeman v. Busch,* 150 F.Supp. 2d 995, 1002 (S.D.Iowa, 2001). "It would be unrealistic to impose upon a university the responsibility for assuring the safety of its adult students and the safety of others." *Rafel v. Illinois Wesleyan University,* 161 Ill.App.3d 348, 514 N.E.2d 552, 112 Ill.Dec. 889, 42 Ed. Law Rep. 1306 (1987).

[9] 786 So.2d 927, (La.App.2 Cir., 2001).

[10] *Id.* at 931.

[11] *Nero v. Kansas State University*, 861 P.2d 768 (Kan., 1993).

[12] *Id.* at 772.

[13] *Id.* at 780.

[14] *Id.*

[15] 758 So.2d 86 (Fla., 2000).

[16] 713 A.2d 764 (R.I., 1998).

[17] *Id.* at 765.

[18] *Id.* at 766.

[19] *Id.*

[20] 961 S.W.2d 712 (Ark., 1998).

[21] 236 F.Supp.2d 602 (W. D. Va., 2002).

[22] *Id.*

[23] See footnote 2, *infra*

[24] Foster, S. and Moorman, A. Gross, V., *Family Services Agency, Inc.: The Internship As A Special Relationship In Creating Negligence Liability* 11 J. Leg. Aspect Sport 245 (2001).

[25] 989 F.2d 1360 (Pa. 3rd Cir. 1993).

[26] "There is a distinction between a student injured while participating as an intercollegiate athlete in a sport for which he was recruited and a student injured at a college while pursuing his private interests, scholastic or otherwise. This distinction serves to limit the class of students to whom a college owes the duty of care that arises here. Had Drew been participating in a fraternity football

game, for example, the College might not have owed him the same duty or perhaps any duty at all." *Id.* at 1367.

[27] 594 A.2d 506 (Del., 1991).

[28] *Id.* at 520.

[29] Tooher, "In Settlement, College Admits Blame for Suicide of Student," Lawyers Weekly USA, issue 2003-17/2003 LWUSA 537 (Aug. 18, 2003).

[30] 726 P.2d 413 (Utah, 1986).

[31] *Id.* at 416.

[32] *Rubtchinsky v. State University at Albany*, 60 N.Y.S.2d 256 (Ct.Cl. 1995).

[33] *Garofalo v. Lambda hi Alpha Fraternity*, 616 N.W.2d 647, 654 (Iowa, 2000) (holding that neither a national fraternity nor its Iowa chapter had a duty to protect a student from his decision to drink following a fraternity activity).

[34] For example, *see Hoeffner v. The Citadel*, 429 S.E.2d 190 (S.C., 1993). In *Gillum v. Yale University*, the plaintiffs alleged that during the fall of 1988 and into the winter of 1989, Gillum, a Yale graduate student, received inadequate psychiatric care and evaluation from the defendants. They further alleged that this malpractice caused Gillum to kill himself and Bryant, with whom he had a personal relationship. The court properly concluded, as a matter of law, that the plaintiffs could not state a cause of action.

[35] 954 P2d 983 (Wyo., 1998).

[36] *Id.* at 985.

[37] 617 N.W.2d 293 (Iowa, 2000).

[38] "We entertain serious doubts about the merits of plaintiff's argument. His claim rests, after all, not on a violation of the Act but on an alleged failure to take advantage of a discretionary exception to its requirements. We need not resolve the question, however, because plaintiff has not preserved the issue for our review. His claim that the university wrongfully withheld information "under the guise of the Buckley Amendment" was neither raised before the district court nor ruled upon in its decision." *Id.* at 296.

[39] 617 N.W.2d 293 (Iowa, 2000).

[40] *Id.* at 297.

THE SHAM TRANSACTION DOCTRINE: WILL THE MISCHIEF EVER END?

By:

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I. INTRODUCTION:

One of the most misunderstood areas in the federal tax law is the sham transaction doctrine. This misunderstanding has led to confusion, and in many cases resulted in the misapplication of the doctrine. Those instances of misapplication have served to foster additional confusion. In an effort to unravel some of this confusion, the Senate has passed as part of the CARE Act of 2003 (hereafter "CARE Act")[1] provisions aimed at codifying parts of the doctrine. Unfortunately, the CARE Act only addresses one component of the sham transaction doctrine, and appears to have been proposed in response to some questionable recent results at the appellate court level.[2] The CARE Act provisions fail to address the deeper problem -- that all taxpayers are not treated equally.

The reasons for the confusion surrounding the sham transaction doctrine are legion. These include, the structure of the federal judiciary, judicial bias, limitations placed upon the application of provisions that without limitation could be used to prevent tax avoidance, Internal Revenue Service overreaching, the failure on the part of the judiciary to adhere to a logical and consistent pattern of analysis and a failure on the part of judges to carefully consider the language they employ in applying the doctrine or rejecting its application. No case has contributed more to this confusion than the Supreme Court's now 25 year old opinion in *Frank Lyon.*[3]

This article first seeks to place the doctrine in context by exploring its origins and evolution. Those few Supreme Court decisions involving cases where the sham transaction doctrine was at the fore will then be analyzed, including the court's *Frank Lyon* opinion.[4] Finally, the CARE Act will be analyzed and alternatives to it suggested.

II. THE SHAM TRANSACTION DOCTRINE

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II. THE SHAM TRANSACTION DOCTRINE

A. OVERVIEW

The sham transaction doctrine has been one of the principal mechanisms employed by the courts to measure the substance of a transaction. It is an invaluable tool in discriminating between *bona fide* transactions and those whose sole purpose or effect is tax avoidance.[5] Two major branches of the doctrine evolved as a consequence of its result oriented bent. These branches ostensibly function independent of one another and are designed to test whether the claimed transaction or events (1) actually occurred and (2) if they did in fact occur, had an appreciable affect on a taxpayer's beneficial interest apart from tax savings.[6]

Transactions which fail the first prong of the inquiry fit into the category of "factual" sham, while those failing the second prong fall within the category of "economic substance" sham or a "sham in substance."[7] Although in theory, each prong of the sham transaction doctrine is mutually exclusive in application, the courts have sometimes blurred the line of demarcation between the two.[8] A particular transaction must escape sham characterization under both branches of the doctrine before a taxpayer can lay claim to the putative tax benefits.[9] Simply because a transaction escapes characterization as a factual or economic substance sham does not mean that a taxpayer will be allowed the desired tax benefits. A particular transaction must still pass muster under other parts of the substance v. form doctrine and, in the case of some taxpayers, other statutory constraints.

In order for the doctrine to remain a valuable tool in combating tax avoidance flexibility is essential. Flexibility, however, does not justify inconsistent application of the sham transaction doctrine by the courts. The solution is for the Supreme Court and/or Congress to develop a logical and coherent uniform approach to the sham issue.[10] This approach should mandate that courts, in the course of their analysis of alleged sham transactions, ask and answer a series of questions designed to uncover the true nature of the transaction. This would greatly reduce the instances of arbitrary and inconsistent application of the sham doctrine and in the opinion of the author eliminate the need for sweeping legislative intervention such as that contained in the applicable provisions of the CARE Act.

B. THE SUPREME COURT CASES

The Supreme Court has done little more then articulate a series of maxims. These maxims, while providing fodder for the authors of legal briefs and articles, have been acknowledged by the courts to not be particularly helpful in resolving substance v. form cases.[11] Moreover, many of these cases are susceptible to numerous interpretations. Nevertheless, since any discussion of the sham transaction doctrine would be incomplete without reference to them, the more prominent Supreme Court cases will be discussed.

The case generally credited with firmly establishing the rule that the substance rather than the form of a transaction controls for federal tax purposes is *Gregory v. Helvering*.[12] The tax benefit sought by Mrs. Gregory was the conversion of what would have been ordinary dividend income upon the receipt of shares of Monitor Securities Corporation from a corporation controlled by her, to capital gain upon their sale following the putative reorganization at issue. In rejecting arguments that compliance with the literal language of the statute should be controlling, the Supreme Court found the *Gregory* reorganization to be "an elaborate and devious form of conveyance masquerading as a corporate reorganization and nothing else" and therefore "outside the plain intent of the statute."[13] *Gregory* is at once a sham transaction, a step transaction and a business purpose case, with support for each of these characterizations easily found in the opinion's broad language.

In *Higgins v. Smith*,[14] the court applied the principles enunciated in *Gregory*, in refusing to allow a claimed loss. The facts of *Higgins v. Smith* were as follows. Smith the sole shareholder of Innisfall Corporation ("Innisfall") owed Innisfall approximately $70,000. Smith sold securities to Innisfall at the market price in exchange for a reduction in the outstanding indebtedness. Smith's cost basis in the securities was in excess of the price charged Innisfall, and he claimed a loss equal to that difference. The court noted that since Smith still exercised substantial control over the securities as a result of his ownership of Innisfall, there was "not enough substance in [the] ... sale finally to determine a loss."[15] The court rejected the taxpayer's reliance on its prior opinion in *Burnet v. Commonwealth Improvement Company*.[16] But for the fact that *Commonwealth Improvement* involved gain recognition, as opposed to the deductibility of a loss, its facts are essentially indistinguishable from those present in *Higgins v. Smith*. The significance of this difference was not lost on the court; indeed, it formed the basis for the court's refusal to follow *Commonwealth Improvement*.[17] The Supreme Court thus recognized that there is an additional hurdle beyond that of recognition and realization upon taxpayers seeking to claim a loss deduction -- that is, the claimed loss must be *bona fide* and have actually been sustained in order to be deductible.

The quintessential Supreme Court sham transaction opinion is *Knetsch v. United States*.[18] The issue before the Court in *Knetsch* was the deductibility of interest expense incurred as a result of the taxpayer's purchase of deferred annuity savings bonds. In analyzing the transaction, the Supreme Court put aside the lower court's finding "that Knetsch's only motive in purchasing these 10 bonds was to attempt to secure an interest deduction.'"[19] Instead, the Court examined the transaction to determine if Congress intended to provide for the allowance of an interest expense deduction under the circumstances of that case. Considerable weight was placed by the Court on the fact that after paying "interest" on the debt, Knetsch, almost immediately thereafter borrowed substantially all of the payment back from the insurance company in the form of a policy loan. This recurring practice of "borrowings" following closely on the heels of "interest payments" left Knetsch with virtually nothing of value, effectively eliminating any commercial non-tax purpose for his entry into the transaction. Based upon this fact, the Court had little difficulty concluding that "what was done" amounted to the purchase of an interest expense deduction and that the transaction at issue was a sham. [20]

In *Frank Lyon*,[21] the Supreme Court decisively reaffirmed the principle enunciated in *Gregory* and *Knetsch*, that the existence of a tax-avoidance motive should not, in and of itself, cause a transaction to be disregarded for federal income tax purposes. The transaction before the court in *Frank Lyon* was infinitely more complex than the *Gregory* "reorganization." While *Frank Lyon* is generally viewed as one of the preeminent sham cases, the real issue in that case was one of characterization, *i.e.*, was the Frank Lyon Company ("Lyon Company") truly the owner of the property or did it simply fulfill a financing function. The Supreme Court may have been correct when it held that the sale/leaseback before it was not a "simple sham."[22] Whether it was correct in holding that the Lyon Company, rather than Worthen Bank & Trust Company ("Worthen"), was the owner of the building for federal income tax purposes is an entirely different question.[23]

While the Supreme Court articulated numerous factors in support of its decision to bless the sale/leaseback transaction at issue in *Frank Lyon*, the linchpin of its holding was the fact that it involved multiple independent parties, was compelled by business or regulatory requirements, and that Worthen's solution would have been the same even if the Lyon Company were not the investor.[24] That Worthen's solution would have remained the same, while undeniably significant with respect to any analysis of the transaction under the factual sham branch of the doctrine, is less significant in the evaluation of the economic substance of the arrangement. It simply does not follow that the transaction had sufficient economic substance to be respected from the Lyon Company's perspective, or that the Lyon Company was the owner of the building for federal income tax purposes simply because only one alternative was open to Worthen.[25]

Moreover, the rationalizations employed by the Supreme Court, such as "the government is likely to lose little revenue" and "[n]o deduction was created that is not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently,"[26] did not mandate that the transaction be respected from the Lyon Company's perspective. Merely because parties to a transaction intend to consistently adhere to the form of the transaction does not insulate the transaction from analysis into its substance. The manner in which the Service argued, and the Supreme Court analyzed, *Frank Lyon* -- primarily as a sham case, when the real issue was that of benefits and burdens of ownership -- is arguably responsible for much of the confusion and inconsistency in the subsequent application of the sham transaction doctrine.

C. FACTUAL SHAMS

The claimed events comprising a particular transaction must have actually occurred (*i.e.*, they must not constitute a factual sham) before any consideration may properly be given to the question of whether the transaction possesses sufficient substance to avoid characterization as an economic substance sham. Thus, for example, if a taxpayer claims to have transferred property to a charity when in fact no property exists or where no transfer occurred, it would be appropriate for a court to deny the claimed charitable contribution deduction on factual sham grounds. It is not often that the issue of whether a transaction constitutes a factual sham arises in a factual setting as basic as the preceding one.[27]

A case considered by some to represent a classic factual sham case is *Goodstein v. Commissioner*.[28] In *Goodstein*, the First Circuit was confronted with a tax avoidance plan which had as its purpose the creation of interest expense deductions.[29] The status of *Goodstein* as a factual sham case is rooted in the fact that the lender in that case did not possess funds even remotely approximating the amount of the putative loan. Since the taxpayer's ability to borrow all but a minimal portion of the purchase price was essential to his purchase of the Treasury notes, and his lender did not have the ability to furnish the funds necessary to complete the acquisition, it followed that no Treasury notes were acquired or monies borrowed.

In *Falsetti*,[30] the Tax Court held that the real estate transaction before the court was a "sham in substance,"[31] since "petitioners engaged in the expedient of drawing up papers to characterize the transactions in question as something contrary to the economic realities thereof, solely to obtain unallowable tax benefits."[32] The facts of *Falsetti* were sufficiently egregious to have justified the denial of the claimed tax benefits on factual sham grounds.[33]

Price[34] and *Sheldon*[35] two cases involving similar financial instruments[36] are illustrative of the distinction between transactions that constitute factual shams and those that do not. In both of these cases, the Tax Court examined the objective evidence to determine whether or not the transactions were *bona fide* market transactions.[37] The factors examined were (1) the size of the transactions and the ability of those involved to honor their obligations, (2) whether the economic results were prearranged and (3) the size of the margin required in relation to the transactions at issue.[38] Taken together these factors amounted to an objective test for determining reality in the confines of the business environment where the transactions were alleged to have occurred. The *Price* transactions failed each aspect of this test.[39] Whereas, in *Sheldon*, the Tax Court rejected the Service's arguments that the transactions at issue were fictitious, because "the size of the transactions or trades in issue was common in the 1981 T-Bill market," the entities which sold the treasury bills had the ability to acquire them, the *Sheldon* transactions were not prearranged to produce a specific economic result, and that while the margin payments involved were small, they were adequate given the profit and loss potential of the transactions.[40]

Finally, the court addressed the Service's primary argument rooted in *Goodstein* and *Frank Lyon*, that the failure on the part of Sheldon's partnership (GSDII) to take delivery of the Treasury bills it purchased, coupled with the fact that the financing for the purchases was provided by the sellers rendered the transactions fictitious.[41] The court rejected this argument, noting that while "a third party in repo transactions, may help insure the genuiness of a transaction ... the lack of a third party does not conversely require a finding that a transaction is fictitious or illusory."[42] Based upon the above, the court concluded that the transactions before it in *Sheldon* were not factual shams because during the years in question they were common government securities transactions.[43]

D. ECONOMIC SUBSTANCE SHAMS

Prior to the Supreme Court's decision in *Frank Lyon*, the parameters of the economic substance branch of the sham transaction doctrine had generally been defined by the *Knetsch* line of cases and circuit court cases such as *Fabreeka Products, Inc.*[44] and *Goldstein.*[45]

Fabreeka Products involved a corporation's purchase of public utility bonds. These bonds were callable on thirty days notice, and were pledged as security for a loan incurred in connection with the purchase. Fabreeka paid a substantial premium above the call price for the bonds. The bonds were not called and, in accordance with the applicable statutory provision, a deduction was claimed in an amount equal to the premium. Fabreeka then distributed the bonds, subject to the loan, to its shareholders. The shareholders then sold the bonds receiving an amount approximating what Fabreeka had paid for them. Since the shareholders took as their basis a reduced amount because of the premium write-off, they recognized a gain. As a result of this transaction Fabreeka was able to effectively deduct the dividend it paid, thus doing indirectly what it could not do directly.

In holding for the taxpayer, the First Circuit stated that "the taxpayers made actual 'investments' in the ordinary sense of the word. . . . During the necessary holding period they incurred fully all of the risks of ownership . . . ."[46] Despite finding that Fabreeka's only motive for engaging in these transactions was tax related; the court respected the transactions rejecting the government's claim that an investment motive on the part of the taxpayer was required. The fact that *Fabreeka Products* held the bonds for a period of 30 days was arguably the most significant factor influencing the court's decision.

In *Goldstein*, the Second Circuit affirmed the Tax Court's denial of the claimed interest expense deductions but on a ground different than that espoused by the lower court.[47] Rather, than accepting the "sham" label affixed to the transactions by the Tax Court, the Second Circuit held instead that §163 "should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction ...."[48] Central to this holding was the court's view that "Congress could not have intended to permit a taxpayer to reduce his taxes by means of an interest deduction that arose from a transaction that had no substance, utility, or purpose beyond the tax deduction."[49]

The economic substance doctrine generally was applied in those instances where there was no requirement that a taxpayer possess any degree of profit motive to support a claimed loss or deduction. If a particular transaction actually occurred and could have produced, or did produce a profit, the claimed tax benefits would generally be respected. The Supreme Court in *Frank Lyon* did not alter that approach. Where the Supreme Court went wrong in *Frank Lyon*, was the undue degree of emphasis it placed on the presence of a third party to the transaction in holding that the sale/leaseback transaction before it did not constitute a "simple sham."[50] The critical factor in avoiding characterization as an economic substance sham was that the Lyon Company could have derived an economic return on its investment. Had the transaction held out no prospect of an economic return or other benefit to the Lyon Company aside from the tax benefits associated with its role in the transaction, characterization of the transaction as an economic substance sham would have been appropriate. That Worthen, or any of the other parties involved, might have derived some economic return or benefit from the transaction would simply have been beside the point.[51]

In *Rice's Toyota World, Inc.*[52] the Tax Court attempted to apply the Supreme Court's reasoning to the computer sale/leaseback arrangement before it.[53] Resort to the economic substance doctrine in *Rice's Toyota* was necessary because the taxpayer was a corporation and one of the issues involved a claimed interest expense deduction. *Rice's Toyota* was significant because of the Tax Court's effort to articulate a bright line test for determining when a transaction should be characterized as a sham. The court held that in order to characterize a transaction as a sham, (1) the taxpayer must have had no business purpose for entering into the transaction other than obtaining tax benefits *and* (2) the transaction must have lacked economic substance because it possessed no reasonable possibility of generating an economic profit.[54] The failure on the part of the Tax Court, and upon review the Fourth Circuit, to carefully measure the language employed or to recognize that *Frank Lyon* was less a sham case than a benefits and burdens case, represent significant flaws in both opinions.[55] The correct result was reached in *Rice's Toyota* not because the two-pronged test was a good one, but rather because the facts were so bad.

That the Tax Court itself had misgivings with respect to the viability of its *Rice's Toyota* opinion is clear from its later opinions in *Glass*[56] and *Rose*.[57] In *Glass*, the court held that the London option straddle transactions before it were "shams in substance."[58] The most significant problem with Judge Nims' *Glass* opinion was the court's failure to confront its earlier decisions in *Smith*[59] and *Miller*[60] rejecting the Service's argument that the straddles at issue were economic substance shams. Instead, the court characterized the transactions as "shams in substance," as opposed to "economic substance shams," and eliminated the need for the Tax Court to have to consider approximately 1,100 cases. [61] Much of the subsequent *Glass* litigation, and the appellate level sham speak generated by it, may have been avoided had Judge Nims attempted to distinguish or reconcile his earlier straddle decisions. While it is questionable that he could have done so, his failure to confront these earlier authorities is inexcusable.

In *Rose*,[62] the court developed a "generic tax shelter" test. This represented a comprehensive effort by the Tax Court to examine earlier economic substance sham cases as well as profit motive cases in order to cull from these authorities a "unified approach" to be utilized in deciding tax shelter cases.[63] The court articulated what it considered certain key indicators of the presence or absence of economic substance. [64] The court then compared these "key indicators" to those factors articulated as objective criteria in numerous profit motive cases involving §183.[65] Transactions which possessed unfavorable characteristics, such as those where (1) nonrecourse debt was employed, (2) there was an absence of arms-length negotiation or (3) the assets acquired were overvalued were held to represent "generic tax shelters."[66] Under *Rose*, "generic tax shelters" were to be analyzed by reference to objective factors as opposed to subjective ones.[67] Perhaps because it unfairly labeled entire categories of transactions as *per se* tax avoidance arrangements, the "generic tax shelter" standard was not adopted by other courts.[68] This is unfortunate, because the adoption of a uniform approach early in the process could have avoided much of the confusion affecting the economic substance prong of the sham transaction doctrine.

The Tax Court took a significant step in reshaping its formulation of the economic substance sham doctrine in *Cherin*.[69] *Cherin* involved a cattle shelter which had previously been held to be lacking in substance.[70] The court began its analysis by holding that a finding that the petitioner had a predominant non-tax motive for entering into the transaction would not resolve the case in petitioner's favor. [71] It then stated that, "[a] business transaction by its very nature must have economic substance, that is, a realistic potential for profit."[72] In the opinion of the *Cherin* court, a transaction possesses a realistic potential for profit when it is "conceived and planned in accordance with standards applicable to the particular industry," such that when "judged by those standards the hypothetical reasonable businessman would make the investment."[73]

Thus, *Cherin* attempted to correct a significant flaw in the *Rice's Toyota* opinion. After *Cherin*, it was clear that where a taxpayer's sole non-tax purpose for entering into a transaction was to earn an economic profit, the transaction would be respected only if, objectively, there was a reasonable possibility that the sought after profit could be earned. If a transaction could not produce a profit exclusive of tax benefits, the tendency in the Tax Court was to find that a taxpayer lacked a subjective non-tax purpose for entering into the transaction.[74] Where a reasonable possibility of deriving an economic profit did exist the tendency was to find that the subjective prong was satisfied as well.

This approach is exemplified by the court's opinion in *Levy*,[75] a case involving a computer equipment sale/leaseback transaction. The *Levy* court began its analysis by noting that the taxpayers entered into the transaction in order "to diversify their business investments by entering into a legitimate investment involving the purchase and leaseback of computer equipment."[76] The court was impressed by the thorough and complete investigation of the transaction made by the taxpayers' financial advisor. This investigation included a cash flow analysis which addressed the components of the transaction critical to the earning of an economic profit.[77] Following its conclusion that the taxpayers had a *bona fide* business purpose for entering into the transaction, the court then embarked upon an analysis of its economic substance (*i.e.*, the objective potential for profit inherent in the transaction). The court pointed to a number of factors which it considered to be of particular significance in evaluating the economic substance of a transaction.[78] These factors closely tracked those found by the court to be probative with respect to its analysis of the taxpayers' subjective motive for entering into the transaction.[79] This tracking demonstrates that where a transaction possesses a reasonable possibility of producing a profit, exploration of a taxpayer's subjective state of mind, in the context of the analysis of the economic substance sham issue, is essentially a duplication of effort, although it remained germane in the case of a taxpayer subject to the requirements of §165(c). While perhaps implicit in its finding that the taxpayers had a subjective non-tax purpose for their entry into the transaction at issue in *Levy*, the failure of the tax court to explicitly address the question of whether when judged by industry standards a "hypothetical reasonable businessman" would have entered into the transaction is disturbing. The Tax Court should have considered whether the transaction at issue in *Levy* was "the kind of transaction that some people enter into without a tax motive."[80] Arguably, the failure on the part of the *Levy* court to specifically explore the relevant industry's view of the transaction represents a flaw in its opinion.

In *Levy*, the Tax Court also held that *bona fide* (*i.e.*, non-sham) equipment leasing transactions are "a type of significantly tax-motivated transaction that Congress intended to encourage."[81] The court's conclusion was unsupported by any citation evincing such Congressional intent. This holding is significant because a taxpayer seeking to reap tax benefits from non-sham equipment leasing transactions need show a lesser degree of profit motive than a taxpayer engaging in transactions not perceived to be congressionally encouraged.[82] The Tax Court's willingness to accord equipment leasing sale/leaseback transactions special status was arguably without an adequate foundation in law. Rather, it was most likely directly related to the fact that non-sham equipment leasing cases involved assets possessing real value and the leverage involved was not perceived to be excessive.

In *Sheldon*,[83] a divided Tax Court abandoned the trend of subjugating the subjective prong of the economic substance sham test to its objective counterpart. *Sheldon* involved the financed purchase of Treasury bills. As a consequence of the interaction of the accrual method of accounting (for the interest expense incurred in connection with the repurchase agreements) and §454(b) (for the interest income earned on the underlying Treasury bills), the transactions at issue in *Sheldon* produced an enormous mismatching of income and expenses.[84] That the Tax Court was significantly influenced by this mismatch is beyond dispute.[85]

The majority in *Sheldon* relied extensively on *Goldstein*,[86] and to a lesser degree on *Knetsch*,[87] to support the conclusion that the transactions at issue were economic substance shams. The *Sheldon* majority concluded that 20 out of 25 repurchase agreements afforded the partnership in question (GSDII) the opportunity to profit from changes in interest rates or resulted in favorable interest rate differentials relative to the underlying Treasury bills.[88] In spite of this they held that the transactions in issue, the Treasury bill purchases and all of the repurchase agreements, were economic substance shams.[89]

The court engaged in an extensive analysis of the taxpayer's purpose for entering into the transactions. The majority pointed out that GSDII could have sold certain of the Treasury bills as opposed to entering into the four final repurchase agreements which increased the amount of its losses. In the opinion of the majority this "betrayed an exclusive concern for tax benefits, *i.e.*, a willingness to intentionally incur losses in order to defer the reporting of interest income until 1982."[90] Despite acknowledging that profits could have been made in the type of transactions at issue in *Sheldon* and the right of taxpayers to structure their transactions to obtain the maximum tax benefit legally obtainable, the *Sheldon* majority held that the petitioner's "sole objective was to obtain interest deductions."[91]

Finally, the majority rejected the petitioners' argument that they could have profited from the transactions as structured. The majority viewed this profit potential as essentially window dressing.[92] It also dismissed the fact that substantially similar transactions entered into in a subsequent year produced an economic profit for GSDII.[93] The *Sheldon* court held that that *Goldstein* does not "permit deductions merely because a taxpayer had or experienced some deminimis gain."[94] The principal reasons articulated by the majority in *Sheldon* for rejecting the transactions at issue were (1) the transactions occurred at year-end, thus providing the tax benefit of deferral of income, (2) GSDII was unconcerned with whether the transactions as structured would result in economic gains or losses, and (3) the potential for economic gains and losses was not large enough.[95]

Sheldon has been cited as establishing the tenet that the possibility of deminimis gains or losses will not be sufficient to cause a transaction to be imbued with economic substance.[96] However, in cases involving other vehicles such as equipment leasing, the Tax Court continued its practice of evaluating economic substance based upon an analysis of "cash on cash" return, without any consideration given to whether that return is susceptible to being characterized as deminimis.[97] *Sheldon* represented a significant extension of the economic substance sham doctrine and *Goldstein,*[98] either because of the court's willingness to subrogate the objective prong of the sham inquiry to the subjective prong, or because of the extension of the *Goldstein* economic substance rule. It can be viewed as representing the "high water mark" of the Service's success in tax shelter litigation.[99]

Following *Sheldon*, courts were left to struggle with the apparent inconsistency regarding the deductibility of interest expense incurred as a result of participation in a tax shelter in cases such as *Rice's Toyota*, *Rose*, and *Jacobson*,[100] and the complete disallowance of claimed interest deductions in cases like *Sheldon*. This question was resolved by embracing the concept of disparate treatment depending upon the underlying nature of the shelter. Essentially, if interest expense is incurred by a taxpayer as a result of his participation in a tax shelter it may be deductible if it is otherwise *bona fide*; however, if an interest expense deduction is at the heart of the tax shelter it will not be deductible.[101]

In 1995, the Ninth Circuit, in *Sacks,*[102] handed the Service a significant setback when it reversed a Tax Court decision holding that a sale-leaseback arrangement involving solar energy units was an economic substance sham. The court began by conducting a traditional inquiry into the economic substance of the transactions at issue. The

Ninth Circuit held that the sale-leaseback "had genuine economic effects, and was not a sham," because the taxpayer had a genuine personal obligation to pay the purchase price, fair market value was paid for the solar energy equipment, the tax benefits were not created (*i.e.*, they would have existed for someone) from thin air, the solar water heating business was genuine and Sacks acquired the benefits and burdens of ownership in that he would benefit or suffer from a rise or fall in the price of energy and solar energy devices.[103]

Where the appellate court's analysis took a significant turn was its willingness to respect a transaction that was likely to be unprofitable on a pre-tax basis. The court stated that the taxpayer's "investment did not become a sham just because its profitability was based on after-tax instead of pre-tax projections."[104] The court concluded that "[w]here a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis."[105] The critical aspect of the appellate court's holding was its view that the absence of pre-tax profitability had little relevance "where Congress has purposely used tax incentives to change investors' conduct."[106] The fact that certain transactions have been congressionally blessed has long existed within the tax law.[107] Whether this should act as a grant of amnesty from the objective prong of the economic substance sham test is open to question.

E. THE CORPORATE TAX SHELTER CASES

1. THE CONTINGENT INSTALLMENT SALE ("CIS") CASES

Even before the courts were through mopping up the remnants of the first wave of post *Frank Lyon* tax shelter litigation, a second wave of litigation involving a more dangerous breed of tax shelter was unfolding. The first of these cases, *ACM Partnership*,[108] featured a transaction designed to create capital losses to offset previously recognized capital gains.[109] The Merrill Lynch promoted CIS transaction at issue in the *ACM Partnership* case was both simple and crass. It was designed to take advantage of the basis allocation rules applicable to contingent installment sales coupled with the presence of a foreign entity as a partner in the initial year of the partnership's activities.

In affirming the Tax Court's holding that the transactions at issue lacked economic substance and should not be respected, the Third Circuit relied upon many of the economic substance sham cases discussed earlier in this article. In analyzing the economic substance of the transaction at issue, the court examined both the objective substance of the transaction and subjective motivation behind it. The court did not, however, apply the rigid two part analysis developed in *Rice's Toyota.* Rather, it viewed the objective and subjective prongs simply as factors to be considered in reaching a determination regarding economic substance. The court first examined the objective economic consequences of the transactions to ACM, determining them to be virtually nonexistent.[110] It then examined the subjective aspects surrounding the transactions in question, ultimately concluding that the transactions had been planned and executed without any regard to their pre-tax economic consequences.[111] Having reached these conclusions, the Third Circuit had no difficulty affirming the Tax Court.[112]

The appeal was not a complete loss for ACM. The Third Circuit did reverse the Tax Court's disallowance of the actual economic losses sustained by ACM. Relying on *Wexler* and language in that case that "in some circumstances, a sham transaction may have separable, economically substantive, elements,"[113] the court examined the circumstances surrounding the actual loss sustained by ACM. Concluding that the $6 million out-of-pocket loss was separate and distinct from the $87 million of tax losses, the court allowed the actual loss. This aspect of the Third Circuit's *ACM Partnership* opinion highlights the fundamental unfairness and disparate treatment accorded corporate v. non-corporate taxpayers. The out-of-pocket losses incurred by non-corporate taxpayers would have been disallowed under §165(c)(2), as the CIS transaction was not entered into primarily for profit. Since ACM's principal partner was a corporation it was rewarded for its attempted tax avoidance, and others made to foot the bill for its failed attempt.[114]

2. THE "COLI" CASES

Another area in which the Service has achieved a great deal of success in applying the sham transaction doctrine is in cases involving interest deductions associated with the purchase of corporate owned life insurance (hereafter "COLI").[115] The principle tax benefits inuring to a corporate participant in a COLI plan was the systematic deduction of interest expense on policy loans.[116] In holding that the COLI plans at issue lacked economic substance and were therefore shams, each of the courts pointed to a number of factors with the most important one being that the COLI plans could only be profitable when the tax benefits associated with the interest deductions were factored in. The structure of the COLI plans, the systematic borrowing against the policy value, the fact that the plans were designed to be "mortality neutral," together with the policy withdrawals to pay future premiums assured that non-tax benefits would not inure to the corporate participants. In each of the cases, the court likened the COLI transaction to the transaction at issue in

Knetsch. They went further, however, deciding that parts of the COLI plans before them constituted factual shams.

3. THE "ADR" CASES

In *IES*,[117] the Eighth Circuit, and in *Compaq Computer Corporation*,[118] the Fifth Circuit, each reversed lower court holdings (the district court in *IES* and the Tax Court in *Compaq*[119]) rejecting claimed tax benefits, specifically foreign tax credits, resulting from transactions involving the purchase of American Depository Receipts (hereafter "ADR"). The Fifth Circuit and the Eighth Circuit took slightly different paths in reaching the same result. The Fifth Circuit, in *Compaq*, began its analysis by quoting the now famous passage from Justice Marshall's opinion in *Frank Lyon*. Similarly, the Eighth Circuit also relied heavily on the fact that Twenty-First Securities Corporation was an independent entity that had previously engaged in this type of transaction. To the extent that Twenty-First was a real entity and that the trades in question actually occurred on a legitimate exchange, that should have been accorded weight only with respect to the issue of factual sham.

The Fifth Circuit began its analysis by stating that "even assuming Compaq sought primarily to get otherwise unavailable tax benefits . . . this need not invalidate the transaction."[120] There can be no doubt that it embraced this premise because Compaq's sole reason for entering into the ADR transactions in question was one of tax avoidance.[121] The court acknowledged that Compaq would not have entered into the ADR transaction but for the fact that it had a large capital gain that the capital loss from the ADR transaction offset. Remarkably, it ignored this fact.[122]

At the center of the Service's defeat in both *IES* and *Compaq Computer* was the refusal of the Eighth and Fifth Circuits to credit the Service's argument that that foreign taxes paid in connection with the ADR transactions were transactional costs in the same way that the commissions, fees and interest expense were.[123] This refusal resulted in its conclusion that the ADR transactions were profitable on a pre-tax basis.[124] The most startling aspect of the Fifth Circuit's opinion is its holding that if tax law effects are to be counted, all such effects even federal income tax savings should be taken into account.[125] This assertion runs counter to established legal principles, and is akin to the approach taken by the Fifth Circuit in *Tufts*.[126] Query whether the Fifth Circuit intends by its statement to mean that unless favorable federal income tax consequences are included in any analysis, state and local taxes and property taxes should also be ignored in determining whether a transaction holds out a reasonable possibility of an economic profit?

Finally, with respect to its finding that the ADR transactions had risk, the basis for its conclusion is speculation as to what might have happened, as opposed to what did happen over the short period of time in question.[127] The presence of tightly controlled theoretical risk should not be allowed to breathe substance into an otherwise substance free transaction. What the Fifth and Eighth Circuits seem to have forgotten, is when risk is tightly controlled in a real transaction, the profit potential is also severely circumscribed. In substance, like the First Circuit had done 40 years earlier *Fabreeka Products*, both circuits ignored the absence of a subjective non-tax motive, preferring to focus on what it considered to be the substantial profit potential inherent in the ADR transactions. Neither court addressed the question of whether IES or Compaq Computer had a real and substantial investment in the ADRs, or whether their interest was fleeting and inconsequential. The entire sequence of tightly controlled trading was accomplished within a very short period of time; for example, in *Compaq Computer*, the execution of all of the purchases and sales took little more than an hour.[128] More importantly, *Compaq Computer* and *IES* are arguably illustrative of the deeper systemic problem resulting from treating corporate taxpayers differently than non-corporate taxpayers.[129]

F. THE NON-SHELTER CASES

In her opinion in *Compaq Computer*, Judge Cohen referred to the difference between those cases involving the "closing out a real economic loss in order to minimize taxes or arranging a contemplated business transaction in a tax-advantaged manner" and those where the taxpayer entered into "prearranged loss transaction designed solely for the reduction of taxes on unrelated income."[130] The two cases she referred to as falling in the former category are *Cottage Savings*[131] and *Esmark, Inc.*[132]

Unquestionably, *Cottage Savings* is one of the most significant non-tax shelter sham cases to be decided. The *Cottage Savings* case involved the issue of whether losses resulting from "mortgage swaps" should be recognized and had its origin in the Tax Court. The device utilized was relatively straight forward -- it involved the entry into transactions which did not have an effect on the taxpayers' current economic position so as not to engender adverse regulatory consequences, but which would nevertheless cause a loss to be recognized for federal income tax purposes.[133]

The Tax Court specifically found that the "transactions were motivated solely by the desire of [the] petitioner and its trading partners to recognize for tax purposes (but not for regulatory purposes) the losses in market values of the loan portfolios each institution owned ...."[134] Finding that the transactions were between "independent parties," the court held that the losses created warranted recognition and were otherwise *bona fide*. It is clear that the cornerstone of the Tax Court's opinion was the independence of the taxpayer and its trading partners. The appearance of independence and arms-length dealing in *Cottage Savings* was more illusion then reality.[135] The Tax court's opinion in *Cottage Savings* reflects a respect for the form of the transaction that was not present in the court's many tax shelter opinions. The court relied on formalistic differences between the swapped mortgages, despite the fact that the parties to the transaction and the industry itself viewed these differences to be insignificant. The Tax Court's failure to fully examine the economic substance of the swaps in its analysis of the §165 issue was inexplicable. In reversing the Tax Court the Sixth Circuit adopted an approach rooted in principles of economic substance holding that a realized and recognized loss must also be deductible under §165.[136] Upon conducting such an analysis, the Sixth Circuit concluded that a *bona fide* loss was not sustained as a result of the swaps.[137] In the Supreme Court, the Service's defense of the *bona fide* loss "argument" upon which it had prevailed consisted of only a footnote citation to *Higgins v. Smith*. Whether the Service would have prevailed on the §165 issue had it vigorously pursued this issue is open to question.[138]

Shortly before it decided *Cottage Savings*, the Tax Court issued its opinion in *Esmark*, a case that involved a tender offer/redemption transaction in which Mobil acquired the stock of an Esmark subsidiary in exchange for Esmark stock which Mobil had acquired specifically for this purpose. Mobil's offer had been declared the highest bid amongst the eight received by Esmark, only after it expressed its willingness to accept the tender offer/redemption format desired by Esmark.[139] Mobil was willing to accept this format provided it "would not cost Mobil any more than its bid and would not expose Mobil to any additional liabilities or costs."[140] Had Mobil not agreed to the tender offer/redemption format, Esmark would have declared Allied Chemical, which had also agreed to that format, to be the highest bidder.

The Service advanced what the Tax Court described as "a number of overlapping 'substance over form' arguments ... [in an effort to recast the] transaction as a sale of Vickers to Mobil, followed by redemption of [its] stock for cash."[141] The most significant aspect of *Esmark* was that rather than testing the component parts of the transaction before it to determine whether each was *bona fide*, the Tax Court judged the transaction in light of its overall business purpose.[142]

Peerless Industries[143] is an oxymoron -- a non-tax shelter interest deduction case. In August 1981, Peerless delivered to Lebanon Valley College ("LVC") a zero coupon bond maturing in 50 years with a face amount equal to $20,000,000 in exchange for a payment of $23,066. The statutory scheme in effect at the time the bond was issued allowed an accrual basis taxpayer to deduct a ratable amount of the original issue discount on the bond ($19,976,934) or $399,538 per year, instead of the approximately $3,500 that would have accrued on the $23,066 purchase price. Since LVC was a tax-exempt institution, it did not have to pay tax on the $399,538 deducted by Peerless. Peerless also had the option to redeem the bond for $45,377 in August 1986, at which time it would have claimed $2 million of tax deductions at a cost of $22,311.

After thoroughly reviewing of the law regarding the economic substance doctrine, the district court in Peerless held that "the transaction does not lack economic substance for want of an 'appreciable impact' on the taxpayer's beneficial position."[144] Having, thus, disposed of what it considered to be the objective prong of the economic substance sham analysis the court then proceeded to look at the taxpayer's motives for creating the debt. Finding that there was no question that tax motives were present, the court then continued its analysis by examining whether a non-tax purpose was also present. Noting that the taxpayer's non-tax purpose was to provide LVC with an investment that would substantially enhance its endowment, the court then sought to determine if that purpose was sufficient to avoid sham characterization. Based upon its reading of the Third Circuit's opinion in *Weller,*[145] it concluded that it was not. In holding that the non-tax purpose necessary to support an interest deduction must be a "business purpose,"[146] the district court misread *Weller*, and accorded undue weight to the Supreme Court's citation of it in *Knetsch*. The Third Circuit affirmed the district court without opinion.[147] Although the court in *Peerless Industries* appears to have applied a conjunctive test in evaluating economic substance, subsequent Third Circuit precedent leaves little doubt that it adheres to the position that the objective and subjective parts of the economic substance doctrine are merely factors to be considered and not rigid tests.[148]

In 1999, the Service prevailed in the Tax Court in *United Parcel Service*.[149] This victory -- on sham grounds, in a non-tax shelter case, over a large corporate taxpayer -- was short lived, as the Eleventh Circuit two years later reversed the Tax Court.[150] The issue before the court in *United Parcel Service* was whether UPS would be allowed to shift the income from its lucrative excess-value charge ("EVC") business offshore utilizing a Bermuda subsidiary, Overseas Partners, Ltd ("OPL").[151] In reversing the Tax Court, the Eleventh Circuit invoked the spirit of *Frank*

Lyon, holding that the economic effects entitling a transaction to be respected "include the creation of genuine obligations enforceable by an unrelated party."[152] It then concluded that there was a real insurance policy between UPS and the third party insurer which conveyed the right to receive the EVCs collected by UPS to the third party. Despite acknowledging that the odds of the third party insurer losing money were slim, and that the reinsurance agreement with OPL further reduced that risk, the court held that it did assume some risk. Perhaps believing that resting its holding on the "risk" assumed by the third party was questionable, the Eleventh Circuit went onto conclude that OPL was a separate independent taxable entity not under the control of UPS.[153] It also noted that UPS had parted with the funds produced by the EVCs and no longer had control over those funds.[154] Both of these assertions are questionable. *United Parcel Service* represented a stinging defeat for the Service, and no doubt was one of the catalysts behind the Senate's passage of the CARE Act and its efforts to reform the economic substance doctrine.

III. IS A LEGISLATIVE RESPONSE TO THE "CONFUSED" STATE OF THE SHAM TRANSACTION DOCTRINE NECESSARY?

The initial question is whether the sham transaction doctrine is in such a confused state as to require comprehensive Congressional intervention? The author believes that it is not. To be sure, there are tax law changes that need to be made to level the existing playing field, but these changes do not require "comprehensive" legislation aimed at establishing bright lines within the judicially created sham transaction doctrine. Indeed, attempts to do so may serve to render the sham transaction doctrine less effective as a means of combating tax avoidance.

Frank Lyon and its progeny have resulted in different appellate court formulations of the economic substance sham doctrine. These differences, however, are not nearly as significant as the Senate would believe. For example, contrary to the report accompanying CARE Act §701, the Sixth Circuit has not adopted a conjunctive test.[155] It is also unclear that any circuit beyond the Fourth Circuit still adheres to the *Rice's Toyota* standard. While the Eighth Circuit alluded to the two-prong test in *IES*, it made it clear that it was not adopting that standard.[156] Similarly, the Fifth Circuit in *Compaq Computer* found it unnecessary to decide whether to adopt the *Rice's Toyota* standard or the more flexible standard articulated in *ACM Partnership*.[157] Moreover, the wisdom of legislatively mandating the adoption of a rigid two prong test, whether that test is framed in the conjunctive or disjunctive is questionable.[158] The better approach is the application of the flexible standard that has been adopted by many of the circuits.

A. THE CARE ACT RESPONSE

On April 9, 2003, the Senate passed the CARE Act. The provisions of Title VII of the CARE Act contain a proposed addition to §7701 of the Internal Revenue Code. This proposal seeks to curtail the use of "transactions that rely on the interaction of highly technical tax law provisions," and to provide standards for the application of the economic substance doctrine.[159] While it is clear that changes are required in order to level the playing field for all taxpayers, CARE Act §701 does not accomplish this goal.

The centerpiece of CARE Act §701 is the proposed clarification of the economic substance doctrine, [160] through the addition of Prop. §7701(m)(1). These rules provide that a transaction has economic substance only if the transaction materially effects a taxpayer's economic position, the taxpayer has a substantial non-tax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing the non-tax purpose.[161] The Senate does not intend this provision to effect a court's determination as to when an economic substance analysis should be conducted or otherwise affect the flexibility afforded the courts in connection with the application of the doctrine. [162] This provision has been subject to criticism principally upon the ground that it is too broad and will ensnare many legitimate transactions in its web.[163] The accompanying committee report indicates, however, that "[i]f the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision."[164]

Also included in CARE Act §701 is a special rule where a taxpayer relies on the existence of profit potential in order to establish that a transaction has economic substance.[165] Under the terms of this special rule, a transaction will not be treated as having economic substance by reason of a potential for profit unless the present value of the anticipated pre-tax profit from the transaction is substantial in relation to the net tax benefits that would be allowed if the transaction were respected.[166] Additionally, the reasonably expected pre-tax profit from the transaction must exceed a risk-free rate of return.[167] Of critical importance is the fact that Prop. §7701(m)(3)(D) provides that in determining expected net tax benefits to the lessor of tangible property subject to a lease, neither tax credits nor depreciation are to be considered in determining the amount of the expected net tax benefits and the requirement that the expected pre-tax profit exceed a risk-free rate of return is inapplicable.[168] Furthermore, in a direct response to *IES* and *Compaq Computer,* a provision mandating that fees, transaction expenses and foreign taxes are to be taken into account as expenses in determining whether there is the requisite pre-tax profit required by Prop. §7701(m)(1)(b)(ii) has been included.[169]

CARE Act §701 has been a source of considerable consternation for many tax practitioners. These concerns are to a great extent not warranted, this provision adds little to the existing body of law, and by its articulation of specific standards will likely serve to frustrate the application of the economic substance sham doctrine to future transactions. For example, the provision dealing with the standard of profit potential has been watered down by other parts of the statute, and its legislative history, so as to call into question its value in all but the most egregious cases.

B. WHAT IS THE APPROPRIATE LEVEL OF LEGISLATIVE ACTION?

Any confusion regarding the proper application of the sham transaction doctrine can be traced to the absence of clear guidelines with respect to its application. The guidelines referred to are not quantitative (*e.g.*, how significant must the economic consequences be) or qualitative (*e.g.*, what is an adequate non-tax purpose) similar to those proposed in CARE Act §701. Rather, the guidelines that have been absent from the judicial landscape are quasi-substantive and quasi-procedural in nature -- that is, what should a court focus on when confronted with a case in which the Service is advancing a sham argument.[170]

While these procedural guidelines would go far in alleviating the instances of inconsistent application of the sham transaction doctrine, there does remain a definite need to fix some of the problems wrought by *Frank Lyon* and its progeny. One problem area where Congressional intervention may be warranted is in the foreign tax credit arena. Overturning the result in *Compaq Computer* and *IES* can be accomplished simply by adopting a provision similar to Prop. §7701(m)(1)(C) and granting to the Service the authority to waive its application upon a finding of an absence of a tax avoidance motive for the transaction. A more difficult question is presented with respect to the question of transactions involving "tax-indifferent" parties.[171] Any response here should not be limited to addressing situations like those present in the CIS cases and *Andantech, L.L.C.* (*i.e.*, transactions involving foreign entities). Rather, the time has come to rethink whether tax-exempt entities should continue to be permitted to trade on their exemption. The environment which has encouraged transactions such as those at issue in *Brown*[172] and *Compaq Computer* must be eliminated.

The most critical and certainly sure to be the most controversial, revision involves a significant change in the tax "culture." The disparate treatment that has existed between different types of taxpayers must be eliminated. The rules governing an individual's ability to deduct losses from a trade or business or a transaction entered into for profit should be made applicable to *all* taxpayers.[173] The extension of the "at risk" rules of §465 and the "passive activity loss" rules of §469 to *all* taxpayers should also be a priority,[174] but not a substitute for the extension of §165(c). If cases like *ACM Partnership*, *Winn Dixie* and *Compaq Computer* have taught us anything, it is that some of the most aggressive, and in some cases egregious, forms of tax avoidance are conceived, planned or signed off on within the hallowed halls of the Fortune 500. There is no longer any justification for giving corporate taxpayers a free pass. All taxpayers need to be held to the same standards -- the past 15 years have demonstrated that.

(C) A UNIFORM APPROACH TO THE SHAM ISSUE

While the adoption of the statutory changes suggested above will lessen the need for the courts to rely upon the sham transaction doctrine, it will not eliminate that need. Therefore, it is imperative that uniform standards for the doctrine's application be employed by the courts. The inconsistent analysis, and in some cases result, in the application of the sham transaction doctrine is reflective of the practice of deciding cases by a sort of judicial "sense of smell," as opposed to hard analysis.[175] While most in the judiciary would rail at the suggestion that they need to be instructed in how to apply a particular doctrine, especially one as old as the sham transaction doctrine, the fact remains that in many cases the opinions are reflective of a dearth of analysis. In some cases this can be traced to bad "lawyering," in others the fault lies squarely with the judiciary.

What is an appropriate judicial approach to a case where the sham transaction doctrine has been advanced by the Service? At a *minimum*, the courts should conduct inquires into the following:

(1) HOW WAS THE TRANSACTION IMPLEMENTED?

This requires an analysis of whether the transaction[176] conformed with general business and legal practices as well as practices peculiar to the particular industry involved. Thus, the focus here should be on the form of the transaction in the context of the industry in which it took place. Implicit in this is that lawyers must fulfill their obligation to the courts and fully educate the judiciary as to industry practice. By focusing on accepted industry practice and overlaying those practices on the transaction before it, the courts will be able to identify areas of deviation. Deviation from established industry practice would be a factor favoring judicial rejection of a transaction. Essentially, the initial inquiry should focus on whether there are any transactional "irregularities." Assuming that a transaction survives this initial inquiry, the next question to be addressed is whether the parties involved in it were capable of honoring the obligations which they purported to create. This analysis will reveal whether the transaction constitutes a mere "paper chase" to be disregarded as a factual sham, or whether further inquiry into its economic substance is warranted.

(2) WHY DID THE TAXPAYER ENTER INTO THE TRANSACTION?

The next step should be an inquiry into the taxpayer's reasons for entering into the transaction. For example, did the taxpayer enter into the transaction to derive an economic profit or was there some other (non-tax) reason for it. A court should conduct a detailed inquiry into the reasons articulated by the taxpayer for engaging in the transaction. What the taxpayer actually did should then be evaluated in light of the proffered explanation. The purpose of this inquiry is to determine whether a reasonably prudent person seeking to accomplish the articulated goals would have engaged in this particular transaction to accomplish those non-tax goals. Simply because a court concludes that a taxpayer had a *bona fide* non-tax goal for accomplishing a particular result should not cause the inquiry to come to an end. Rather, each part of the transaction should be independently examined to determine whether it has economic substance. Conversely, a taxpayer's failure to proffer a non-tax reason for engaging in a transaction should not automatically result in a finding that the transaction is a sham. This approach would allow the courts to remain faithful to the lessons of *Gregory*, *Knetsch* and *Frank Lyon.* The absence of a non-tax purpose for a transaction should, however, be viewed as a factor strongly favoring judicial rejection of a transaction.

(3) WHAT IS THE LEVEL OF EXPECTED TAX BENEFIT FROM THE TRANSACTION?

Regardless of the non-tax reasons articulated by a taxpayer, a court should conduct an inquiry into the level of tax benefits the transaction as structured will produce. The purpose of this inquiry should not be to arrive at a dollar figure which will then in robotic fashion be compared to the substantiality of the non-tax purpose. If a transaction as structured has the potential to produce an economic benefit or in some other manner materially affects a taxpayer's position, the fact that substantial tax benefits may also result should not cause the transaction to be disrespected. This should be the case even if the value of the expected tax benefits exceeds the value or worth of the expected non-tax benefits flowing from the transaction. The amount of expected tax benefits should simply represent one factor to be considered in the overall inquiry into the economic substance of the transaction and should not *per se* result in a finding of tax avoidance.

(4) HOW SIGNIFICANT IS THE NON-TAX PURPOSE FOR THE TRANSACTION?

In order to properly evaluate the economic substance of a transaction, it is essential that the courts conduct an inquiry into the materiality of the transaction on the taxpayer's economic or legal position. The issue of materiality of impact and substantiality of non-tax purpose should not be viewed as separate. Rather, they are opposite sides of the same coin. For a non-tax purpose to be substantial, it clearly must have a material impact on the taxpayer's economic position and/or legal position. Efforts to separate the two simply detract from the analysis essential to the proper functioning of the sham transaction doctrine. The evaluation of the expected impact of a transaction cannot be conducted in a vacuum. Tax considerations aside, what may represent a material impact for one taxpayer may not represent a material impact for another. The presence or absence of risk is also an important factor to be considered. How a change in position is viewed within an industry may also affect the determination of materiality of impact, and thus substantiality of non-tax purpose. This standard must be applied in a flexible manner. Congressionally drawn bright lines can only serve to detract from the analysis necessary to properly apply the doctrine. Finally, in evaluating the weight to be given to a claimed non-tax purpose, it is appropriate for the courts to consider the tax benefits flowing from the transaction in weighing the substantiality of that purpose.

(5) IF PROFIT IS THE GOAL, HOW MUCH PROFIT IS ENOUGH?

The traditional standard in evaluating the necessary level of profit is that the transaction must possess a "reasonable possibility of a profit." The question of what constitutes a "reasonable possibility of a profit" has dogged the courts for decades. In order to properly address this issue, a number of questions must be answered. To begin with, how should we define "profit?" Certainly, the inclusion of tax savings in determining the profitability of a transaction is inappropriate. Instead, the focus should be on cash flows, operating revenues, and potential appreciation inherent in the assets employed in any activity. In assessing the potential for profit inherent in a transaction, the starting point should be the expectation and understanding of the industry in which the transaction occurs. The amount invested, or the amount of risk assumed, by the taxpayer should also be a relevant factor to be considered in making a determination as to whether there is sufficient profit potential in a particular transaction. Finally, the expected tax benefits to be derived from the transaction must also be considered in weighing the adequacy of any expected profit from a transaction. The existence of substantial tax benefits that exceed expected pre-tax profit should not, standing alone, result in a transaction being characterized as lacking economic substance.[177]

IV. CONCLUSION

The sham transaction doctrine is to some degree in a state of disrepair. A number of factors have contributed to this problem. There is nothing wrong with the doctrine itself, although the damage caused to it over the years through less than precise judicial language and Service overreaching may require some legislative intervention. However, that intervention need not be as complicated as §701 of the CARE Act. In fact, if the Supreme Court were to alter its practice of avoiding involvement in sham transaction cases, perhaps the court could fix some of the problems wrought by its opinion in *Frank Lyon.* As things presently stand, *Frank Lyon* will apparently continue to cause mischief in the sham area. If the economic substance provisions of the CARE Act are ultimately adopted, we simply will have exchanged one set of problems for another, since the CARE Act fails to address the most serious systemic problem – the disparity of treatment between different classes of taxpayers.

ENDNOTES

[1] *See,* S. 476, §701, passed by the Senate on April 9, 2003. On April 2, 2003, H.R. 1555 containing provisions substantially similar to §701 was introduced in the House and is currently under consideration.

[2] *See, e.g., Compaq Computer Corp v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *United Parcel Service v. Commissioner,* 254 F.3d 1014 (11th Cir. 2001).

[3] 435 U.S. 561 (1978).

[4] It is impossible in any article to analyze all of those cases in which the sham transaction doctrine has been at the center of the dispute. This article focuses on those cases which the author believes were critical to the evolution of the doctrine, and those which appear to have motivated the Senate to pass §701 of the CARE Act.

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[5] *See, e.g., Rice's' Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 196, *aff'd in part and rev'd in part*, 752 F.2d 89 4th Cir. 1985).

[6] *See, e.g., Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989) ("Courts have recognized two basic types of sham transactions.").

[7] *See, e.g., Lerman v. Commissioner*, 939 F.2d 44, 48, n.6, *cert. denied*, 502 U.S. 984 (1991) ("A factual sham is one in which the alleged transactions never actually took place. In an economic sham, or a sham in substance, the alleged transactions actually took place, but are nonetheless without economic substance.").

[8] *See, e.g., Glass v. Commissioner*, 87 T.C. 1087 (1986), *aff'd sub nom., Herrington v. Commissioner*, 854 F.2d 755 (5th Cir. 1988), *cert. denied*, 490 U.S. 1065 (1989); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Ratliff v. Commissioner*, 865 F.2d 97 (6th Cir. 1989), *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Keane v.Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Killingsworth v. Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Friedman v. Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Kielmar v. Commissioner*, 884 F.2d 959 (7th Cir. 1989); *Lee v Commissioner*, 897 F.2d 915 (8th Cir. 1989); *Bohrer v. Commissioner*, 945 F.2d 344 (10th Cir. 1991). *Compare, e.g.,* the definition of a "sham in substance" as set forth in *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988), *cert. denied*, 488 U.S. 824 (1988) (transaction is a sham in substance if it is fictitious or lacking in a business purpose or economic effect beyond the creation of a tax loss) with the definition found in *Falsetti v. Commissioner*, 85 T.C. 332, 347 (1985) ("expedient of drawing up papers to characterize transactions contrary to economic realities and which have no economic significance beyond expected tax benefits."). The latter sounds like an economic substance sham, while the former, at least in part, sounds like a factual sham.

[9] Generally, it is of little practical significance which branch of the sham doctrine a transaction stumbles over; nevertheless, the characterization of a transaction as a factual or economic substance sham is not wholly irrelevant. For example, if a transaction constitutes an economic substance sham a portion of that transaction may nevertheless be respected for federal tax purposes. *See, e.g., Rice's Toyota World Inc. v. Commissioner*, 752 F.2d at 89.

[10] The preferred course would be for the Supreme Court to clean up the mess it created in its *Frank Lyon* opinion and through its years of inaction in the sham transaction arena.

[11] *See, e.g., Goldstein v. Commissioner,* 364 F.2d 734, 741, n.7 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967) ("black-letter maxims ... singularly unhelpful when it comes to deciding cases."). Stating that the substance of a transaction is controlling, simply begs the question.

[12] 293 U.S. 465 (1935).

[13] *Id.* at 470.

[14] 308 U.S. 473 (1940).

[15] *Id.* at 476.

[16] 287 U.S. 415 (1932).

[17] 308 U.S. at 477.

[18] 364 U.S. 361 (1960).

[19] *Id.* at 365.

[20] The tax benefits perceived by the Supreme Court in *Knetsch* to be unwarranted could have effectively been denied without characterizing the entire transaction as a sham had the court applied tax accounting principles to its facts, since the tax avoidance scheme at issue was tantamount to a cash taxpayer claiming an interest expense deduction based upon the delivery of his own note to his creditor. *See, Battlestein v. Internal Revenue Service*, 681 F.2d 1182 (5th Cir. 1980). The one unnecessary step in a commercial sense was the preplanned and systematic borrowing of the previously paid interest. This effectively negated the earlier interest payment. It is unlikely that the Court would have reached a similar result had Knetsch not repeatedly engaged in the "payment/borrowing" tactic. Indeed, Justice Douglas argued in his dissent that unless "the transaction itself [was] ... hocus-pocus, the interest charges incident to completing it would seem to be deductible ...." 364 U.S. at 370.

[21] 435 U.S. 561 (1978).

[22] *Id.* at 580. *Frank Lyon* may have been ahead of its time. If it was a sham, it was a "complex sham."

[23] Worthen wished to finance its construction of a bank and office building to replace its existing facility. This direct approach was precluded by factors beyond Worthen's control, thus forcing it to seek alternative means to accomplish its goal. The arrangement at issue in *Frank Lyon* received the approval of both federal and state regulators; however, each insisted on the addition of one major condition -- that the building be owned by an independent third party and that Worthen have the option to acquire the building at a set price. The Lyon Company was eventually chosen by Worthen to fulfill the role of independent investor. The building was sold to the Lyon Company as it was completed for a price that exceeded the amount of the permanent financing by $500,000. The Lyon Company leased the building back to Worthen, and entered into a ground lease with Worthen that ran for a period ten years beyond the last renewal option on the building lease. Purchase options, exercisable at four different points in time during the initial lease term, provided for payments

to the Lyon Company of an amount equal to the unamortized principal balance of the permanent financing, the Lyon Company's initial $500,000 investment, plus six percent interest on that investment. The six percent figure is identical to the maximum amount of interest that Worthen could have paid under Arkansas law. *Frank Lyon Co. v. United States*, 75-2 USTC ¶9545 (D.C. AR 1975).

[24] 435 U.S. at 583-84.

[25] As noted by the Court, the legal rights and obligations arising under the transaction as structured "were obviously different from those that would have resulted had Worthen been able simply to make a mortgage agreement with New York Life and ... receive[d] a $500,000 loan from Lyon." *Id.* at 576. To be sure, the Lyon Company had undertaken an element of risk as a consequence of the transaction, but as Justice Stevens noted in his dissenting opinion, the principal risk assumed by the Lyon Company was not unlike that of a lender of money as opposed to an owner of property. *Id.* at 585. Viewing Lyon as having performed an intermediate banking function would have been fully consistent with the real limitations placed upon its ability to profit from the transaction.

[26] *Id.* at 580.

[27] *See, e.g., American Electric Power, Inc. v. United States*, 136 F. Supp 2d 762 (2001 DC OH), *aff'd*, 326 F.3d 737 (6th Cir 2003) (backdating of insurance policies).

[28] 267 F.2d 127 (1st Cir. 1959). *See, e.g.,* Joshua D. Rosenberg, *Tax Avoidance and Income Measurement,* 87 Mich. L. Rev. 365, 385, n.49 (1988).

[29] Prior to the advent of the modern tax shelter era a significant number of the decided sham transaction cases arose in the context of interest expense deductions. *See, e.g., Lewis v. Commissioner*, 328 F.2d 634 (7th Cir. 1964), *cert. denied*, 379 U.S. 821 (1964); *Rubin v. United States*, 304 F.2d 766 (7th Cir. 1962); MacRae *v. Commissioner*, 34 T.C. 20 (1960), *aff'd*, 294 f.2d 56 (9th Cir. 1961), *cert. denied*, 368 U.S. 955 (1962), *reh. denied*, 368 U.S. 1005 (1962); *Dooley v. Commissioner*, T.C.M. 1962-305, *aff'd*, 332 F.2d 463 (7th Cir. 1964). The reason for this activity was that interest expense was deductible without reference to the any profit motive standard. Sham analysis represented the only method available to the courts to curb taxpayer abuses.

[30] 85 T.C. 332 (1986).

[31] Judge Nims defined a sham in substance, "as the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." *Id.* at 347. The notion of a "sham in substance" first surfaced in *Falsetti*. Query, whether Judge Nims created this "purgatory" between factual sham and economic substance sham so that he could apply it to the London option cases at issue in *Glass*. *See,* the text accompanying notes 56 through 61, *infra.*

[32] *Id.* at 355.

[33] For example, the case was marked by an absence of arms length dealing. The price of the property rose steadily as it was "sold" to various related entities; by the time it was acquired by Falsetti's partnership, its purchase price far exceeded its fair market value. Moreover, neither World Realty nor Monterey Pines two of the entities to whom the property was purportedly sold ever acquired title to the building. Moreover, even after the putative sales to World Realty and Monterrey Pines, the promoter or an entity controlled by him continued to use the property as collateral for loans.

[34] 88 T.C. 860 (1987).

[35] 94 T.C. 738 (1990). While I have endeavored to remain objective in my discussion of *Sheldon*, the reader should be aware that the author represented the Petitioners before the Tax Court.

[36] Financial instruments, such as physical commodities, futures, options and forward contracts were the tax avoidance vehicle of choice in a number of shelter cases. *See, e.g., Freytag v. Commissioner*, 89 T.C. 849 (1987), *aff'd*, 904 F.2d 1011 (8th Cir. 1990), *cert. denied,* 501 U.S. 868 (1991); *Brown v. Commissioner*, 85 T.C. 968 (1985), *aff'd sub nom., Sochin v. Commissioner*, 843 F.2d 351 (9th Cir. 1988), *cert. denied*, 488 U.S. 824 (1988); *Forseth v. Commissioner*, 85 T.C. 127 (1985), *aff'd sub nom., Mahoney v. Commissioner*, 808 F.2d 1219 (6th Cir. 1987), *aff'd sub nom., Enrici v. Commissioner*, 813 F.2d 293 (9th Cir. 1987), *aff'd*, 845 F.2d 746 (7th Cir. 1988); *Julien v. Commissioner*, 82 T.C. 492 (1984). This popularity is best explained by the fact that unlike tangible property such as equipment, lithographs, master recordings or cattle it is much more difficult to discern between real and fictitious transactions where the only evidence of a transaction is a confirmation slip.

[37] This analysis was necessary, because unlike a case involving tangible property -- such as equipment, cattle or real estate -- where a court would be able to examine the property to ascertain whether or not it existed, generally this was not possible in the case of government securities.

[38] 88 T.C. at 883-884.

[39] The court's finding that the economic consequences were prearranged should have been sufficient to support a finding that the transactions in question were factual shams. *See, DeMartino v. Commissioner,* T.C.M. 1986-263, *aff'd*, 862 F.2d 400 (2d Cir. 1988).

[40] 94 T.C. at 754-57.

[41] *Id.* at 757.

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[42] *Id.*

[43] *Id.* at 758.

[44] 294 F.2d 876 (1st Cir. 1961).

[45] 364 F.2d 734 (2d Cir. 1966).

[46] 294 F.2d at 878.

[47] 364 F.2d at 737.

[48] *Id.* at 741. Ironically, an opinion in which the Second Circuit disavowed reliance on sham transaction principles, has become one of the most oft relied upon "sham" transaction opinions. *See, e.g., Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[49] *Id.* at 742. The court's use of the disjunctive clearly implies that a finding of substance, utility or purpose would have resulted in the allowance of the claimed interest deduction.

[50] As noted earlier, *Frank Lyon* was in reality a characterization case. The Service did itself, taxpayers and the courts a disservice, by advancing the sham argument. *See*, the text accompanying notes 21 through 26, *supra.*

[51] *See, e.g., Hilton v. Commissioner*, 74 T.C. 305, 348 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982) (wherein the court examined the buyer-lessor's interest in order to determine the substantiality of that interest). The sale/leaseback at issue in *Frank Lyon* could have been structured in such a way so that both Worthen and the third party lending institution would have enjoyed an economic return or benefit, but the Lyon Company effectively would have been precluded from doing so. *See, Burns v. Commissioner*, 78 T.C. 185, 212 (1982) ("the interjection of the third party may be no more than 'window dressing.'").

[52] 81 T.C. 184 (1983), *aff'd in part and rev'd in part*, 752 F.2d 89 (4th Cir. 1985).

[53] The computer equipment involved had been purchased by Finalco for $1,297,643 shortly before Rice's Toyota purchased a seventy percent interest in that same equipment for $1,455,227.

[54] Lee Sheppard has expressed the view that the *Rice's Toyota* test is in fact a conjunctive one. *See*, Lee A. Sheppard, *News Analysis: Drafting Economic Substance, Continued*, 24 Ins. Tax Rev. 870, 872 (2003). Sheppard has simply misread the language of *Rice's Toyota*. A taxpayer must fail both prongs of the test in order for a transaction to be considered a sham. The *Rice's Toyota* standard is clearly a disjunctive one, not a conjunctive one.

[55] The *Rice's Toyota* test is not sufficiently flexible to curb perceived abuses and generally has not been followed. *See, e.g., Shriver v. Commissioner*, 899 F.2d 724,

727 (8th Cir. 1990) ("we do not read *Frank Lyon* to say anything that mandates a two-part analysis."); *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989) ("transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer."); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988), *cert. denied*, 488 U.S. 824 (1988) ("the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis").

[56] 87 T.C. 1087. *Glass* and its progeny, *e.g., Fox v. Commissioner*, T.C. Memo 1988-570, 56 T.C.M. 863, gave rise to much of the confusion confronting the courts today. *Compare, Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) (reversing the Tax Court's *Fox* opinion) with *Gardner v. Commissioner*, 954 F.2d 836 (2d Cir. 1992) and *Lerman v. Commissioner*, 939 F.2d 44 (3rd Cir. 1991), *cert. denied*, 502 U.S. 984 (1991) (affirming that same opinion), reaching contrary conclusions with respect to the question of whether a loss even arises in the context of an economic substance sham.

[57] 88 T.C. 386 (1987), *aff'd*, 868 F.2d 851 (6th Cir. 1989).

[58] *See*, note 31, *supra.*

[59] 78 T.C. 350 (1982). Although raised by the Service, this issue was not considered by the court in *Fox v. Commissioner*, 82 T.C. 1001 (1984). Judge Nims decided both of these cases, in addition to *Falsetti* and *Glass.*

[60] 84 T.C. 827, 844-45 (1985), *rev'd,* 836 F.2d 1274 (10th Cir. 1988).

[61] Had the court applied a more traditional form of analysis such as that employed in *Fox* (holding that losses are allowable under §165(c)(2) only from transactions entered into primarily for profit), the substantive outcome would have been the same. Given the putative tax benefit flowing from the transactions and the minimal prospects for economic gain or loss it is unlikely that any taxpayer could have established that the transaction was motivated "primarily for profit." The court would, however, have had to examine the subjective intent or motive of each of the taxpayers whose cases were pending before it.

[62] 88 T.C. 386. At issue in *Rose* were depreciation and miscellaneous deductions together with a claimed investment tax credit in connection with the taxpayers' participation in a lithograph shelter.

[63] *Id.* at 408.

[64] *Id.* at 410-11. One of these factors was whether the transaction effected a shift in the benefits and burdens of ownership. The incorporation of the benefits and burdens question into the court's analysis of the economic sham issue reflects the degree to which the two issues have become intertwined.

[65] *Id.* at 412.

[66] *Id.* at 412-13.

[67] The court set forth four reasons for its belief that the "generic tax shelter" test was preferable to the traditional analysis under §183. Included amongst these were the perceived ability to achieve greater consistency both in application and as and between similarly situated taxpayers. Another was the flexibility to allow the court's to "separate the real economic aspects [of a transaction] from [its] 'financial fantasies.'" *Id.* at 414.

[68] In affirming *Rose*, the Sixth Circuit declined to adopt the "generic tax shelter" standard. Rather, it held that regardless of the test the *Rose* court applied, it engaged in an economic substance inquiry.

[69] 89 T.C. 986 (1987).

[70] *Id.* at 992.

[71] *Id.* Again turning to *Frank Lyon* for support, the Tax Court added a gloss to the oft quoted language of that opinion, stating "the substance of a transaction ... determines its tax consequences. It must *in fact, not in expectation*, be 'imbued with tax-independent considerations.'" *Id.* at 993 (Emphasis added).

[72] *Id.*

[73] *Id.* at 994. *Cherin*, thus, stands for the proposition that industry practices are important in reaching a conclusion as to whether a transaction possesses sufficient economic substance to be respected for federal tax purposes. This language suggested that the proper standard for evaluating the economic substance of a transaction might be a "but for" test. The "reasonable person within the industry" approach of *Cherin* has not been applied with any degree of consistency by the courts. The only case in which the court considered industry standards in a meaningful way was *Jacobson v. Commissioner*, T.C. Memo 1988-341, *rev'd*, 915 F.2d 832 (1990), involving a movie shelter. If a court were forced to determine in each instance how a particular transaction would be viewed within the industry in which it occurs, decisions as to economic substance would not be made in a vacuum.

[74] The converse of this was not true. *See, e.g., Larsen v. Commissioner*, 89 T.C. 1229 (1987), *aff'd in part and rev'd in part sub nom., Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990), where despite having found that the taxpayer did not have a business purpose for entering into the four transactions at issue, it nevertheless found that two of the transactions possessed sufficient economic substance (*i.e.*, satisfied the objective prong of the doctrine) to justify their recognition for Federal income tax purposes.

[75] 91 T.C. 838 (1988).

[76] *Id.* at 855. The court's holding was punctuated by its finding that the transaction was a "legitimate long term investment," and that the taxpayers "participated in the ... transaction only after they were convinced that the investment had a reasonable possibility of producing a profit." *Id.* at 856.

[77] *Id.* at 855.

[78] These were (1) the presence or absence of arm's length negotiations, (2) whether the price paid for the equipment reflected its fair market value, (3) the structure of any financing, (4) adherence to contractual terms and (5) the reasonableness of income and residual value projections. *Id.* at 856.

[79] There also was a considerable identity of factors between the determination with respect to the economic substance sham issue and the benefits and burdens issue in *Levy*. This is of course reflective of the fact that the current sham formulation was derived for the most part from the Supreme Court's *Frank Lyon* opinion. *See, also, e.g., Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981), cited in *Levy*, where the analysis with respect to both issues was conducted simultaneously.

[80] *Yosha v. Commissioner*, 861 F.2d 494, 499 (7th Cir 1988).

[81] 91 T.C. at 872.

[82] Taxpayers seeking to lay claim to tax benefits from non-favored transactions are required to show that they entered into the transaction primarily for profit. *Fox v. Commissioner*, 82 T.C. 1001 (1984). Those whose transactions are of a type considered by the court to be congressionally sanctioned need demonstrate a lesser degree of subjective profit motive.

[83] 94 T.C. 738.

[84] The partnership in question, GSDII, deducted $5,675,708 of interest expense in 1981 and $3,776,828 of interest expense in 1982, while reporting $9,392,846 of interest income in 1982. Thus, transactions which overall produced a net loss of $59,690 would have supported a 1981 interest expense deduction approximately one hundred times greater than the economic loss sustained.

[85] As Judge Wells observed in his dissenting opinion, "[i]t is evident from the majority opinion that deferral is the majority's real concern with the transactions in issue." 94 T.C. at 777.

[86] 364 F.2d 734 (2d Cir. 1966). The majority stated that there was "no essential or real difference between *Goldstein* and this case." *Id.* at 768. According to the dissent, "the majority simply incant[ed] '*Goldstein*' and [left] for the reader the task of refuting petitioner's argument and figuring out why the transactions [at] issue [were] 'in form and substance' the same as those in *Goldstein*." *Id.* at 775-76.

[87] 363 U.S. 361. The majority described *Knetsch* as reflecting "circumstances which are strikingly similar to [*Sheldon*]." *Id.* at 762, n.14. It was never explained how the circumstances were similar.

[88] The dissent would have respected these 20 repurchase agreements. *Id.* at 776-77.

[89] *Id.* at 763.

[90] *Id.* at 764-65.

[91] *Id.* at 767. Judge Wells, the judge who presided at the trial, argued in his dissenting opinion that "GSDII anticipated an economic profit ...." *Id.* at 783.

[92] *Id.* at 768.

[93] *Id.* at 768-69. The cash investment that produced the $18,360 profit in the subsequent year was approximately $28,800 and as the dissent pointed out, this amounted to a 64% return. *Id.* at 774, n.6. Had the majority evaluated market expectations, it may not have overlooked the fact, confirmed by the Service in a requested finding of fact, that gains or losses of a magnitude consistent with those experienced by GSDII were common in the marketplace. It is curious that the majority acknowledged the Service's requested finding of fact that transactions of the size entered into by GSDII were common in the marketplace, *Id.* at 754, but chose to ignore the Service's requested finding regarding the magnitude of gains or losses.

[94] *Id.* at 767. The dissent vigorously disagreed with this interpretation of *Goldstein*. *Id.* at 773. Moreover, it is impossible to discern whether the majority was referring to a "profit motive" (subjective) or "reasonable possibility of a profit" (objective) test when it chose to employ the phrase "profit objective test."

[95] *Id.* at 769.

[96] *See, e.g., United States v. Wexler*, 31 F.3d 117 (3rd Cir. 1994).

[97] *See, e.g., Martuccio v. Commissioner*, T.C. Memo 1992-311, *rev'd on other grounds*, 30 F.3d 734 (6th Cir 1994), wherein the tax court determined that a computer sale/leaseback transaction was not a "sham in substance" (*i.e.,* an economic substance sham) where the taxpayer's out-of-pocket investment (cash, principal and interest payments) was equal to $134,189 and he could have reasonably expected to receive $137,478 from rents and residual value over an 8 year period from 1984 through 1992.

[98] *See, e.g., United States v. Wexler*, 31 F.3d at 124, n.9, wherein the Third Circuit noted that "*Sheldon* actually expanded the sham transaction doctrine, because it barred interest deductions from arrangements motivated by tax benefits even if the transactions could have generated a profit."

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[99] Arguably, *Sheldon* stands for the proposition that if the tax benefits flowing from a transaction are too great, those benefits will not be allowed.

[100] 915 F.2d 832, 840 (2d Cir. 1990) ("Even if the motive . . . is to avoid taxes, interest incurred therein may still be deductible . . . .").

[101] *See, e.g., Lee v. Commissioner*, T.C. Memo 1997-172, 73 T.C.M. 2545 (formally adopting the rule in the Tax Court).

[102] 69 F.3d 982 (3rd Cir. 1995).

[103] *Id.* at 988.

[104] *Id.* at 991.

[105] *Id.*

[106] The Ninth Circuit stated that both Congress and the state legislature "purposely skewed the neutrality of the tax system, even more than . . . usual . . . because they sought to induce people to invest in solar energy."

[107] *See, e.g., Fox v. Commissioner*, 82 T.C. 1001 (1984).

[108] 157 F.3d 231 (3rd Cir. 1998), *cert denied*, 526 U.S. 1017 (1999).

[109] In many ways, these transactions were reminiscent of the commodity tax straddle cases that resulted from the promotional activities of a number of brokerage firms, including Merrill Lynch, the promoter of the contingent installment sale (hereafter "CIS") transaction at issue in *ACM Partnership. See, e.g., Smith v.* Commissioner, 78 T.C. 350 (1982). Proving that old tax shelter promoters never die, they just slap some new paint on old transactions and find a new breed of taxpayer anxious to shift the burden to others.

[110] Describing ACM's investment in Citicorp notes as "fleeting and inconsequential" the Third Circuit viewed the true substance of what occurred as ACM passing $175 million of cash through Citicorp notes before converting 80% of it back to cash and the other 20% into LIBOR notes. 157 F.3d at 250.

[111] Relying on *Goldstein* and its earlier opinion in *Wexler* (which in turn had relied heavily upon *Sheldon*), the court rejected ACM's argument that the Tax Court improperly applied *Gregory* in conducting a "generic tax-independent" inquiry into the non-tax purpose and pre-tax profitability of the CIS transaction. Undertaking an inquiry into ACM's business purpose and the potential profitability of the CIS transaction, the court concluded that contrary to ACM's contention, the Citicorp notes were not an accommodation to acquire the debt that Colgate wished to retire, but rather the timing of the acquisition of the Colgate debt was determined so as to accommodate the CIS transaction. It also

found that the Citicorp notes were ill-suited for the proffered purpose because of their illiquidity which resulted in substantial transaction costs. 157 F.3d at 254-55. The Third Circuit also concluded that the CIS transaction had been planned and executed without any regard to their pre-tax economic consequences, the attendant transaction costs, and the fact that the value of the LIBOR notes would have declined had interest rates behaved in the manner predicted by Colgate. The court cited *Sheldon* in dismissing ACM's contention that the Tax Court overestimated the rise in interest rates necessary to render the CIS transaction profitable as immaterial in the face of falling interest rates and at best demonstrable of a nominal, incidental pre-tax profit which would not support a finding of a non-tax profit motive. Indeed, the facts in *ACM Partnership* on the issue of nominal, incidental pre-tax profit are far worse then they were in *Sheldon.*

[112] The District of Columbia Circuit approached the Merrill Lynch sponsored CIS transactions somewhat differently in *ASA Investerings Partnership,* 201 F.3d 505 (D.C. Cir. 2000) (involving a Merrill Lynch CIS deal sold to Allied Signal Corporation), *Saba Investerings Partnership,* 273 F.3d 1135 (D.C. Cir. 2001) (involving a Merrill Lynch CIS deal sold to Brunswick), and recently in *Boca Investerings Partnership,* 314 F.3d 625 (D.C. Cir. 2003) (involving a Merrill Lynch CIS deal sold to American Home Products). In each of these cases, the court denied the claimed loss deductions on the grounds different from those employed in *ACM Partnership*. The rationale applied by the District of Columbia Circuit in denying the claimed losses was that there was no non-tax business purpose for its partnership with the foreign entities, other than the need to employ that form in order to carry out the CIS scheme.

[113] 157 F.3d at 261-262.

[114] *Compare, e.g., Fox v. Commissioner*, 82 T.C. 1001.

[115] *See, In Re: CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002); *Winn Dixie Stores, Inc. v. Commissioner,* 113 T.C. 254 (1999), *aff'd,* 254 F.3d 1313 (11th Cir. 2001), *cert. denied,* 535 U.S. 986 (2002); *American Electric Power v. United States*, 136 F. Supp 2d 762 (S.D. OH 2001), *aff'd*, 326 F.3d 737 (6th Cir 2003). The Service's string of successes in this area has been halted, at least temporarily, by the district court's opinion in *Dow Chemical Co. v. United States*, 250 F. Supp 2d 748 (E.D. MI 2003).

[116] The broad based COLI plans at issue in *CM Holdings*, *Winn Dixie* and *American Electric Power* were generally structured to comply with the stricture of §264 that interest was not deductible on policy loans in excess of $50,000 by having the corporate participant purchase life insurance policies on the lives of its employees. *See, e.g.*, 113 T.C. at 264. Essentially, the COLI plans were structured to provide the maximum tax benefit through high nominally level premiums and high policy loans.

[117] 253 F.3d 350 (8th Cir. 2001).

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118 277 F.3d 778 (5th Cir. 2001).

119 113 T.C. 214 (1999).

120 277 F.3d at 786.

121 Without pointing to any specifics in the record, the court then simply went onto conclude that "the evidence shows that Compaq actually and legitimately also sought the (pretax) $1.9 million profit it would get . . . ." *Id.* at 787. With apologies to Jackie Gleason, the Fifth Circuit's holding that Compaq had a subjective non-tax motive for the ADR transactions was "Kramdenesque" -- "hamina, hamina, hamina." The Fifth Circuit was not alone in this regard. In *IES*, the Eighth Circuit confined its "discussion" of IES's non-tax motive or profit motive to stating that "a taxpayer's subjective intent to avoid taxes . . . will not determine whether there was a business purpose to a transaction." 253 F.3d at 355.

122 277 F.3d at 787, n.8. The Service might have been better served challenging the claimed loss as opposed to the foreign tax credit. The court's efforts to explain away the fact that this transaction would not have been done absent a perfect alignment of all tax conditions by reference to yields on tax-exempt bonds v. non-tax exempt bonds is at best sophomoric. Judge Jones simply confused a situation where an investment of substance is made in one vehicle as opposed to another (bona fide investment in tax-exempts v. taxables), with a preconceived planned fleeting and inconsequential "acquisition" of the ADRs. *Compare, ACM Partnership*. Moreover, while the purchaser of tax-exempts may get less on a pre-tax basis then he would have from taxable bonds, he is not "investing" in a transaction that would yield him a pre-tax loss absent his particular tax circumstances.

123 The reliance by both courts on *Old Colony Trust Co.*, 279 U.S. 716, 729 (1929), missed the mark. While technically correct that the amount of income should be the gross dividend as opposed to the net dividend, both courts failed to adequately explain why foreign taxes do not represent transactional costs. 253 F.3d at 354. The reason for the allowance of a foreign tax credit against United States Income tax is to prevent double taxation of income. As such, it is properly viewed as a defensive section. The use of this defensive provision as a sword, rather than as a shield, in order to avoid tax on income unrelated to the dividend (*i.e.,* tax on an unrelated capital gain), is an inappropriate use of the foreign tax credit provisions.

124 If as the Fifth Circuit has held, Compaq had a $1.9 million profit on its ADR transaction, then should not Gallagher, the other side of the ADR transactions, also have sustained a $1.9 million loss? The answer is of course not, as it is safe to assume that Gallagher would not have been in business very long exercising such trading "acumen." Gallagher's role in the ADR transaction was essentially that of a middleman or facilitator between Twenty-First Securities' clients and

the tax-exempt entities who were trading on their exemption when they loaned to him the ADRs used in the transactions at issue. *Id.* at 352.

[125] 277 F.3d at 785.

[126] 651 F.2d 1058 (5th Cir. 1981), *rev'd,* 461 U.S. 1215 (1983), wherein the Fifth Circuit ignored established precedent when it held that in determining amount realized nonrecourse debt only had to be included to the extent of a property's fair market value.

[127] 277 F.3d at 787. The only risk to Compaq was that the Service might challenge its ADR transactions and that the Service's determination would be upheld.

[128] Compare, *ACM Partnership*, discussed at notes 108 through 114, *supra*.

[129] Query, whether Judge Jones would have been so quick to bless this "pig-in-a-poke" if it had been purchased by an individual taxpayer or closely held C Corporation?

[130] 113 T.C at 220.

[131] 90 T.C. 372 (1988), *rev'd*, 890 F.2d 848 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991).

[132] 90 T.C. 171 (1988), *aff'd without published opinion* 886 F.2d 1318 (7th Cir. 1989).

[133] Any institution desiring to trigger advantageous federal tax consequences through a swap could have done so. The trick, however, was not to engage in transactions which would cause them dire regulatory consequences. What was needed was the cooperation of their regulatory agency, the Federal Home Loan Bank Board ("FHLBB"), and the FHLBB willingly lent its assistance to the savings and loan industry. It simply modified its reporting requirements through the issuance of Memorandum R-49 ("R-49"). 90 T.C. at 388-89. The only requirement imposed by the FHLBB in exchange for its agreement to become a participant in this arrangement was that the mortgage loans involved had to be "substantially identical." R-49 set forth the criteria that had to be met and the mortgage swaps were carefully matched to insure compliance with the requirements of R-49. Neither the taxpayer nor its trading partners engaged in any evaluation of the interests being swapped beyond their compliance with R-49.

[134] *Id.* at 384.

[135] The purpose of the swaps was tax savings through the recognition of losses. Each of the parties to these swaps derived the same tax benefit; consequently, there was no arms-length dealing with respect to the allocation of tax benefits --

each of the trading partners won, while the Treasury lost. Moreover, given the purpose of R-49, the facilitation of the recognition of tax losses while at the same time not substantially affecting the economic position of each of the reciprocating parties, and the absolute deference paid to its criteria the parties surely did not act at arms-length in an economic sense either. The parties did not expect or anticipate that any meaningful change in economic position would result from the swap. The fact that the parties did not retain the right to pursue reimbursement from one another was clearly not motivated by any real desire to shift risk since the instruments in question were deemed to be substantially identical.

[136] 890 F.2d 848, 852 (6th Cir. 1989), *rev'd*, 499 U.S. 554 (1991). The requirements of §165, that a claimed loss be "*bona fide*" and be "actually sustained," are additional hurdles that a taxpayer seeking to deduct a loss must overcome. *See,* the text accompanying notes 14 through 17, *supra.*

[137] It relied, however, on a number of "created loss" cases -- *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir. 1935), *cert. denied*, 296 U.S. 586 (1935); *Horne v. Commissioner*, 5 T.C. 250 (1945); *Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977); *Davis v. Commissioner*, 586 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979); *Keats v. United States*, 865 F.2d 86 (6th Cir. 1988) – whose facts were distinguishable from those present in *Cottage Savings*.

[138] Writing for the majority, Justice Marshall insinuated that had the Service been more supportive of the Sixth Circuit's approach, the §165 issue might have received serious consideration by the Court. The Court did state that "[i]n view of the Commissioner's failure to advance any other arguments [beyond *Higgins v. Smith*] in support of the Court of Appeals ruling ... we conclude that, *for purposes of this case*, Cottage Savings sustained its losses within the meaning of §165." *See,* 499 U.S. at 568. (Emphasis added). *See, also,* Loren D. Prescott, Jr., *Cottage Savings Association v. Commissioner: Refining the Concept of Realization*, 60 Fordham Law Rev. 437, 447 (1991).

[139] Esmark "pursued the tender offer/redemption format primarily because it was believed to result in no recognition of taxable income to [it] and would, therefore, provide [its] shareholders with the highest end value for their Esmark stock." 90 T.C. at 176.

[140] *Id.*

[141] *Id.* at 183. However, none of the arguments advanced asked the court to declare the transaction to be either a factual or economic substance sham. In the final analysis, *Esmark* was primarily a step transaction case. Its citation in the context of a sham case is therefore surprising.

[142] *Compare, Andantech, L.L.C. v. Commissioner*, T.C. Memo 2002-97, *aff'd in part & remanded for reconsideration in part,* 331 F.3d 972 (D.C. Cir 2003), wherein the Tax Court utilized the economic substance sham doctrine, the step

transaction doctrine as well as numerous other grounds in support of its rejection of the cross border computer sale-leaseback at issue in that case. Unlike its approach in *Esmark*, the Tax Court in *Andantech* examined the various component parts of the transaction at issue.

[143] 1994 U.S. Dist. LEXIS 411 (E.D. PA 1994), *aff'd without opinion*, 37 F.3d 1488 (3rd Cir. 1994).

[144] *Id.* at 21. The court noted that there was no offsetting transaction or investment that washed out the debt.

[145] 270 F.2d 294 (3rd Cir. 1959).

[146] 1994 U.S. Dist. LEXIS 411 at 26.

[147] Perhaps it did so because the district court had reached a result which was consistent with the circuit court's view of what the outcome should have been, but which was suspect from a legal standpoint. It appears that the district court may have applied the "*Sheldon* rule" in *Peerless Industries*. *See*, note 99, *supra*.

[148] *See, e.g., In Re: CM Holdings, Inc.*, 301 F.3d 96.

[149] T.C. Memo 1999-268.

[150] 254 F.3d 1014 (11th Cir. 2001).

[151] The plan involved the following steps. Following its formation, the stock of OPC was distributed to the UPS shareholders as a dividend. UPS then purchased an insurance policy from a third party insurer pursuant to which that insurer assumed the risk of loss from excess-value business. UPS continued to collect EVCs and these were the source of the premium payments made to the third party insurer. In addition, UPS continued to interact with its customers regarding claims. The third party insurer entered into an agreement with OPL whereby OPL assumed the excess-value risk, and received a payment from the insurer equal to the premium it had received from UPS, less commissions, fees and excise taxes.

[152] 254 F.3d at 1018.

[153] *Id.* at 1019. While this argument has a certain degree of superficial appeal it ignores the fact that UPS was not publicly traded and that it essentially was employee owned; thus, the OPL shareholders were the UPS shareholders.

[154] This conclusion ignores UPS's assertion that it hoped to develop OPL into a full line insurer. *Id.* at 1021 (Ryskamp Dissent).

[155] In *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993), the Sixth circuit did not adopt a conjunctive test. Rather, the court was simply referring to the

fact that after a determination regarding the economic substance issue was made, a court would have to inquire into the individual taxpayer's subjective profit motive in order to apply §165(c). Later Sixth Circuit cases make it clear that the rule in that circuit is that the objective and subjective inquiries associated with the sham transaction doctrine are simply more precise factors to be considered in evaluating economic substance. *See, e.g., American Electric Power v. United States*, 326 F.3d 737 (6th Cir 2003).

[156] 253 F.3d at 355. In fact, the Eighth Circuit in IES hinted that the rule in that circuit may be closer to a conjunctive standard than a disjunctive one. *Compare, Shriver v. Commissioner*, 899 F.2d 724 (8th Cir. 1990) (objective analysis and subjective analysis are factors in determining the substance of a transaction).

[157] 277 F.3d at 781-82.

[158] A comparison of *Compaq Computer* and *ACM Partnership* reveals that the manner in which the objective and subjective components of the economic substance sham doctrine were applied -- conjunctive, disjunctive or factors -- had little to do with the outcome in either case. Rather, the outcomes were the result of judicial preference and the analytical approach adopted by each court.

[159] S. Rept. No. 108-11

[160] *See*, Prop. §7701(m) (1)(B)(i). It is the intent of the Senate to adopt a conjunctive test rooted in traditional economic substance concepts.

[161] S. Rept No. 108-11 indicates that "the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities."

[162] S. Rept. No. 108-11.

[163] *See, e.g.,* Tax Executives Institute, *IRS Must 'Challenge' Questionable Transactions, TEI Urges*, 2003 TNT 151-21 (August 6, 2003); New York State Bar Association Tax Section, *Economic Substance Codification*, 2003 TNT 121-26 (June 24, 2003); *but see*, Samuel Thompson and Robert Clary, *Coming In From The "Cold": The Case For ESD Codification*, 25 Ins. Tax Rev. 117 (2003).

[164] S. Rept. No. 108-11.

[165] The rule for determining the adequacy of the profit potential in a transaction is set forth in Prop. §7701(m) (1)(B)(ii)(I). This test need not be satisfied in order for a transaction to have economic substance. If, however, a taxpayer asserts that existence of profit potential as the basis for a finding that a transaction will effect a "meaningful change in economic position," then the profit potential rule is applicable. The committee report specifically states that "a reasonable possibility of a profit" will not suffice under this provision.

[166] *See*, Prop. §7701(m) (1)(B)(ii)(I).

[167] *See*, Prop. §7701(m) (1)(B)(ii)(II).

[168] As these items represent the major tax advantages in a leasing transaction, it is not unreasonable to conclude that leasing activities are as a practical matter exempted from an economic substance inquiry under the proposed statutory change. The report does indicate that the Service is free to challenge the economic substance of a transaction where the transaction would not withstand scrutiny under current standards (*e.g.*, where equipment is overvalued).

[169] *See*, Prop. §7701(m) (1)(C).

[170] Lee Sheppard urges that the ideal standard should be one which incorporates risk, business purpose, and sufficient profit not in the alternative but rather in the conjunctive. 24 Ins. Tax Rev. at 874. This approach represents a good analytical starting point, but more is required.

[171] Prop. §7701(m)(2).

[172] 380 U.S. 563 (1965).

[173] Professor McMahon would limit a corporations ability to deduct losses under §165(a) to profit seeking activities. Martin McMahon, *Beyond a GAAR: Retrofitting the Code to Rein In 21st Century Tax Shelters,* 98 Tax Notes 1721, 1738 (March 17, 2003). Professor McMahon would, however, apply a different profit motive standard than that applicable to individual taxpayers under §165(c). Essentially he is advocating adopting a standard similar to that which has been applied in the context of the subjective "prong" of the economic substance sham doctrine. There is no reason to perpetuate the disparity of treatment between individual and corporate taxpayers. In determining whether a loss is deductible pursuant to §165, a corporate taxpayer, just like any other taxpayer, should be made to demonstrate that it entered into the transaction was primarily for profit. Moreover, even if a particular transaction can be arguably linked to normal corporate business activity, it should no longer be assumed that these activities are *per se* business related or driven. If the activities of an individual taxpayer can be denied "trade or business" status, so too, should the activities of a corporation be subject to similar judicial scrutiny.

[174] There simply is no reason why individuals and closely-held C corporations should be subject to these rules while large corporations are exempt. Professor McMahon has expressed his belief that the "at risk" rules should be extended to all taxpayers. *See,* McMahon, 98 Tax Notes at 1740-1741. Professor Eustice has suggested that the time may have arrived to extend both the "at risk" and "passive activity loss" rules to all taxpayers. *See,* James Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles,*" 55 Tax L. Rev. 135, 167 (2002).

[175] In this regard, it should be noted that Judge McKee comments in *ACM Partnership* regarding the approach taken by some in the judiciary are on target. For example, there is no doubt that courts often apply a "smell test" or react viscerally to a particular transaction. 157 F.3d at 265. Many times the visceral reaction complained of by Judge McKee works in favor of a taxpayer. *See, e.g., Cottage Savings; Esmark; United Parcel Service.*

[176] As used in this Section III(C) the term "transaction" is intended to also include a part of an overall transaction. This bifurcated approach is consistent with existing case law. *See, e.g., Rice's Toyota; ACM Partnership.*

[177] The CARE Act approach of making the determination as to adequacy of profit dependent solely upon a comparison of the expected pre-tax profit and the expected tax benefits from the transaction is inappropriate primarily because of its inherent inflexibility. It is arbitrary, and while having some superficial appeal because of its apparent ease of application, is neither fair nor reasonable in its effort to hold all transactions to the same quantitative standard.

BE CAREFUL IN THERE!
MORE FALLING THAN PRICES AT THE HOME DEPOT

by

Dr. Sharlene A. McEvoy*

INTRODUCTION

The Home Depot, the home improvement warehouse retailer, has been called the "best retailer of the 20^{th} century."[1] With its 1081 stores (as of November 2000) and possibly 800 more in the next three years,[2] it has been a mecca for do-it-yourselfers and contractors looking for a wide selection of building materials at low prices. The merchandising behemoth has also been a magnet for lawsuits because many shoppers have been injured on its premises and have sued the company. While many stores are sued for so-called "slip and fall" injuries, it appears that Home Depot's warehouse outlet merchandising style leaves it more vulnerable to these lawsuits. This paper will analyze nearly a score of cases in which The Home Depot's layout or placement of merchandise led to injuries to customers. These cases fall into a predictable pattern: goods fall on customers as they are shopping, customers trip over bulky goods in the aisles or at the corner of aisles, or customers are injured by other patrons carrying bulky goods within the store.

LOOK OUT BELOW (MERCHANDISE FALLING ON CUSTOMERS)

Among the lawsuits against Home Depot, the most common are brought by injured plaintiffs suing because an item has fallen on them. These cases include:

Nathan v. the Home Depot[3], Mitchell v. the Home Depot[4], Morris v. Home Depot, USA[5], Repecki v. Home Depot, USA[6],

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Heffernan v. Home Depot, USA[7], Hernandez v. Home Dept, USA Inc.[8], Pincau v. Home Depot, Inc.[9], Cook v. The Home Depot, Inc.[10], Sanchez v.The Home Depot, Inc.[11], McLennan v. Home Depot, USA, Inc.[12]
Kirhagis v. Home Depot, USA, Inc.[13]

One might think that the liability of the store would be clear but The Home Depot has mounted vigorous defenses in these cases and have been successful in escaping liability in many of them.

In Nathan v. The Home Depot[14], Sandra Nathan was injured while walking in an aisle of the store when a piece of lumber fell from an overhead shelf. Just before the wood hit her, she held up her hands toward it off and twisted her body to get out of the way. The board struck her right wrist and arm causing a fracture.[15] Later when the pain did not abate, she was diagnosed with a nerve injury in the area between the elbow and the wrist. After continuous treatment and physical therapy, her symptoms did not improve and she was diagnosed with a cervical disc problem and a herniated disc. When conservative treatment failed, she underwent surgery for a cervical disc fusion.[16] After a trial a jury agreed that Home Depot was liable and awarded $500.00 for medical expenses and $12,000.00 in general damages.[17]

Nathan appealed the size of the verdict claiming that it was too small in light of the injury she sustained. Nathan's doctor testified that Nathan's disc problem was aggravated by the accident at Home Depot but that she had had a previous cervical injury because of an auto accident in 1974. A doctor engaged by Home Depot questioned whether Nathan's ruptured disc was actually caused by the falling lumber.[18] Nevertheless, the appeals court raised the jury's verdict on medical expenses from $500.00 to $1445.34.

Another hotly contested case was that of Mitchell v. the Home Depot[19] where the facts were similar to those of Nathan. Sylvia Mitchell was shopping for an air conditioner filter at a Home Depot store in Jefferson Parish, Louisiana when a wooden pallet, propped against a merchandise rack near the filters, fell and struck her in the back causing her to fall.[20]

The court found that it was store policy for employees to move empty pallets from the aisle to the rear of the store for storage as soon as possible after the merchandise was unloaded but that store employees were also required to wait on customers prior to performing other duties. Therefore the removal of empty pallets was often delayed and the pallets were left propped against display shelves. The court noted that there was "no provision for tying the pallets to the shelves, or making other arrangements to prevent the pallets from falling."[21]

The court concluded that such store practice was negligent and that Home Depot should have provided protective measures or a place to safely store the pallets where they were less likely to injure customers. Based on the testimony of witnesses, the pallet had been there for some time, according to one, for at least ten minutes.[22] The court also found it negligent for the store not to provide additional employees to inspect and remove the pallets from aisles used by customers, and unreasonable to expect that store employees who were responsible to wait on customers also had to remove empty pallets from the aisles.[23]

The Home Depot contested Mitchell's claim with its usual vigor, suggesting that she caused her own accident by bumping into the pallet. But the court found no such evidence stating that even if Mitchell did inadvertently come in contact with the pallet causing it to fall on her, it was a foreseeable hazard because customers looking at merchandise might bump into them or that "vibrations caused by customers or the impact of shopping carts might dislodge them."[24]

Mitchell complained about neck and back injuries, which included tingling, numbness and radiating pain in her right arm and ribcage. Her doctor concluded that she had suffered a broken rib and that she had aggravated preexisting conditions in her cervical and lumbar regions. Subsequently, she underwent four surgeries on her neck and back. Like Nathan, Mitchell had been in a car accident and had had ten operations on her neck and back prior to the accident in the store. After parsing the effects of her previous accidents and surgeries, the court awarded Mitchell $63,187.87 for pain and suffering, physical disability, past and future medical expenses and aggravation to pre-existing injuries.[25]

The court concluded as a matter of law that a merchant owes a duty to persons who use his premises to exercise reasonable care to keep his aisles, passageways, and floors in a reasonably safe condition. The duty includes a reasonable effort to keep the premises free of any hazardous conditions, which reasonably might give rise to damage.[26] While a shopper has a responsibility to keep a lookout, this duty "is diminished when shelved merchandise distracts his or her attention."[27]

In Morris v. Home Depot, USA,[28] the injury also involved a pallet but this time the customer was unsuccessful in holding the store liable. Michael Morris went to The Home Depot store in Florida to look at unfinished vanities. He claimed that he heard a creaking sound, looked up and saw boxes falling. Morris stated that he tried to push them back into place because he knew he would not have time to get out of the way. He remembered falling backward over something but nothing else until he woke up in the hospital.[29] Subsequent to the accident Morris suffered a loss of memory due to being hit on the head by the falling boxes.

Home Depot brought witnesses and evidence to show that the tall stack of boxes piled up on pallets in the aisle fell on Morris because he pulled the stack over on himself by trying to climb up on them.[30] So the court found in favor of Home Depot. The dissenting judge argued that under the circumstances the jury should have been instructed as to the doctrine of res ipsa loquitur, which allows a jury to draw an inference of negligence "where the instrumentality causing the injury was under the exclusive control of the defendant. And the accident is one that would not, in the ordinary course of events, have occurred without negligence."[31]

The dissenting judge pointed out that Morris was standing in the aisle of a large retail store where customers are expected to roam. Stacked from floor to ceiling were piles of boxes containing merchandise for sale, which had been put there by employees of the store. The dissenter stated, "They should not topple over and fall on top of customers shopping in the aisles . . ."[32]

The Home Depot did not fare so successfully the following year in Repecki v. Home Depot, USA.[33] The facts of Repecki are familiar. On June 17, 1995, Glenn Repecki was a 31-year-old self-employed home improvement contractor, who was shopping at the

Valley Stream store, where he later estimated that he had shopped "at least 100 times."[34]

Mr. Repecki arrived at the store with a customer. The latter wanted Repecki to do a home improvement project at his home and was purchasing the materials. Repecki secured a lumber cart to hold the moldings and boards he had selected. After placing these items on the cart Repecki walked toward a shelf and as he was within a foot of it, a board dropped off a higher shelf and crushed his left big toe.[35]

The 8-inch wide, 1 inch thick and 8 foot long board that struck Repecki had been stored in a bin four feet above the floor. The lumber was held in the bin by a 1-1/2 inch toeboard, which stretched across the front of the bin, which was described as fairly full. The boards were in the bin haphazardly. Before the accident Repecki had not touched any of the boards in the bin but did see them on top of the toeboard.[36] The plaintiff introduced photographs illustrating the condition of the boards as well as photographs of similar containers in five other Home Depot stores on Long Island.

The plaintiff's evidence was confirmed by a "loss prevention" supervisor at the store who testified that some stores stacked the lumber vertically in bins 3-3-1/2 feet above the floor. The supervisor also testified that store employees would straighten out the lumber several times a day.[37] He conceded that Home Depot "was a self-service warehouse and the customers were encouraged to remove the lumber themselves."

The court stated that a retail storekeeper is required to use reasonable care to prevent objects for which he is responsible from falling and causing injury to persons lawfully in the vicinity. Significantly, the court noted, "Particularly in self-service stores, it is reasonably foreseeable that material stored and piled on high shelves may fall, striking a customer."[38]

The court was convinced that the plaintiff proved to a preponderance of the evidence that Home Depot "created a condition setting the stage for a potentially dangerous and a reasonably foreseeable situation by placing the large lumber of boards in a vertical condition in a bin 3-1/2 feet above the floor rather than at ground level. Repecki also proved that "Home Depot had actual knowledge that . . . the lumber boards were in a dangerous condition, namely placed on top of other boards in a precarious position."[39]

True to form, Home Depot argued that Repecki was contributorily negligent and even Repecki conceded that he had noticed lumber resting precariously on the toeboard on prior occasions and that on the day of the accident he could have pushed the boards back.

The court found that a "reasonably prudent customer would have been more careful in walking near the bin knowing that heavy lumber boards were hazardously placed."[40] The court concluded that Home Depot was 85% and Repecki was 15% negligent. The latter's doctor testified that he will have permanent pain and stiffness in both joints of the big toe requiring him to use a stiff shoe for the rest of his life. The defense's orthopedic surgeon confirmed the diagnosis so the court awarded Repecki $10,000 for injuries and pain and suffering and $25,000 for stiffness and continuing aggravation of the arthritic condition of the toe and $3800 for the loss of wages for a total of $38,800 diminished by 15% for contributory negligence for $32,800.[41]

The Home Depot was more successful in staving off a claim in Pineau v. Home Depot, Inc.[42] Pineau was shopping at a Connecticut Home Depot store when he was struck on the knee by a box of tiles that fell from a shelf 14 feet high causing him permanent injuries. Pineau claimed that the store's employees were stocking shelves with a forklift in an adjacent aisle when they negligently caused the box to fall on Pineau who was on the other side.[43]

A Home Depot employee, one Wilezynaki testified that on the evening of the incident he was raising pallets of tiles from the floor to the high shelves. He said he did not check to see if there were any boxes already on the shelf before he started loading. During the process of moving the tiles, he and another employee heard a noise and ran to the next aisle to see what had happened. The employee spoke to Pineau and then called the manager. The employee testified, "that this was not the first time that merchandise had fallen off shelves while employees were using the forklift." He also claimed that customers cannot reach the high shelves because the ladders are too short.[44]

Another employee Grimshaw testified that he was using the forklift to remove the boxes of files from the shelf. He heard the box fall as he was unloading a box on his side of the aisle. He also stated that the usual time to load and unload shelves was early in the morning and late in the evening. At the time of the accident however, the store was open to the public.[45] He testified that Wilezynski was "spotting" him from the ground to be sure that no one was in the aisle near the forklift but that there was no employee guarding the aisle where Pineau was shopping.[46] Despite clear testimony as to Pineau's injury and that of the Home Depot's employees, evidentiary issues conspired to defeat the plaintiff's case.

Home Depot was also successful in fending off a claim in Heffernan v. Home Depot, USA, Inc.[47] Peter Heffernan was a customer at a Georgia Home Depot when a paint sprayer fell off a shelf and injured his shoulder. Evidence showed that the paint sprayer was stored on a recessed shelf five feet, ten inches off the floor. Heffernan was six feet tall and so had no problem seeing or reaching it. When Heffernan touched the hose on the sprayer, it fell from the shelf. He claimed that it had been improperly assembled by the store but brought forward no evidence to prove it.[48] Heffernan also argued that the display was unsafe. Home Depot countered that the paint sprayer display had been inspected several times during the week prior to the accident and daily checks were done to see that displays were assembled properly. In addition, signs were posted in the area-advising customers to ask for assistance. There also was no evidence presented that there had been any previous accidents with the display. Countering Hefferman's claim, Home Depot presented evidence that he "failed to exercise ordinary care for his own safety."[49] A Home Depot employee testified that although he asked Heffernan repeatedly if he needed help, the latter ignored him. In addition, he placed his foot on a beam two feet off the ground to climb on the display.

The court found that Home Depot exercised ordinary care in keeping its premises safe and that a jury could find that Home Depot's frequent safety inspections were reasonable and the store had no reason to anticipate a hazard "it had no reason to believe existed . . ."[50] Home Depot presented a vigorous defense as its counsel attempted to cast doubt on Heffernan's deposition by questioning him about a prior crime. Heffernan answered several questions about the crime until his attorney objected.[51]

The jury found in favor of Home Depot and the Georgia appeals court affirmed the verdict. Home Depot's handling of this case typifies its aggressive stance in all of the claims brought against the store.

Cook v. the Home Depot, Inc.[52] is a case similar in many ways to Heffernan, including the outcome. Cook was injured in a Georgia Home Depot when a piece of plywood measuring four feet by one half inch fell on his foot. Cook approached a stack of plywood sheets five feet high but because of the height of the pile, he could not see the top piece. When he touched it, it fell on his foot and broke it.[53] Cook argued that Home Depot was negligent by failing to keep the premises safe, failing to store the plywood properly, failing to warn customers about the danger of moving lumber without help and failing to have enough employees to assist customers in the lumber area.[54]

The Court commented that before an invitee can recover damages, he must show that the proprietor of the store knew of a "dangerous instrumentality" on the property.[55] The Court found that Cook made no showing that the store was aware of the condition of the stacked plywood.

Cook argued that Home Depot had constructive notice of the condition of the plywood because of prior similar incidents. But the Court found that the only other incident involved lumber being pulled down by customers or other articles being dropped by customers and "these are not sufficiently similar to give Home Depot constructive notice of any defect in the stacking of the plywood such as would cause the incident described.[56]

The Court also stated that Cook presented no evidence that Home Depot stored the plywood improperly nor was there any evidence of how the plywood should have been stored. Cook also did not dispute the notion that customers will sometimes rearrange a stack of plywood to obtain the piece they want.[57]

While Cook claimed that the store did not have enough employers to help customers, he conceded that he did not seek assistance before removing the lumber.[58] On all counts the Court found that Cook's claims fell short.

In Hernandez v. Home Depot, USA[59] the issue was not falling lumber but a falling can of insecticide that injured Miriam Hernandez's eyes. When the jury found for Home Depot, Hernandez appealed and the Florida appeal court found that the trial judge had wrongly excluded expert testimony presented by the plaintiff's safety consultant that its method of stacking the product did "not meet the general retail safety standards in the industry and resulted in the store maintaining an unsafe condition."[60]

Like Hernandez, the plaintiff in Sanchez v. The Home Depot[61] sued when he was struck by an even larger object, which fell from a shelf at The Home Depot. On November 3, 1995, Carlos Sanchez was shopping in a New York Home Depot when a sink fell from a shelf hitting him on the hand.[62]

While Sanchez conceded that there is no evidence that Home Depot placed the sink on the shelf or that it had actual or constructive notice of the placement of the sink, what Sanchez relied on was res ipsa loquitur, "the thing speaks for itself." Among the elements of the doctrine is that "the instrumentality is within the exclusive control of the defendant."[63] Home Depot argued that it did not have exclusive control over the sink because "the sinks were displayed in an open box accessible to all customers."[64]

Sanchez countered that it was more likely that a store employee and not a customer placed the sink on the shelf some time prior to the incident because the shelf from which the sink, estimated as weighing 10-12 pounds, fell was 16 feet high.[65] The Court resolved all ambiguities in favor of the plaintiff-Sanchez and ordered a trial on the issues.

Bricks that fell from a shelf at a Michigan Home Depot were the issue in McLennan v. Home Depot,USA.[66] On May 25, 1997, Mary E. McLennan was shopping for bricks at a Home Depot when she was severely injured when she was hit on the head by bricks that fell from a shelf. Evidence showed that no one was touching the stack when the bricks fell [67] but a popping sound was audible before the bricks fell. Home Depot argued for a summary judgment because there was no evidence that an unsafe condition existed at the store and that McLennan failed to exercise ordinary care for her own safety. Furthermore, Home Depot said McLennan's evidence of causation was based upon speculation and conjecture, and it was thus not adequate to establish liability.[68]

McLennan countered that there was circumstantial evidence from which a reasonable juror could conclude that an unsafe condition existed on Home Depot's premises because the popping sound was that of the metal band breaking. McLennan claimed that she relied on the security of the metal band wrapped around the bricks and did not perceive any danger that she would need to exercise care.[69]

The court concluded that the plaintiff had demonstrated that there was an unsafe or defective condition that did in fact exist at Home Depot. McLennan provided a safety consultant's report, which stated that the bricks were not displayed in a safe and reasonable manner. The report suggested alternative ways that the bricks could have been stacked to provide more safety for patrons. The expert contended that the bricks could have been "shrink wrapped" with a protective barrier installed overhead. The court believed that a jury could find that an unsafe condition existed on the premises.[70]

Although Home Depot claimed that McLennan could not prove that its negligence was a proximate cause of her injuries, the court noted that Michigan courts have permitted res ipsa loquitur to be employed as a device to permit recovery. The court stated that the incident is not the type that occurs in absence of someone's negligence. "Bricks should not fall if properly stacked and secured." Securing the bricks and maintaining their display in good repair is the duty of the business invitor."[71]

The court also did not accept the notion that McLennan failed to exercise ordinary care of her own safety by not asking a sales associate for assistance and handling the bricks herself. Nor did it accept The Home Depot's argument that "the brick display was an open and obvious danger for which the defendant owed no duty to warn or protect and that McLennan was expected to discover the defect herself."[72] The court thus denied The Home Depot's motion for summary judgment.

Kirhagis v. Home Depot, U.S.A.[73] is an unpublished opinion from the Federal Reporter. Like other victims, Kirhagis was injured by an item falling from a shelf. Kirhagis claimed injury from a bundle of metal studding that fell from the shelf of a Home Depot in Baltimore County, Maryland. Kirhagis claimed that the studding fell after a forklift operated by a Home Depot employee bumped into the shelves and dislodged the studding.[74] Kirhagis appealed an adverse ruling from the district court but the Court of Appeals upheld the lower courts because the plaintiff had not carried the burden of proof.[75]

TRIP AND FALL CASES AT HOME DEPOT

In addition to cases involving items falling from shelves and injuring customers, Home Depot has been sued for injuries caused by ladders and merchandise in its aisles. As with the cases with the falling items, the results in the lawsuits were mixed in the following cases. Nichols v. Home Depot, Inc.[76], Miranda v. The Home Depot, Inc.[77], Pielke v. Home Depot, U.S.A.[78], Read v. Home Depot[79], Maravalli v. Home Depot, U.S.A.[80], Michalskiv v. Home Depot, Inc[81]

Nichols v. Home Depot, Inc.[82] involved a customer who sued Home Depot for injuries when he fell from a ladder while attempting to retrieve some merchandise. The Home Depot denied liability. The case revolved around "overstock" which is placed at least eight feet above the floor, accessible only by ladder. The court found that a trier of fact could find that this method of storing overstock presents dangers to its customers because the store has adopted a set of standards to prevent customers from climbing ladders to reach this merchandise.[83]

Despite the fact that ladders were to be used only by store employees, they were accessible to customers and the court believed that there was a genuine issues of material fact that a jury could find that the store's method of stocking its merchandise was unorthodox, and that it violated every safety rule it had adopted to prevent accidents with ladders.[84]

The case of Miranda v. The Home Depot, Inc.[85] decided by the same Florida District Court of Appeals three years later also involved a ladder but in this case the customer hit her eye on the ladder in the store. Anita Miranda saw a planter at Home Depot that she wanted to buy located on a bottom display shelf blocked by a ladder. Miranda claimed that when she was unsuccessful in summoning an employee to assist her, she put her head, shoulders and upper torso through the ladder in order to retrieve the planter. As she tried to stand, she hit her right eye on a crossbar of the ladder and cut open an incision from her cataract surgery.[86]

When Miranda sued Home Depot moved for summary judgment arguing that there was no breach of reasonable care and that the ladder's presence was open and obvious, making the plaintiff's conduct the proximate cause of the accident. The trial court found in favor of the store and the appeals court affirmed.

The court found that the Nichols case was inapropos because in the latter case the customer climbed the store ladder and as he reached for merchandise then lost his balance and fell to the floor.[87]

Miranda relied on Nichols but the court disagreed because of the foreseeability of the risk of harm. In Nichols, it was foreseeable that a customer might mount a ladder but Miranda's injury was "an unusual occurrence: the customer reaching through the ladder and then forgetting her stance and withdrawing in a manner which caused her to hit the cross bar which she had moments earlier maneuvered through.[88] It was neither probable nor foreseeable that someone would injure themself in this manner.[89] Thus the court concluded that Home Depot breached no duty to its customers when it failed to anticipate the harm that befell Miranda.

In Pielke v. Home Depot, U.S.A.[90] the culprit was not a ladder but an eight-foot long pipe in the hands of a customer. Pielke and her husband were shopping at the Towson, Maryland store when they brought the items that they hoped to purchase to a checkout line. As he waited in line, she walked through the store's small tool section and was struck by a heavy pipe eight feet long, which was being purchased by a customer. The counter at this cashier station was shorter than the pipe so the pipe had to be held vertically or across the counter practically obstructing the aisle.[91]

After she was hit, Pielke turned toward the cashier station and saw a male customer and a female employee laughing at her. The male customer completed his purchase and apologized to Pielke. The employee did not try to determine the extent of her head injury or the identity of the customer.[92]

Pielke and her husband summoned the manager and explained what had occurred and asked the manager to bring some water. The latter agreed but did not return for forty-five minutes until Pielke's husband paged him! The manager explained that Home Depot was not responsible for the accident, that he would not fill out an accident report and that the Pielkes should have obtained the name of the customer themselves.[93]

Subsequent to the accident, Pielke suffered from severe tightness in the neck and shoulder pain, pain in her jaw and sinus problems. In addition she had a vitreous detachment with a large floater in her right eye causing her to see a large black dot obstructing her vision in certain circumstances.

Pielke alleged in her complaint that Home Depot failed to protect her from the risk of injury by other customers, that Home Depot ignored its duty to determine the extent of her injuries, to offer emergency medical assistance and determine the identity of the customer.[94]

Pielke lost on all claims. The court found that the risk of the long pipe in the hands of the customer was open and obvious and that a storekeeper's duty does not extend to dangerous conditions that are open and obvious to the invitee.[95]

The court also found that a business invitee has a duty to exercise due care for his or her own safety which includes a "duty to look and see what is around the invitee." The court said:

> Pielke clearly had a duty to exercise due care for her own safety. As part of this duty a customer in a self-service store can be expected to watch out for other customers hauling heavy merchandise that

> might easily be fumbled or dropped. Indeed Pielke presumably was aware of this risk when she entered the store with her husband to purchase various supplies and items for a home repair project and, prior to the accident had taken those items to another cashier station, engaging in the very sort of activity that led to her injury.[96]

The court concluded, "the risk of injury from customer mishandling of merchandise was as well known to Pielke as to Home Depot."[97] The court also found that Home Depot had no duty to render assistance to Pielke once her husband was on the scene nor did the store have an obligation to learn the identity of the pipe-wielding customer.[98]

In Read v. Home Depot, USA[99] the issue was an obstruction in the aisle of the store. Bobbie Read was a 60-year old who, with his sister and daughter, visited a Tennessee Home Depot looking for a light fixture. As the women were walking in the aisle looking at the lighted chandeliers overhead, Read did not see a carton protruding into the aisle further than the stack, tripped over it, fell and was injured.[100]

Although Home Depot moved for a summary judgment, the Tennessee Appeals Court found for Read. The court said:

> "The presence of the "cloud of light" for the express purpose of attracting the attention of customers placed a special duty of care upon the defendant to provide safety for the customers whose attention was diverted from their pathway to the ceiling."[101]

The court also noted that Home Depot employees had the duty to clear the aisle promptly of cartons by putting them on the shelves. They knew that cartons were in the aisle but left them in the walkway while they went to lunch.[102] Since her attention was drawn to the ceiling, Read's view of the floor was obstructed by her companions and the carton in the aisle, the court found that Read was not at fault.[103]

In Maravalli v. Home Depot U.S.A.,[104] the court found that, unlike the Read case, the presence of the sink vanity on the floor of the aisle was not an inherently dangerous condition because "the sink vanity's location was readily observable, and the defendant had no duty to warn the plaintiff of the condition."[105] The court said it is a well-settled rule that there is no duty on the part of a landowner to warn against a condition that can be readily observed by those employing reasonable use of their senses."[106] Home Depot was granted summary judgment.

Michalski v. The Home Depot, Inc.[107] also involved a fall. Jacqueline Michalski tripped and fell over a pallet resting on the forks of a forklift truck as she was shopping for bathroom cabinets. The cabinets in which she was interested were above eye level on the left side of the aisle. As she looked up at the cabinets, she stepped back for a better view and tripped over a pallet four feet wide, and four inches high. She filed suit in the New York State Supreme Court claiming that Home Depot "was negligent in creating a dangerous and hazardous condition." The store removed the case to federal district court, which granted summary judgment.[108]

Michalski claimed that Home Depot created a dangerous condition by leaving the forklift parked in an aisle and failed to protect her from or warn her of the dangerous condition. Thus the store should be held liable for her injury. Home Depot conceded that while it was responsible for leaving the forklift in the aisle, it should not be liable "because the condition was open and obvious to a passerby."[109]

The Court of Appeals remanded the case for further proceedings as to whether the pallet over which Michalski tripped was a hazard and whether it was an open and obvious condition. The court stated that a jury could conclude "that the average shopper in a retail store might not be familiar with forklift trucks and therefore not recognize the machine from the back as a forklift let alone anticipate or expect a pallet to be present at floor level."[110]

A jury, said the court, might find that a forklift was not obvious in a store "that draws a shopper's gaze up to twenty feet high shelves stacked with merchandise," or that Home Depot breached its duty to protect or warn Michalski of foreseeable harm to which she might be exposed as a visitor not expecting to encounter pallets on the floor or distracted by the merchandise for sale in the store.[111] The court concluded that a grant of summary judgment to Home Depot was inappropriate.

CONCLUSION

It is clear that one who sues Home Depot for injuries sustained in the store either from objects falling from shelves or merchandise left in the aisles, is in for a battle because the chain fights every case vigorously and has won many summary judgments.

What is surprising is given the chain's large warehouse type building with aisles bordered by shelves stacked from floor to ceiling with construction merchandise, the store is not more vigilant in warning customers of potential hazards from other patrons, or store employees. As one judge explained:

> The store is a working warehouse operation. Merchandise is replenished onto the shelves while the store is open to the public. The store's practice is to use forklifts to transport wooden pallets of merchandise to aisle ways used by customers. The pallets are set down in the aisles adjacent to the display shelving and the sales personnel unload the merchandise from the pallets and stock it onto the shelves while customers are shopping.[112]

As long as there have been self-service stores, there have been objects falling from shelves, dislodged by patrons or employees. In the case of The Home Depot, offering construction materials in a self-service format is a relatively recent development[113] and the consequences of falling products and tripping over items in the aisles can be dire.

What can be gleaned from these cases is that Home Depot is a very dangerous place to shop. There are threats to personal safety from careless employees, from customers who are carrying large unwieldy merchandise through the aisles and from the nature of the store itself, which permits heavy objects to be placed on high shelves. Heavy machinery like forklifts and pallets may obstruct aisles.

Once a person is injured at the store, Home Depot will fight vigorously choking off cases by moving summary judgment, contending that the injured customer contributed to his or her own injury or by arguing that the hazard in the store that led to the injury was "open and obvious." In most of the cases discussed in this paper, the store was most successful in avoiding liability in the cases where patrons fell down than when objects fell from its shelves. Nevertheless the plaintiffs who successfully held the store liable often had to engage safety consultants to help them prove that The Home Depot had breached its duty as a business inviter.

Despite its aggressive stance in lawsuits, in March 2001, The Home Depot finally decided to cleanup its cluttered stores. It has decided to stop the practice of having sales people stock shelves during the day. It is also removing wooden pallets from the aisles as well as the forklift trucks. This will be a departure from the vision of Arthur Blank and Bernard Marcus in 1979 when the first store opened in Atlanta "with sawdust on the scuffed floors and forklifts working the aisles."[114]

The numbers of lawsuits evidences that the busy warehouse atmosphere has become a problem. The new program is called SPI or Service Performance Improvement and should affect all stores by early 2002. Despite its aggressive defense in the civil suits discussed in the paper, the chain recognizes that limiting forklifts and stocking activities during the day will reduce accidents. In addition the chain has mandated that all merchandise on the top shelves be secured to a pallet with plastic wrap to prevent items from falling.[115]

Home Depot should also consider posting signs at entrances to its stores reminding customers that its layout poses potential risk and that customers should be vigilant given the nature of the merchandise and the store's operation. "Be Careful In There" is a caveat that should be observed by all that enter The Home Depot.

ENDNOTES

[1] Rick Brooke, "Home Depot Turns Copycat in Its Efforts to Stoke New Growth," Wall St. J., Nov. 21, 2000 at A-1 (hereinafter "Home Depot Turns Copycat".)

[2] Id. at A-16.

[3] 522 So 2d 712 (LA App 5 Cir. 1988).

[4] 1993 WL 302652 (F.D. La.).

[5] 673 So. 2d 521 (Fla. App. 3 Dist. 1996).

[6] 942 F. Supp. 126 (E.D.N. Y. 1996).

[7] 486 S.E. 2d 51 (Ga. App. 1977).

[8] 695 So. 2d 484 (Fla App. 3 Dist (1997).

[9] 45 Conn App 248 695 A. 2d 14 (Conn. App. 1997).

[10] 214 Ga. App. 133 447 S.E. 2d 35 (Ga. App. 1994).

[11] 1998 WL 812 571 (E.D.N.Y.).

[12] 10 F Supp. 2d 837 (E.D.Mich. 1998).

[13] 187 F. 3d 630, 1999 WL 507161 (4th Cir. Md.) (unpub. Opin.).

[14] 522 So 2d. 712 (supra, note 3).

[15] Id.

[16] Id. at 713.

[17] Id.

[18] Id. at 714.

[19] 1993 WL 302652 (supra, note 4)

[20] Id. at 1.

[21] Id.

[22] Id. at 2.

[23] Id.

[24] Id.

[25] Id. at 5.

[26] Id. at 6.

[27] Id.

[28] 673 So. 2d. 520 (supra, note 5).

[29] Id.

[30] Id.

[31] Id.

[32] Id. at 521

[33] 942 F. Supp. 126 (supra, note 6)

[34] Id. at 127.

[35] Id. at 128.

[36] Id.

[37] Id.

[38] Id. at 129.

[39] Id. at 130.

[40] Id.

[41] Id. at 131.

[42] 695 S. 2d. 14 (supra, note 9)
[43] Id. at 15.

[44] Id. at 17.

[45] Id. at 18.

[46] Id.

[47] 486 S.E. 2d 51 (supra, note 7).

[48] Id. at 52.

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[49] Id.

[50] Id.

[51] Id. at 53.

[52] 214 Ga App.133, 447 S.E. 2d 35 (Ga. App. 1994).

[53] Id. at 36.

[54] Id.

[55] Id.

[56] Id. at 37.

[57] Id.

[58] Id.

[59] 695 So. 2d 484 (supra, note 8).

[60] Id. at 485.

[61] 1998 W.L. 812571 (supra, note 11).

[62] Id. at 1.

[63] Id.

[64] Id. at 2d

[65] Id.

[66] 10 F. Supp. 2d 837 (supra, note 12).

[67] Id.

[68] Id. at 838.

[69] Id.

[70] Id. at 839.

[71] Id. at 840.

[72] Id.

[73] 187 F. 3d 630 (supra, note 13).

[74] Id.

[75] Id.

[76] 541 So. 2d 639 (Fla. App. 3 Dist. 1989)

[77] 604 So 2d 1237 (Fla. App 3 Dist. 1992)

[78] 155 F 3d 560 (4th Cir. 1998) (unpublished op)

[79] 1998 TN 30396 <http://www.versuslaw.com>

[80] 266 A.D. 2d 437 698 N.Y.S.2d 708 (A.D. 2 Dept. 1999).

[81] 2000 Co 2. 0042311 <http://www.versuslaw.com>

[82] 541 So. 2d 639 (supra, note 71).

[83] Id at 640.

[84] Id.

[85] 604 So. 2d. 1237 (supra, note 77)

[86] Id. at 1238.

[87] Id.

[88] Id. at 1239.

[89] Id.

[90] 155 F. 3d 560 (supra, note 79).

[91] Id. at 2.

[92] Id.

[93] Id.

[94] Id. at 3.

[95] Id.

[96] Id. at 4.

[97] Id.

[98] Id at 5.

[99] 1998 TN 30396 (supra, note 79).

[100] Id. at 3.

[101] Id. at 3-4.

[102] Id. at 4.

[103] Id.

[104] 698 N.Y.S. 2d 708 (supra, note 80).

[105] Id. at 709.

[106] Id.

[107]2000 CO 2 004231 (supra, note 81).

[108] Id. at 2.

[109] Id. at 4.

[110] Id. at 9.

[111] Id. at 10.

[112] 1993 WL 302 652, (supra, note 4).

[113] Brooks, "Home Depot Turns Copycat," (supra, note 1) A-16.

[114] Chad Terhune, "Home Depot's Home Improvement," Wall St. J., Mar 8, 2001 at B-1.

[115] Id. at B-4.

EDICAL MALPRACTICE LITIGATION IN FLORIDA: CAPS ON NON-ECONOMIC DAMAGES

by

Alvin Stauber*

> Recommendation 27. The Legislature should, in medical malpractice cases, cap non-economic damages at $250,000 per incident. The Task Force believes that a cap on non-economic damages will bring relief to this current crisis. Without the inclusion of a cap on potential awards of non-economic damages in a legislative package, no legislative reform plan can be successful in achieving the goal of controlling increases in healthcare costs, and thereby promoting improved access to healthcare. Although the Task Force was offered other solutions, there is no other alternative remedy that will immediately alleviate Florida's crisis of availability and affordability of healthcare. The evidence before the Task Force indicates that a cap of $250,000 per incident will lead to significantly lower malpractice premiums.
>
> --[Florida] Governor's Select Task Force on Healthcare Professional Liability Insurance (2003)

On August 28, 2002, the Governor's Select Task Force on Healthcare Professional Liability was created by Executive Order of Florida Governor Jeb Bush "to examine Florida's current crisis in the availability and affordability of medical malpractice insurance."[1] After studying the issue for five months, the Task Force submitted its report, which included 60 recommendations for action. As indicated in the above excerpt from Recommendation 27, the Task Force felt strongly that the key to solving Florida's "crisis" was the imposition of a $250,000 cap on non-economic damages in medical malpractice cases.

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The view of the Task Force is shared by many members of the medical community in Florida. In fact, on March 27, 2003, hundreds of Florida doctors converged on Tallahassee to demonstrate their support of the cap. And that support extends beyond physician groups in Florida. As one commentator reflected: "[The cap] is the obvious bumper-sticker solution. It is favored by doctors, insurance companies, President Bush, Gov. Jeb Bush, the U.S. House and the Florida House."[2] The cap is opposed, predictably, by lawyers who argue that the cap unfairly punishes those victims who suffer the most.[3] The Florida controversy is a microcosm of the national debate on the issue. According to an American Medical Association report published last year, Florida is one of twelve states in the midst of a medical liability insurance crisis.[4]

The purpose of this paper is to examine the issue of caps on non-economic damages in medical malpractice litigation, with attention directed to the situation in Florida. A brief history of legislation and case law on the issue will be provided, and an analysis of data on medical malpractice cases during the period 1998-2002 will be undertaken. Finally, recommendations for addressing the issue will be set forth.

History of Caps on Non-Economic Damages in Florida

The concept of capping non-economic damages is not new. In the 1970s and 1980s, almost two-thirds of the states adopted caps on the recovery of damages, with most of these caps applying to non-economic damages. The courts in seven states, including Florida, found the caps to be unconstitutional.[5]

In 1984, the Governor of Florida created by Executive Order the Governor's Task Force on Medical Malpractice to address medical malpractice insurance problems. The Task Force submitted numerous proposals for action but specifically recommended that no caps should be placed on damages.[6] In 1986, however, the Florida Legislature enacted the Tort Reform and Insurance Act, finding that "a solution to the current crisis in liability insurance has created an overpowering public necessity for a combination of reforms to both the tort system and the insurance regulatory system."[7] As part of the tort reform package, the Act imposed a cap on non-economic damages of $450,000. The language of the statute was straightforward and succinct:

> 768.80 Determination of noneconomic damages.—In any action to which this part applies, damages for noneconomic losses to compensate for pain and suffering, inconvenience, physical impairment, mental anguish, disfigurement, loss of capacity for enjoyment of life, and other nonpecuniary damages may be awarded to each person entitled thereto. Such damages may not exceed $450,000.[8]

In an attempt to justify the imposition of the cap, the Legislature included the following statement in the preamble to the law:

> WHEREAS, the Legislature desires to provide a rational basis for determining damages for noneconomic losses which may be awarded in certain civil actions, recognizing that such noneconomic losses should be fairly compensated and that the interests of the injured party should be balanced against the interests of society as a whole, in that the burden of compensating for such losses is ultimately borne by all persons, rather than by the tortfeasor alone.[9]

The Tort Reform and Insurance Act's cap on non-economic damages was not limited to medical malpractice litigation. The Legislature determined that there was a financial crisis in the entire liability insurance industry, including medical malpractice insurance. The applicability of the law was quite extensive, governing "any action for damages, whether in tort or contract."[10]

The cap on non-economic damages was short-lived, however, because the Supreme Court of Florida, less than a year after the cap became effective, found the cap unconstitutional because it denied claimants access to the courts, as guaranteed by the Florida Constitution.[11] The court brushed aside appellee's argument that the legislature had not totally abolished a cause of action, that it had only capped the recovery, thereby not denying access to the courts. Unimpressed, the court stated:

> Access to courts is granted for the purpose of redressing injuries. A plaintiff who receives a jury verdict for, e.g., $1,000,000, has not received a constitutional redress of injuries if the legislature statutorily, and arbitrarily, caps the recovery at $450,000. Nor, we add, because the jury verdict is being arbitrarily capped, is the plaintiff receiving the constitutional benefit of a jury trial as we have heretofore understood that right. Further, if the legislature may constitutionally cap recovery at $450,000, there is no discernible reason why it could not cap the recovery at some other figure, perhaps $50,000, or $1,000, or even $1. None of these caps, under the reasoning of appellees, would "totally" abolish the right of access to the courts.[12]

Citing precedent, the court continued:

> . . . the Legislature is without power to abolish [the right of access to the courts] without providing a reasonable alternative to protect the rights of the people of the State to redress for injuries, unless the Legislature can show an overpowering public necessity for the abolishment of such right, and no alternative method of meeting such public necessity can be shown.[13]

The court delivered its final blow, stating:

> . . . the legislature has provided nothing in the way of an alternative remedy or commensurate benefit and one can only speculate, in an act of faith, that somehow the legislative scheme will benefit the tort victim. We cannot embrace such nebulous reasoning when a constitutional right is involved. Further, the trial judge below did not rely on—nor have appellees urged before this Court—that the cap is based on a legislative showing of "an overpowering public necessity for the abolishment of such right, and no alternative method of meeting such public necessity can be shown."[14]

Undeterred, the cap's proponents in 1988 placed a proposed amendment to the Florida Constitution on the ballot, to impose a $100,000 cap on non-economic damages. The initiative was defeated at the polls.[15]

Cognizant of the judicial, legislative, constitutional, and electoral history of caps on non-economic damages, the current Governor's Select Task Force "carefully considered, in particular, the constitutional right of access to courts in formulating its recommendation [of a $250,000 cap]."[16] In its review of the case law, the Task Force acknowledged that:

> The Florida Supreme Court has consistently held that the Legislature may not impose a monetary cap on non-economic damages unless it provides a commensurate benefit, or it shows:
> - An overpowering public necessity for the abolishment of the right to such damages exists; and
> - There is no alternative method of meeting that public necessity.[17]

Upon concluding its review, the Task Force expressed its confidence that "its recommendations take into consideration the relevant constitutional hurdles that a cap on non-economic damages would entail."[18]

Support for the Cap

The Task Force complemented its analysis of the legal environment of the proposed cap with an analysis of other factors that it believed supported its recommendation on the cap. Perhaps the most vigorous argument forwarded by the Task Force was based on empirical evidence, in particular the experience that the State of California had with its cap. As explained in the Task Force report, California experienced a medical malpractice insurance crisis in the 1970s that the legislature addressed by imposing a $250,000 cap on medical malpractice awards for non-economic losses.[19] According to studies cited in the Task Force report, the most significant factor in California's success in reducing medical malpractice insurance premiums was the $250,000 cap on non-economic damages.[20] The cap was part of a package of reforms known as MICRA (Medical Injury Compensation Reform Act) which, the studies concluded, resulted in the following:

(1) MICRA reduced both malpractice claims payments and incurred losses;
(2) The reduction in claims and losses led to a reduction in malpractice premiums; and
(3) Malpractice premiums declined sharply after the California Supreme Court in 1985 dismissed the final appeal challenging the validity of MICRA.[21]

The Task Force also pointed to HR 4600, a bill containing a $250,000 cap on non-economic damages, that passed the U.S. House of Representatives on September 26, 2002.[22] According to the Congressional Budget Office's analysis of the bill's impact on medical malpractice premiums, the following conclusions were drawn:

> CBO's analysis indicated that certain tort limitations, primarily caps on awards and rules governing offsets from collateral-source benefits, effectively reduce average premiums for medical malpractice insurance. Consequently, CBO estimates that, in states that currently do not have controls on malpractice torts, H.R. 4600 would significantly lower premiums for medical malpractice insurance from what they would otherwise be under current law.[23]

The Task Force also relied on its analysis of the Florida Department of Insurance (FDOI) database to buttress its conclusions. According to this review of medical malpractice closed claims, "one of the primary drivers of the current medical malpractice crisis is that a large percentage of medical malpractice losses (77 percent in Florida) apply to non-economic damages."[24] The analysis continued with the following conclusion:

> . . . a review of the FDOI database reveals that if non-economic damages had been capped at $250,000 in 1992 through 2001, $400 million, or 21.1 percent of the

> $1.9 billion paid, could have been retained in the healthcare community. A cap of $500,000 would have generated a 9% savings, and a $1,000,000 cap would have resulted in a 2 percent savings.[25]

Opposition to the Cap

From a political standpoint, the $250,000 cap in Florida appears to be "dead in the water" this year. As of April 7, 2003, three weeks remained in Florida's legislative session and, although the House had voted in favor of the cap, a Senate committee had already rejected the cap on medical malpractice awards. Florida Senate President Jim King stated that he "doubts the House plan would win approval from [my] colleagues."[26] The situation appears to be the same in Congress, where the House of Representatives on March 13, 2003, also passed a $250,000 cap on non-economic damages in medical malpractice cases; the measure, however, faces an uncertain future in the Senate.[27]

The dim prospects for passage of "cap legislation" is attributable, at least in part, to the fact that some legislators agree with cap opponents that there is no conclusive evidence that caps result in lower medical malpractice liability insurance premiums. As one commentator stated:

> California is the frequently cited example of the effectiveness of caps. But even there, the evidence is murky. After doctors went on strike in 1976, California passed a $250,000 cap . . . But the insurance industry's own data show that malpractice rates kept going up in California despite the caps . . . By 1988, [premiums] had increased 190 percent.[28]

Addressing the eventual reduction in premiums, the commentator continued:

> [In 1988] angry voters passed Proposition 103, mandating a 20% reduction in all insurance premiums and making it much tougher for companies to jack up rates without government and citizen review.[29]

Cap opponents argue, therefore, that voter-passed Proposition 103 mandating premium rollbacks—not the cap—was the real cause of insurance premium reduction in California. And, indeed, even Florida's Task Force conceded in its report that "there is some disagreement among stakeholders over whether the cap is a cause of California's success."[30]

Another argument forwarded by cap opponents is that the "crisis" can be traced to irresponsible underwriting practices and investment losses by insurance companies. One observer noted as follows:

> The current crisis stems from insurers' attempts to cash in on the stock market boom of the '90s by abandoning conservative investment practices. The bear market cost the liability insurance companies $10.8 billion during the first half of 2002, according to a conservative estimate by Weiss Ratings, an industry monitor. And they lost hundreds of millions in the stocks of crooked companies such as Enron and WorldCom.[31]

One Florida lawyer disputes the claim that insurance companies have suffered increasing losses because of huge malpractice awards, stating:

> The cause of the current crisis is not an increase in medical malpractice verdicts or claims. According to *Florida Today*, the number of malpractice claims filed per capita in Florida has decreased significantly since 1995. Floridians today file malpractice cases at their lowest rate since 1984. Jury awards against doctors are rare accounting for 27 out of 1,308 claims paid last year. That's about 2 percent.
>
> Adjusted for inflation, the average jury award in Florida has dropped every year since 1999 to $326,070. Total insurance payouts statewide have dropped an average of 2 percent annually since 1997.[32]

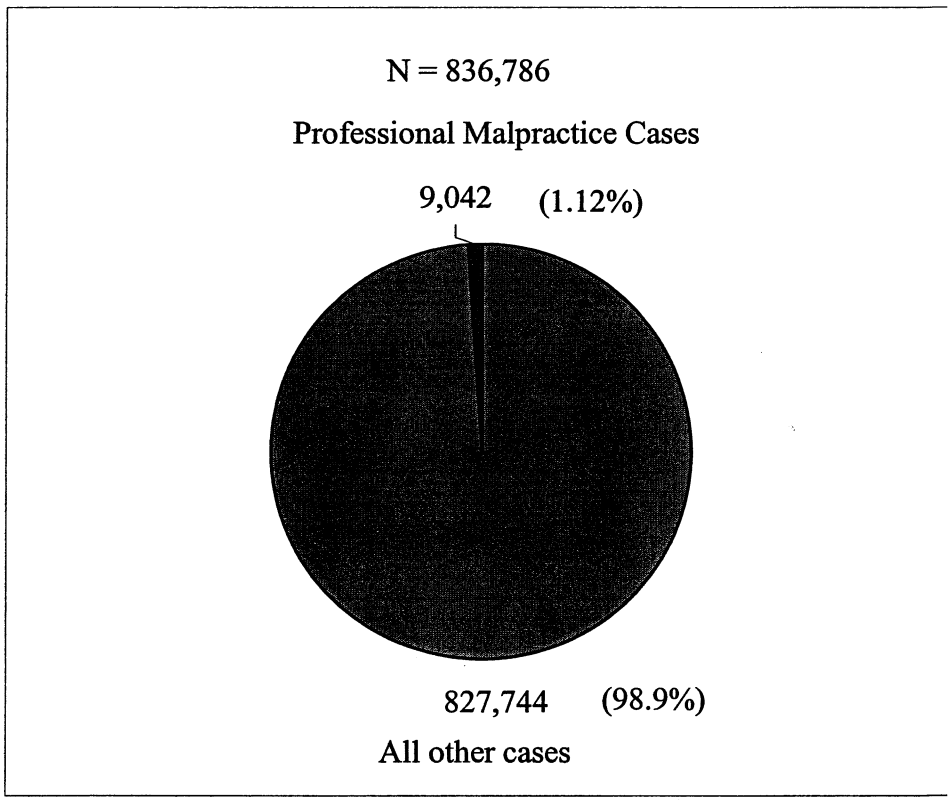
Indeed, opponents of the cap argue that the gap between medical malpractice payouts and premiums collected by insurance companies has increased substantially in the last several years. As one observer noted:

> The gap between medical malpractice payouts and premiums collected by insurance companies more than quadrupled from 1997 to 2001. It takes around five years for claims to be paid; premiums are a projection of future losses. So the data are not directly comparable. But the speed in which the gap is growing raises questions about the cause of the malpractice crisis.[33]

Medical Malpractice Data

To put medical malpractice litigation in perspective, the following chart shows that the total number of professional malpractice cases filed in Florida circuit courts (the principal trial courts) is miniscule compared to the total case volume.[34]

CHART I
CASES FILED IN FLORIDA CIRCUIT COURTS



1997-2002 (FY)

NOTE: Approximately 90% of Professional Malpractice cases involve medical malpractice.

The next chart shows the disposition of medical malpractice cases in comparison with all other cases.[35]

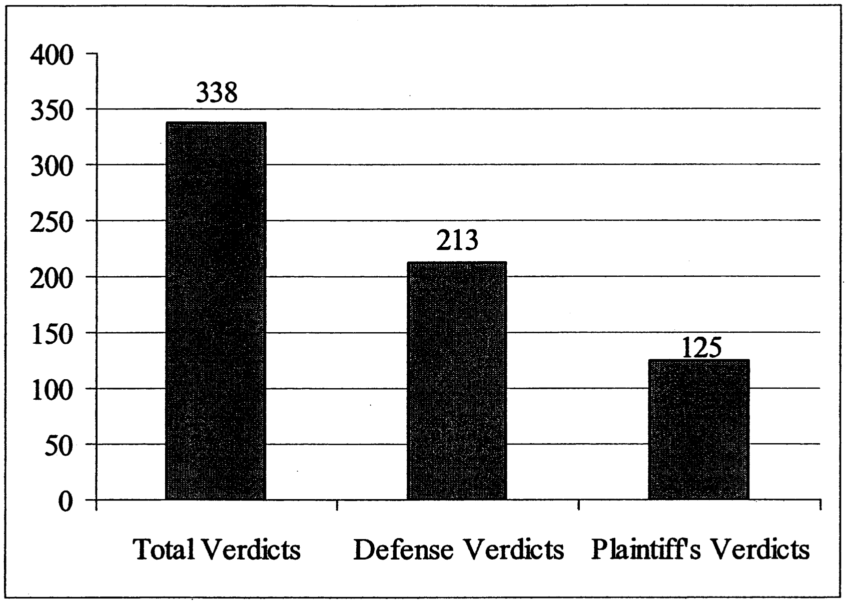
CHART II
CASE DISPOSITION

Fiscal Year	Prof'l Malpractice Cases		All Cases	
	Cases Filed	Jury Verdict	Cases Filed	Jury Verdict
1997-1998	2098	104	155,446	1996
1998-1999	2248	127	160,901	2064
1999-2000	2166	128	162,446	1788
2000-2001	2257	98	171,775	1523
2001-2002	2530	100	186,218	1402
TOTALS	9042	557 (6%)	836,786	8773 (1%)

Chart II shows that the vast majority of cases (99%) in Florida are disposed of without the benefit of a jury verdict. In professional malpractice cases, only 6% of cases are decided by a jury. In terms of volume, approximately 100 professional malpractice cases per year are decided by jury verdict.

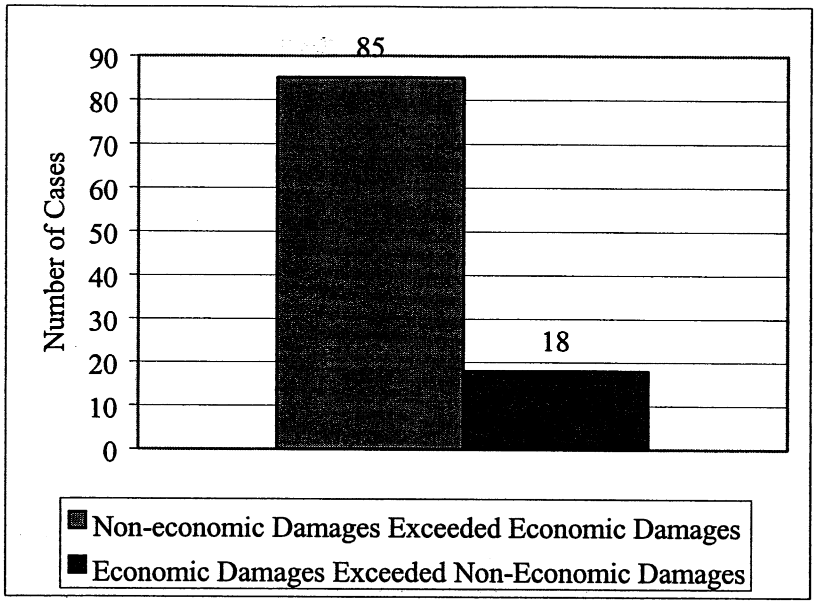
There are several ways that medical malpractice data is tracked. One source is the Florida Jury Verdict Reporter (FJVR), a publication that reports verdicts and settlements in personal injury cases in Florida. From 1998 through 2002, the FJVR reported 338 medical malpractice verdicts. Of these cases, 63% were defense verdicts, while 37% were plaintiffs' verdicts, as depicted in the chart below.[36]

CHART III
MEDICAL MALPRACTICE VERDICTS
Reported in the *Florida Jury Verdict Reporter*
(1998-2002)



Of the 125 verdicts rendered in favor of the plaintiff, 103 verdicts were itemized. Of those itemized verdicts, 83% showed non-economic damages exceeding economic damages, while 17% showed economic damages exceeding non-economic damages (see chart below).[37]

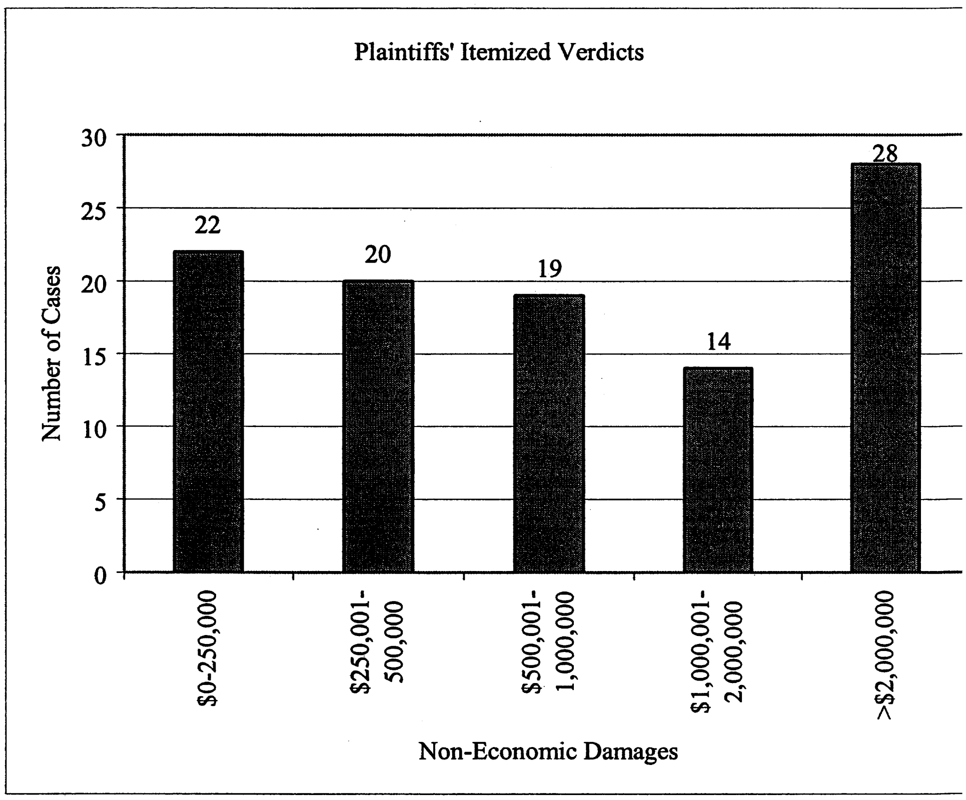
CHART IV
MEDICAL MALPRACTICE VERDICTS
Reported in the *Florida Jury Verdict Reporter*
(1998-2002)



The following chart depicts the amount of non-economic damages for the 103 itemized verdicts.[38] The number of cases within specified dollar intervals is shown.

CHART V
MEDICAL MALPRACTICE VERDICTS
Reported in the *Florida Jury Verdict Reporter*
(1998-2002)

N = 103*



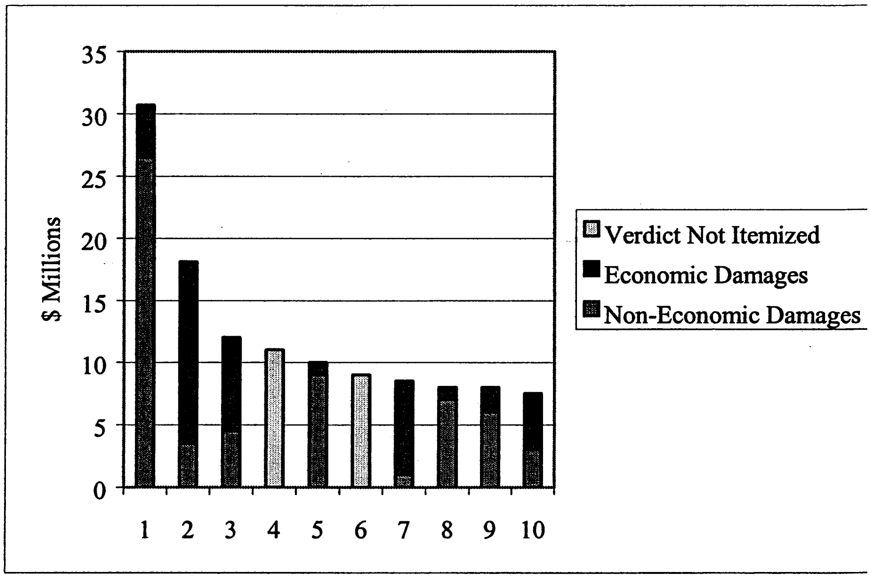
*There were 125 Plaintiff's Verdicts; however, in 22 cases, the verdicts were not itemized.

As can be seen, approximately 27% of the verdicts included non-economic damages in excess of $2 million; the mean amount was equal to $4,716,000.

Finally, the chart below shows a comparison of economic and non-economic damages for the 10 highest verdicts reported during the 1998-2002 period.[39]

CHART VI
MEDICAL MALPRACTICE VERDICTS
Reported in the *Florida Jury Verdict Reporter*
(1998-2002)

TOP 10 VERDICTS



As is evident, non-economic damages accounted for a major portion of these highest ten verdicts, constituting at least two-thirds of the total amount of damages awarded.

Solutions to the "Crisis"

One of the difficulties encountered in attempting to evaluate the efficacy of a cap on non-economic damages is that the data is often incomplete and is subject to so many different interpretations. While the data on case filings and disposition from the Florida Office of the State Courts Administrator would appear to be complete, it is impossible to know with precision how many cases filed involve medical malpractice inasmuch as the category used by the Office is entitled "Professional Malpractice." Cases involving negligence of accountants, lawyers, architects, etc., would be included in this category as well, but not sub-categorized separately. Data from the *Florida Jury Verdict Reporter* is incomplete, because approximately one-third of the medical malpractice verdicts go unreported. As an "unofficial" reporter of trial court decisions, the FJVR is powerless to "require" these decisions to be submitted for publication, resulting in a reporting rate considerably below 100%. Moreover, post-trial alterations (such as remittitur and/or appellate modifications of trial court decisions) are generally not reported. The Florida Department of Insurance Closed Claim Database purports to contain data on all medical malpractice claims that have been closed, but "Department officials testified that they are not confident that their 25 years' worth of information is completely accurate."[40]

Several solutions to the crisis have been recommended. A malpractice insurance premium rollback or freeze would certainly go a long way toward addressing the plight of physicians.[41] Meanwhile, cap proponents have produced numerous variations on cap legislation: (1) increasing the cap to $500,000 or even $1,000,000; (2) exempting particularly egregious cases from the $250,000 cap; (3) applying the cap to each defendant in a case, as opposed to applying the cap to the entire recovery; and (4) tying the cap to inflation [California's $250,000 cap in 1976 would require more than $800,000 in 2003 dollars].[42] A sliding scale for attorney's fees has also been suggested; a bill in Congress limits attorney's fees in malpractice cases to 15 percent of any award over $600,000.[43] And, of course, if lawyers are going to be subjected to further regulation, suggestions for physician regulation are not far behind. As one observer noted:

> Lost in the debate over malpractice premiums is the true crisis: the epidemic of medical malpractice that kills over 160,000 Americans each year, according to a landmark study by Paul C. Weiler of the Harvard School of Public Health. Meanwhile, in California MICRA has made it impossible for many malpractice victims in California to hire a lawyer. That's because its cap—now worth $68,000 in 1975 dollars—has left many of the injured and next of kin without adequate resources.[44]

The push for better discipline of physicians would be an important factor in removing those physicians whose negligence results—

sometimes repeatedly—in large jury awards. By the beginning of May 2003—the end of the current legislative session—the citizens of Florida will find out whether their elected representatives have chosen a cap on non-economic damages a part of the solution of the medical malpractice crisis.

Epilogue

The Florida Legislature did not pass a medical malpractice bill during the 2003 regular session, so Governor Jeb Bush called the legislators back to Tallahassee for a four-day special session on June 16. Governor Bush's plan to cap awards for non-economic damages at $250,000 was approved by the House, but the Senate insisted on a $500,000 cap which, in most cases, would top out at $1.5 million, because the cap could apply to each defendant. The Senate version also allowed for victims of medical malpractice to receive as much as $6 million in cases in which egregious errors had been made. That four-day session ended in a stalemate.[45]

There were two additional special sessions during the summer. Finally, on August 13, the Florida Legislature passed a bill including caps on non-economic damages in medical malpractice cases. Governor Jeb Bush signed the measure the next day.[46] One commentator summed up the result as follows:

> The compromise bill, endorsed late last week by negotiators from both chambers, features a pain and suffering cap of $500,000 for doctors, with $1-million possible if the patient sues more than one doctor or the malpractice results in death or a permanent vegetative state. Hospitals and other facilities got a $750,000 cap, which could double for egregious cases. The bill also increased protection for emergency room doctors and doctors asked to consult in emergencies. They will see a $150,000 cap, which could double if more than one doctor is sued.
>
> Caps on noneconomic damages drew the most attention during the medical malpractice reform debate but are only part of a sweeping bill. The legislation. . . also will temporarily freeze medical malpractice insurance rates, require doctors and hospitals to personally inform patients if they are harmed, and

give more power to the state Board of Medicine to discipline doctors.[47]

ENDNOTES

[1] [Florida] Governor's Select Task Force on Healthcare Professional Liability Insurance: Report and Recommendations (2003), at iii.

[2] John Winn Miller, *Malpractice Reform: No Pain, No Gain,* TALLAHASSEE DEMOCRAT, March 27, 2003 at 15A.

[3] Ken Thomas, *Bush: 'We're Not Going To Let This Issue Lie,'* TALLAHASSEE DEMOCRAT, April 1, 2003, at 4B.

[4] Governor's Select Task Force, *supra* note 1. The twelve states "in crisis" are Florida, Georgia, Mississippi, Nevada, New Jersey, New York, Ohio, Oregon, Pennsylvania, Texas, Washington, and West Virginia. *See also* http://www.ama-assn.org/ama/pub/article/9255-7188.html

[5] *Id.* at 18. The states adopting caps that withstood constitutional challenge were Arkansas, California, Colorado, Hawaii, Idaho, Indiana, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Pennsylvania, South Dakota, Utah, Virginia, West Virginia, and Wisconsin. The states adopting caps that were held unconstitutional were Alabama, Florida, Illinois, New Hampshire, South Dakota, Texas and Washington. Mimi Marchev, National Academy for State Health Policy, THE MEDICAL MALPRACTICE INSURANCE CRISIS: OPPORTUNITY FOR STATE ACTION 2 (July 2002).

[6] *Id.* at 40.

[7] 1986 Fla. Laws ch. 86-160.

[8] FLA. STAT. §768.80 (Supp. 1986).

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[9] 1986 Fla. Laws ch. 86-160.

[10] Alvin Stauber and Craig Varn, *Itemized Verdict Requirements: A Challenge for Juries,* 70 FLA. B. J. 16 (June 1996), at 18. *See* FLA. STAT. §768.71 (Supp. 1986).

[11] Smith v. Dept. of Insurance, 507 So. 2d 1080 (Fla. 1987).

[12] *Id.* at 1088.

[13] Kluger v. White, 281 So. 2d 1, 4 (Fla. 1973).

[14] *Smith, supra* note 11, at 1089.

[15] Governor's Select Task Force, *supra* note 1, at 54. *See also* www.law.fsu.edu/crc/conhist/1988amen.html.

[16] Governor's Select Task Force, *supra* note 1, at 201.

[17] *Id.* at 202.

[18] *Id.* at 211.

[19] *Id.* at 193.

[20] *See* William G. Hamm, Californians Allied for Patient Protection, *An Analysis of Harvey Rosenfield's Report: California's MICRA* 1 (May 6, 1997).

[21] *Id.*

[22] H.R. 4600, 107th Cong. 2d Sess. (April 25, 2002). As of January 6, 2004, that bill had not yet been enacted into law.

[23] Congressional Budget Office Cost Estimate, H.R. 4600, 107th Cong. 2d Sess. 4 (Sept. 24, 2002).

[24] Governor's Select Task Force, *supra* note 1, at 212.

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[25] *Id.*

[26] Thomas, *supra* note 3.

[27] Sheryl Gay Stolberg, *House Acts to Limit Malpractice Awards,* N.Y. TIMES, March 14, 2003, at A24.

[28] Miller, *supra* note 2.

[29] *Id.*

[30] Governor's Select Task Force, *supra* note 1, at 193. *See also* Center for Justice & Democracy, *California Restrictions on Malpractice Victims Have Not Affected Malpractice Premiums* (May 29, 2002).

[31] Harvey Rosenfeld, *A Cure for the Insurance Crisis,* MIAMI HERALD, April 6, 2003, http://www.miami.com/mld/miamiherald/news/opinion/ 560715.htm.

[32] Donald M. Hinkle, *Don't Blame Malpractice Claims for Insurance Crisis,* TALLAHASSEE DEMOCRAT, March 11, 2003, at 7A.

[33] Miller, *supra* note 2.

[34] Office of the State Courts Administrator [Florida], *Summary Reporting System—Circuit Civil Statewide Data,* 1997-2002.

[35] *Id.*

[36] FLORIDA JURY VERDICT REPORTER, 1998-2002. It is estimated that the FVJR reports approximately two-thirds of the medical malpractice jury verdict awards in Florida.

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] Miller, *supra* note 2.

[41] Rosenfield, *supra* note 31.

[42] *See* Governor's Select Task Force, *supra* note 1; Miller, *supra* note 2.

[43] Miller, *supra* note 2.

[44] Rosenfield, *supra* note 31.

[45] Joni James, *Special Session Stalls Again,* MIAMI HERALD, June 25, 2003, at A1.

[46] 2003 Fla. Laws ch. 2003-416.

[47] Colleen Jenkins, *Lawmakers Compromise on Malpractice*, ST. PETERSBURG TIMES, August 15, 2003, at 1.

A CRITICAL ANALYSIS OF THE NEW YORK STATE PROPERTY CONDITION DISCLOSURE ACT

by

Professor Winston Waters* and Professor Martin Han Clarke**

The Property Condition Disclosure Act [hereinafter also referred to as PCDA] signed into law by Governor Pataki last year adds a new article 14 to the Real Property Law.[1] The law requires sellers of one to four family residential property[2] to provide a written statement to prospective purchasers disclosing all known defects relating to the subject property and the dwellings thereon. The disclosures must be made in the form of a "Property Condition Disclosure Statement" [hereinafter also referred to as PCDS] before the buyer executes a binding contract of sale. The law became effective on March 1, 2002.

I. Background

This law requires every seller of residential property to complete, sign, and deliver the property condition disclosure statement to the purchaser (or purchaser's agent)[3] prior to the execution of the contract of sale of real property.[4] The agents of both the buyer and seller must inform their respective principals of their rights and obligations within the meaning of the statute.[5] The act further requires that the PCDS be delivered to the buyer or buyer's agent prior to the signing by the buyer of a binding contract of sale.[6] The law further requires that the completed PCDS signed by both seller and buyer be attached to the real estate purchase contract.[7]

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The PCDS does not apply to (1) unimproved property on which dwellings are to be constructed; (2) condominium or cooperative apartment units, or (3) property in a homeowner's association that is not owned in fee simple by the seller.

There are certain types of transactions involving the sale of an interest in real estate that are exempt from the Act's application.[8] The property condition disclosure statement is not required in the following types of transactions:

A) pursuant to court order;
B) in lieu of foreclosure;
C) to a beneficiary of a deed of trust;
D) pursuant to a foreclosure action;
E) pursuant to a power of sale following a default in the satisfaction of an obligation secured by a mortgage;
F) by a mortgagee or an agent or affiliate thereof who acquired the property by deed in lieu of foreclosure;
G) by fiduciaries;
H) by one co-owner to one or more co-owners;
I) between spouses or former spouses pursuant to divorce decree;
J) to or from a governmental entity;
K) in connection with newly constructed housing;
L) by a sheriff; and
M) pursuant to a partition action.

The law further provides that in the event that the seller learns of a problem within the property after a PCDS has been given, he must immediately notify the purchaser of the problem by an amended PCDS.[9] There does not exist a requirement that the seller revise his PCDS post-closing.[10]

II. Content of the PCDS

The PCDA makes inquiries into several aspects of the property including environmental, structural, mechanical systems and general information about ownership. The original bill first presented to Governor Pataki required the seller to disclose information about the condition of the property which the seller had "constructive knowledge" of.[11] This broad standard would have allowed buyers to bring lawsuits for defects that the sellers could have found through due investigation. The onus would have been placed on the sellers to then discover the defects and negotiate them in anticipation of potential laws uits. Governor Pataki contemplating this difficult standard, vetoed the bill containing the "constructive knowledge" standard. The current Act created an "actual knowledge" standard. The seller is obligated to disclose those items "known" to him or her. The contents of the PCDS form is similarly dictated by this statute. [12]The PCDS contains forty eight questions that must be answered by the seller by either, "Yes," "No," "UNKN," or "NA." The seller is required to answer all questions based upon his knowledge. "Knowledge" means only actual knowledge of a defect or condition on the part of the seller of residential real property.[13]

III. Remedies

The legislation sets forth three types of remedies. One remedy is against a seller for failure to deliver the PCDS. Should the seller fail to deliver a PCDS to the buyer prior to the signing of a binding contract of sale, the buyer shall receive upon the transfer of title a credit of $500.00 against the agreed upon purchase price of the residential real property.[14] Next, a remedy is given to a buyer in the event the statement is not properly completed.[15] Any seller who fails to provide a PCDS or fails to provide a revised property condition disclosure statement shall be liable only for a willful failure to perform the requirements of this article. For such a willful failure, the seller shall be liable for the actual damages suffered by the buyer in addition to any other existing equitable or statutory remedy.[16] The "Liability" portion of the PCDA provides, "[n]othing contained in this article shall be construed as limiting any existing legal cause of action or remedy at law, in statute or in equity."[17] To recover damages the purchaser must prove "actual" damages.

It is important to note that notwithstanding the requirements of the PCDA, parties are not prevented from entering into agreements relating to the physical condition of the premises. The parties may still negotiate the transfer of the premises in "as is" condition.

The PCDA conspicuously states that the disclosure is a statement of conditions and information known to the Seller and is in no way a warranty of any kind.[18] In essence, the forty-eight questions on the Disclosure could be seen as forty-eight potential causes of action. The *Malach* holding, discussed *infra*, stated the opposite, holding "an analysis of the statute leads to the conclusion that there is no cause of action available to the plaintiff under the terms of the Act and provides no such specific right of action to the purchaser for a breach of the disclosure form."[19]

IV. Current Case Law

There has only been one reported case to date interpreting this new law.

In *Malach v. Chuang*, N.Y.L.J., January 10, 2003, at 23, plaintiffs, Monte Malach and Barbara Malach, commenced an action against the defendants, Cheng Lung Chuang and Pei Fang Chuang alleging that the defendants improperly completed the real estate disclosure form required by Article 14 of the Real Property Law, causing plaintiffs to suffer damages.

On March 6, 2002, the defendants completed and signed the Property Condition Disclosure Statement required by N.Y. Real Property Law Section 462. The plaintiffs acknowledged receipt of the PCDS on March 14, 2002. The parties signed a contract of sale.

After obtaining title and entering into possession of the premises, the plaintiffs hired a general contractor to make some repairs to the premises. One of the repairs included the removal of a deck which surrounded a swimming pool. At the trial, plaintiffs' witness testified that the deck was not in good condition and needed replacement. An adjustment had been made in the purchase price to reflect that condition. When the deck was in the process of being removed by the plaintiffs' contractor, it was noticed that the swimming pool was also damaged in that the base of the pool had "rot." The deterioration was around the main supports and body of the pool, and according to the contractor, if left untreated would cause the pool to collapse. The contractor removed the liner of the pool and found new patches around the bottom of the pool placed there in an attempt to prevent the liner from pushing out. The contractor testified that once the deck was removed the rot was visible but that it could also be seen if you looked under the deck. He pointed out that this was an in-ground pool that was placed mostly above ground when it had been installed. The contractor stated that the pool began to collapse while he was doing this work and it had to be removed. He was not hired to replace it.

The gravamen of the plaintiffs' complaint is that the defendants improperly completed the PCDS and that in reliance on the PCDS, plaintiffs entered into a contract and accepted title to the premises. In particular, plaintiffs alleged that the defendants answered question 20 on the form in a manner designed to deceive the plaintiffs. Question 20 appears in the section labeled "Structural" and asks, "Is there any rot or water damage to the structure or structures?" The defendants answered this question "UnKn," the abbreviation for "unknown" on the PCDS. Consequently, plaintiffs contended that the defendants breached their obligation under the "PCDS" by not revealing the true condition of the swimming pool and should be liable for damages. The matter went to trial.

The dilemma from the *Malach* case was whether answering "unknown" on the disclosure form created a liability on the part of the seller. The court held that by accepting an "unknown" answer, the buyer relieved the seller of any potential liability.[20] By accepting the PCDS with "unknowns , the buyer is waiving any claims for defects that arise in those areas so answered. That is the only rational conclusion that can be drawn. Accept an "unknown" answer and the buyer is relieving the seller of any potential liability. How can a buyer prove at trial that the seller had "actual knowledge" of the condition when the seller answered a question "unknown?" The buyer would be better off without the form being completed and left to the common law remedies of fraud or negligent misrepresentation."[21]

In denying the claim, the court said, the Real Property Law Article 14 requires the seller of residential real property to make certain disclosures to the purchaser prior to sale.[22] Other than providing a $500 credit to the purchaser at transfer of title, the statute has no effect on common law or statutory theories of recovery which the purchaser may assert against the seller in a suit for defects that arise after closing.[23] Other than the $500 credit at closing, the other remedies contained in RPL§462 are void for vagueness and unenforceable in a legal or equitable proceeding.[24] The court held that the legislature needs to redraft those sections to create either a new right of action, or eliminate them so as to avoid confusion.[25]

The court further stated that any information disclosed as required by Article 14, merges into the contract of sale and does not exist as its own basis of a common law cause of action.[26] Plaintiffs' relief existed under common law contract theories.[27] Since the property was sold "as is," in order to prove breach of contract the plaintiffs would have to establish that the defendants had actual knowledge or constructive knowledge of the condition of the pool.

Defendants denied having actual knowledge of the condition of the pool. Although defendants admitted that they had a new liner installed and repairs done to the pool in June, 2001, there was no showing that the defendants were notified by the pool repair personnel of the condition of the pool and as to the nature and extent of the existing damages (although plaintiffs did admit paying $3,000.00 to $4,000.00 for repairs and can be charged with knowledge of the nature of the repairs made).[28] Plaintiffs' witness testified that the existence of the repairs to the pool was obvious when he removed the liner after the closing in 2002; however, he did not state an opinion as to the age of the repairs and how long they had been in place. There was further testimony that defendants had rented the premises to third parties for nine years before 1999 and had not been at the house with any regularity during that time. Therefore, the court held that plaintiffs did not prove defendants had actual knowledge of the condition of the pool at the time of closing.[29]

V. CONCLUSION

The New York State Property Condition Disclosure Act is a helpful piece of legislation with several limitations. First, the legislation places an obligation on the part of the seller to make a full and complete disclosure of known problems within the residence for sale or at a minimum make a modest credit in the sum of $500.00.

The legislation provides documentary evidence for a purchaser, should he decide to bring either an action for breach or misrepresentation of the PCDS as well as a common law action against the seller for common law or statutory law causes of action.[30] Thus, unlike a situation where the seller grants the credit and doesn't complete the form, upon completion, the seller has now completed a document that can be used against him in a suit for fraud or misrepresentation. Therefore, the completion of the disclosure provides a document that can be used against the seller in a suit under a common law theory such as one alleging fraud or negligent misrepresentation. The disclosure is certified by the seller giving it certain evidentiary value. By completing the Disclosure the seller may be giving the purchaser advantage in subsequent litigation.[31]

The legislation has several limitations. A carefully drafted contract of sale can incorporate the PCDS in the agreement and make the merger clause applicable to it nullifying its ability to survive the close of title.

The $500.00 credit is usually opted for by a seller upon advice of experienced real estate attorneys. This is particularly the case because given the detail of the information requested, it would be unwise for an attorney to permit his client to complete such a disclosure because of the potential for litigation surrounding breach of the disclosure form.

ENDNOTES

[1] See N.Y. Real Prop. Law §§ 460-467 (McKinney 2003).

[2] N.Y. Real Prop. Law § 461(5). Definitions, provides in part:
As used in this article, the following terms shall have the following meanings:
5. "Residential real property" means real property improved by a one to four family dwelling used or occupied, or intended to be used or occupied, wholly or partly, as the home or residence of one or more persons, but shall not refer to (a) unimproved real property upon which such dwellings are to be constructed, or (b) condominium units or cooperative apartments, or (c) property in a homeowners' association that is not owned in fee simple by the seller.

[3] N.Y. Real Prop. Law § 462(1) (McKinney 2003) provides in part: Definitions
As used in this article, the following terms shall have the following meanings:

> 1. "Agent" means a person who is licensed as a real estate broker or a real estate salesperson pursuant to section four hundred forty-a of this chapter and is acting in a fiduciary capacity.

[4] N.Y. Real Prop. Law § 462 (1)(McKinney 2003) provides:
§462. Property condition disclosure statement
1. Except as is provided in section four hundred sixty-three of this article, every seller of residential real property pursuant to a real estate purchase contract shall complete and sign a property condition disclosure statement as prescribed by subdivision two of this section and cause it, or a copy thereof, to be delivered to a buyer or buyer's agent prior to the signing by the buyer of a binding contract of sale. A copy of the property condition disclosure statement containing the signatures of both seller and buyer shall be attached to the real estate purchase contract. Nothing contained in this article or this disclosure statement is intended to prevent the parties to a contract of sale from entering into agreements of any kind or nature with respect to the physical condition of the property to be sold, including, but not limited to, agreements for the sale of real property "as is".

[5] N.Y. Prop. Law § 466. Duty of an agent
An agent representing a seller of residential real property as a listing broker shall have the duty to timely inform each seller represented by that agent of the seller's obligations under this article. An agent representing a buyer of residential real property, or, if the buyer is not represented by an agent, the agent representing a seller of residential real property and dealing with a prospective buyer, shall have the duty to timely (in any event, before the buyer signs a binding contract of sale) inform such buyer of the buyer's rights and obligations under this article. If an agent performs the duties and obligations imposed upon him or her pursuant to this section, the agent shall have no further duties under this article and shall not be liable to any party for a violation of this article.

[6] Id.

[7] N.Y. Real Prop. Law § 462(1) (McKinney 2003)

[8] N.Y. Real Prop. Law § 463 (McKinney 2003):
Exemptions
A property condition disclosure statement shall not be required in connection with any of the following transfers of residential real property:
1. A transfer pursuant to a court order, including, but not limited to, a transfer order by a probate court during the administration of a decedent's estate, a transfer pursuant to a writ of execution, a transfer by a trustee in bankruptcy or debtor-in-possession, a transfer as a result of the exercise of the power of eminent domain, and a transfer that results from a decree for specific performance of a contract or other agreement between two or more persons;
2. A transfer to mortgagee or an affiliate or agent thereof by a mortgagor by deed in lieu of foreclosure or in satisfaction of the mortgage debt;

3. A transfer to a beneficiary of a deed of trust;
4. A transfer pursuant to a foreclosure sale that follows a default in the satisfaction of an obligation that is secured by a mortgage;
5. A transfer by a sale under a power of sale that follows a default in the satisfaction of an obligation that is secured by a mortgage;
6. A transfer by a mortgagee, or a beneficiary under a mortgage, or an affiliate or agent thereof, who has acquired the residential real property at a sale under a mortgage or who has acquired the residential real property by a deed in lieu of foreclosure;
7. A transfer by a fiduciary in the course of the administration of a decedent's [FN1] estate, a guardianship, a conservatorship, or a trust;
8. A transfer from one co-owner to one or more other co-owners;
9. A transfer made to the transferor's spouse or to one or more persons in the lineal consanguinity of one or more of the transferors;
10. A transfer between spouses or former spouses as a result of a decree of divorce, dissolution of marriage, annulment, or legal separation or as a result of property settlement, agreement incidental to a decree of divorce, dissolution of marriage, annulment or legal separation;
11. A transfer to or from the state, a political subdivision of the state, or another governmental entity;
12. A transfer that involves newly constructed residential real property that previously had not been inhabited;
13. A transfer by a sheriff; or
14. A transfer pursuant to a partition action

[9]N.Y. Real Prop. Law § 464. Revision
If a seller of residential real property acquires knowledge which renders materially inaccurate a property condition disclosure statement provided previously, the seller shall deliver a revised property condition disclosure statement to the buyer as soon as practicable. In no event, however, shall a seller be required to provide a revised property condition disclosure statement after the transfer of title from the seller to the buyer or occupancy by the buyer, whichever is earlier.

[10] Id.

[11] Benjamin Weinstock and Joanne Agrippina, _Home Sellers Have a Duty to Make Full Disclosure, N.Y.L.J., Feb 2, 2002, at 1._

[12] See N.Y. Real Prop. Law §462(2) (McKinney 2003). Also, see a complete copy of the "PCDS" annexed hereto as Appendix A.

[13] N.Y. Real Prop. Law § 461 (McKinney 2003).

[14] N.Y. Real Prop. Law § 465 (McKinney 2003).

[15] See N.Y. Real Prop. Law §465 [1] and [2](McKinney 2003).

[16] See N.Y. Real Prop. Law §465 [1] and [2](McKinney 2003).

§ 465. Remedy
1. In the event a seller fails to perform the duty prescribed in this article to deliver a disclosure statement prior to the signing by the buyer of a binding contract of sale, the buyer shall receive upon the transfer of title a credit of five hundred dollars against the agreed upon purchase price of the residential real property.
2. Any seller who provides a property condition disclosure statement or provides or fails to provide a revised property condition disclosure statement shall be liable only for a willful failure to perform the requirements of this article. For such a willful failure, the seller shall be liable for the actual damages suffered by the buyer in addition to any other existing equitable or statutory remedy.

[17] N.Y. Real Prop. Law §467 provides:
§ 467. Liability
Nothing contained in this article shall be construed as limiting any existing legal cause of action or remedy at law, in statute or in equity.

[18] See N.Y. Real Prop. Law §462(2)(McKinney 2003).

[19] Malach v. Chuang, 194 Misc.2d 651, 754 N.Y.S.2d 835, 838 (Civil Court, Richmond County 2002).

[20] Id. At 845

[21] Id.

[22] Id.

[23] Id.

[24] Id.

[25] Id.

[26] Id.

[27] Id.

[28] Id.

[29] Id.

[30] N.Y. Real Prop. Law §467 (McKinney 2003).

31 *Malach v. Chuang*, 194 Misc.2d 651, 754 N.Y.S.2d 835 (Civil Court, Richmond County 2002)

PROPERTY CONDITION DISCLOSURE STATEMENT

APPENDIX A

§ 462. Property condition disclosure statement

2. The following shall be the disclosure form:

PROPERTY CONDITION DISCLOSURE STATEMENT

NAME OF SELLER OR SELLERS:

PROPERTY ADDRESS:

THE PROPERTY CONDITION DISCLOSURE ACT REQUIRES THE SELLER OF RESIDENTIAL REAL PROPERTY TO

CAUSE THIS DISCLOSURE STATEMENT OR A COPY THEREOF TO BE DELIVERED TO A BUYER OR BUYER'S AGENT PRIOR TO THE SIGNING BY THE BUYER OF A BINDING CONTRACT OF SALE.

PURPOSE OF STATEMENT: THIS IS A STATEMENT OF CERTAIN CONDITIONS AND INFORMATION CONCERNING THE PROPERTY KNOWN TO THE SELLER. THIS DISCLOSURE STATEMENT IS NOT A WARRANTY OF ANY KIND BY THE SELLER OR BY ANY AGENT REPRESENTING THE SELLER IN THIS TRANSACTION. IT IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR TESTS AND THE BUYER IS ENCOURAGED TO OBTAIN HIS OR HER OWN INDEPENDENT PROFESSIONAL INSPECTIONS AND ENVIRONMENTAL TESTS AND ALSO IS ENCOURAGED TO CHECK PUBLIC RECORDS PERTAINING TO THE PROPERTY.

A KNOWINGLY FALSE OR INCOMPLETE STATEMENT BY THE SELLER ON THIS FORM MAY SUBJECT THE SELLER TO CLAIMS BY THE BUYER PRIOR TO OR AFTER THE TRANSFER OF TITLE. IN THE EVENT A SELLER FAILS TO PERFORM THE DUTY PRESCRIBED IN THIS ARTICLE TO DELIVER A DISCLOSURE STATEMENT PRIOR TO THE SIGNING BY THE BUYER OF A BINDING CONTRACT OF SALE, THE BUYER SHALL RECEIVE UPON THE TRANSFER OF TITLE A CREDIT OF FIVE HUNDRED DOLLARS AGAINST THE AGREED UPON PURCHASE PRICE OF THE RESIDENTIAL REAL PROPERTY.

"RESIDENTIAL REAL PROPERTY" MEANS REAL PROPERTY IMPROVED BY A ONE TO FOUR FAMILY DWELLING USED OR OCCUPIED, OR INTENDED TO BE USED OR OCCUPIED, WHOLLY OR PARTLY, AS THE HOME OR RESIDENCE OF ONE OR MORE PERSONS, BUT SHALL NOT REFER TO (A) UNIMPROVED REAL PROPERTY UPON WHICH SUCH DWELLINGS ARE TO BE CONSTRUCTED OR (B) CONDOMINIUM UNITS OR COOPERATIVE APARTMENTS OR (C) PROPERTY ON A HOMEOWNERS' ASSOCIATION THAT IS NOT OWNED IN FEE SIMPLE BY THE SELLER.

INSTRUCTIONS TO THE SELLER:

(a) ANSWER ALL QUESTIONS BASED UPON YOUR ACTUAL KNOWLEDGE.

(b) ATTACH ADDITIONAL PAGES WITH YOUR SIGNATURE IF ADDITIONAL SPACE IS REQUIRED.

(c) COMPLETE THIS FORM YOURSELF.

(d) IF SOME ITEMS DO NOT APPLY TO YOUR PROPERTY, CHECK "NA" (NON-APPLICABLE). IF YOU DO NOT KNOW THE ANSWER CHECK "UNKN" (UNKNOWN).

SELLER'S STATEMENT: THE SELLER MAKES THE FOLLOWING REPRESENTATIONS TO THE BUYER BASED UPON THE SELLER'S ACTUAL KNOWLEDGE AT THE TIME OF SIGNING THIS DOCUMENT. THE SELLER AUTHORIZES HIS OR HER AGENT, IF ANY, TO PROVIDE A COPY OF THIS STATEMENT TO A PROSPECTIVE BUYER OF THE RESIDENTIAL REAL PROPERTY. THE FOLLOWING ARE REPRESENTATIONS MADE BY THE SELLER AND ARE NOT THE REPRESENTATIONS OF THE SELLER'S AGENT.

GENERAL INFORMATION

1. HOW LONG HAVE YOU OWNED THE PROPERTY?

2. HOW LONG HAVE YOU OCCUPIED THE PROPERTY?

3. WHAT IS THE AGE OF THE STRUCTURE OR STRUCTURES? NOTE TO BUYER--IF THE STRUCTURE WAS BUILT BEFORE 1978 YOU ARE ENCOURAGED TO INVESTIGATE FOR THE PRESENCE OF LEAD BASED PAINT.

4. DOES ANYBODY OTHER THAN YOURSELF HAVE A LEASE, EASEMENT OR ANY OTHER RIGHT TO USE OR OCCUPY ANY PART OF YOUR PROPERTY OTHER THAN THOSE STATED IN DOCUMENTS AVAILABLE IN THE

PUBLIC RECORD, SUCH AS RIGHTS TO USE A ROAD OR PATH OR CUT TREES OR CROPS. YES NO UNKN NA

5. DOES ANYBODY ELSE CLAIM TO OWN ANY PART OF YOUR PROPERTY? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

6. HAS ANYONE DENIED YOU ACCESS TO THE PROPERTY OR MADE A FORMAL LEGAL CLAIM CHALLENGING YOUR TITLE TO THE PROPERTY? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

7. ARE THERE ANY FEATURES OF THE PROPERTY SHARED IN COMMON WITH ADJOINING LAND OWNERS OR A HOMEOWNERS ASSOCIATION, SUCH AS WALLS, FENCES OR DRIVEWAYS? YES NO UNKN NA (IF YES DESCRIBE BELOW)

8. ARE THERE ANY ELECTRIC OR GAS UTILITY SURCHARGES FOR LINE EXTENSIONS, SPECIAL ASSESSMENTS OR HOMEOWNER OR OTHER ASSOCIATION FEES THAT APPLY TO THE PROPERTY? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

9. ARE THERE CERTIFICATES OF OCCUPANCY RELATED TO THE PROPERTY? YES NO UNKN NA (IF NO, EXPLAIN BELOW)

ENVIRONMENTAL

NOTE TO SELLER - IN THIS SECTION, YOU WILL BE ASKED QUESTIONS REGARDING PETROLEUM PRODUCTS AND HAZARDOUS OR TOXIC SUBSTANCES THAT YOU KNOW TO HAVE BEEN SPILLED, LEAKED OR OTHERWISE BEEN RELEASED ON THE PROPERTY OR FROM THE PROPERTY ONTO ANY OTHER PROPERTY. PETROLEUM PRODUCTS MAY INCLUDE, BUT ARE NOT LIMITED TO, GASOLINE, DIESEL FUEL, HOME HEATING FUEL, AND LUBRICANTS. HAZARDOUS OR TOXIC SUBSTANCES ARE PRODUCTS THAT COULD POSE SHORT- OR LONG-TERM DANGER TO PERSONAL HEALTH OR THE ENVIRONMENT IF THEY ARE NOT

PROPERLY DISPOSED OF, APPLIED OR STORED. THESE INCLUDE, BUT ARE NOT LIMITED TO, FERTILIZERS, PESTICIDES AND INSECTICIDES, PAINT INCLUDING PAINT THINNER, VARNISH REMOVER AND WOOD PRESERVATIVES, TREATED WOOD, CONSTRUCTION MATERIALS SUCH AS ASPHALT AND ROOFING MATERIALS, ANTIFREEZE AND OTHER AUTOMOTIVE PRODUCTS, BATTERIES, CLEANING SOLVENTS INCLUDING SEPTIC TANK CLEANERS, HOUSEHOLD CLEANERS AND POOL CHEMICALS AND PRODUCTS CONTAINING MERCURY AND LEAD.

NOTE TO BUYER - IF CONTAMINATION OF THIS PROPERTY FROM PETROLEUM PRODUCTS AND/OR HAZARDOUS OR TOXIC SUBSTANCES IS A CONCERN TO YOU, YOU ARE URGED TO CONSIDER SOIL AND GROUNDWATER TESTING OF THIS PROPERTY.

10. IS ANY OR ALL OF THE PROPERTY LOCATED IN A DESIGNATED FLOODPLAIN? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

11. IS ANY OR ALL OF THE PROPERTY LOCATED IN A DESIGNATED WETLAND? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

12. IS THE PROPERTY LOCATED IN AN AGRICULTURAL DISTRICT? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

13. WAS THE PROPERTY EVER THE SITE OF A LANDFILL? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

14. ARE THERE OR HAVE THERE EVER BEEN FUEL STORAGE TANKS ABOVE OR BELOW THE GROUND ON THE PROPERTY? YES NO UNKN NA IF YES, ARE THEY CURRENTLY IN USE? YES NO UNKN NA LOCATION(S) ARE THEY LEAKING OR HAVE THEY EVER LEAKED? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

15. IS THERE ASBESTOS IN THE STRUCTURE? YES NO

UNKN NA (IF YES, STATE LOCATION OR LOCATIONS BELOW)

16. IS LEAD PLUMBING PRESENT? YES NO UNKN NA (IF YES, STATE LOCATION OR LOCATIONS BELOW)

17. HAS A RADON TEST BEEN DONE? YES NO UNKN NA (IF YES, ATTACH A COPY OF THE REPORT)

18. HAS MOTOR FUEL, MOTOR OIL, HOME HEATING FUEL, LUBRICATING OIL OR ANY OTHER PETROLEUM PRODUCT, METHANE GAS, OR ANY HAZARDOUS OR TOXIC SUBSTANCE SPILLED, LEAKED OR OTHERWISE BEEN RELEASED ON THE PROPERTY OR FROM THE PROPERTY ONTO ANY OTHER PROPERTY? YES NO UNKN NA (IF YES, DESCRIBE BELOW)

19. HAS THE PROPERTY BEEN TESTED FOR THE PRESENCE OF MOTOR FUEL, MOTOR OIL, HOME HEATING FUEL, LUBRICATING OIL, OR ANY OTHER PETROLEUM PRODUCT, METHANE GAS, OR ANY HAZARDOUS OR TOXIC SUBSTANCE? YES NO UNKN NA (IF YES, ATTACH REPORT(S))

STRUCTURAL

20. IS THERE ANY ROT OR WATER DAMAGE TO THE STRUCTURE OR STRUCTURES? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

21. IS THERE ANY FIRE OR SMOKE DAMAGE TO THE STRUCTURE OR STRUCTURES? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

22. IS THERE ANY TERMITE, INSECT, RODENT OR PEST INFESTATION OR DAMAGE? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

23. HAS THE PROPERTY BEEN TESTED FOR TERMITE, INSECT, RODENT OR PEST INFESTATION OR DAMAGE? YES NO UNKN NA (IF YES, PLEASE ATTACH REPORT(S))

24. WHAT IS THE TYPE OF ROOF/ROOF COVERING (SLATE, ASPHALT, OTHER.)? ANY KNOWN MATERIAL DEFECTS? HOW OLD IS THE ROOF? IS THERE A TRANSFERABLE WARRANTEE ON THE ROOF IN EFFECT NOW? YES NO UNKN NA (IF YES, EXPLAIN BELOW)
25. ARE THERE ANY KNOWN MATERIAL DEFECTS IN ANY OF THE FOLLOWING STRUCTURAL SYSTEMS: FOOTINGS, BEAMS, GIRDERS, LINTELS, COLUMNS OR PARTITIONS. YES NO UNKN NA (IF YES, EXPLAIN BELOW)

MECHANICAL SYSTEMS & SERVICES

26. WHAT IS THE WATER SOURCE (CIRCLE ALL THAT APPLY - WELL, PRIVATE, MUNICIPAL, OTHER)? IF MUNICIPAL, IS IT METERED? YES NO UNKN NA

27. HAS THE WATER QUALITY AND/OR FLOW RATE BEEN TESTED? YES NO UNKN NA (IF YES, DESCRIBE BELOW)

28. WHAT IS THE TYPE OF SEWAGE SYSTEM (CIRCLE ALL THAT APPLY - PUBLIC SEWER, PRIVATE SEWER, SEPTIC OR CESSPOOL)? IF SEPTIC OR CESSPOOL, AGE? _________ DATE LAST PUMPED? _________ FREQUENCY OF PUMPING? _________ ANY KNOWN MATERIAL DEFECTS? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

29. WHO IS YOUR ELECTRIC SERVICE PROVIDER? _________ WHAT IS THE AMPERAGE? _________ DOES IT HAVE CIRCUIT BREAKERS OR FUSES? _________ PRIVATE OR PUBLIC POLES? _________ ANY KNOWN MATERIAL DEFECTS? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

30. ARE THERE ANY FLOODING, DRAINAGE OR GRADING PROBLEMS THAT RESULTED IN STANDING WATER ON ANY PORTION OF THE PROPERTY? YES NO UNKN NA (IF YES, STATE LOCATIONS AND EXPLAIN

BELOW)

31. DOES THE BASEMENT HAVE SEEPAGE THAT RESULTS IN STANDING WATER? YES NO UNKN NA (IF YES, EXPLAIN BELOW)

ARE THERE ANY KNOWN MATERIAL DEFECTS IN ANY OF THE FOLLOWING (IF YES, EXPLAIN BELOW. USE ADDITIONAL SHEETS IF NECESSARY.):

32. PLUMBING SYSTEM? YES NO UNKN NA
33. SECURITY SYSTEM? YES NO UNKN NA
34. CARBON MONOXIDE DETECTOR? YES NO UNKN NA
35. SMOKE DETECTOR? YES NO UNKN NA
36. FIRE SPRINKLER SYSTEM? YES NO UNKN NA
37. SUMP PUMP? YES NO UNKN NA
38. FOUNDATION/SLAB? YES NO UNKN NA
39. INTERIOR WALLS/CEILINGS? YES NO UNKN NA
40. EXTERIOR WALLS OR SIDING? YES NO UNKN NA
41. FLOORS? YES NO UNKN NA
42. CHIMNEY/FIREPLACE OR STOVE? YES NO UNKN N A
43. PATIO/DECK? YES NO UNKN NA
44. DRIVEWAY? YES NO UNKN NA
45. AIR CONDITIONER? YES NO UNKN NA
46. HEATING SYSTEM? YES NO UNKN NA
47. HOT WATER HEATER? YES NO UNKN NA
48. THE PROPERTY IS LOCATED IN THE FOLLOWING SCH OOL DISTRICT UNKN

NOTE: BUYER IS ENCOURAGED TO CHECK PUBLIC RECORDS CONCERNING THE PROPERTY (E.G. TAX RECORDS AND WETLAND AND FLOOD PLAIN MAPS)

THE SELLER SHOULD USE THIS AREA TO FURTHER EXPLAIN ANY ITEM ABOVE. IF NECESSARY, ATTACH ADDITIONAL PAGES AND INDICATE HERE THE NUMBER OF ADDITIONAL PAGES ATTACHED.

SELLER'S CERTIFICATION: SELLER CERTIFIES THAT THE INFORMATION IN THIS PROPERTY CONDITION DISCLOSURE STATEMENT IS TRUE AND COMPLETE TO THE SELLER'S ACTUAL KNOWLEDGE AS OF THE DATE SIGNED BY THE SELLER. IF A SELLER OF RESIDENTIAL REAL PROPERTY ACQUIRES KNOWLEDGE WHICH RENDERS MATERIALLY INACCURATE A PROPERTY CONDITION DISCLOSURE STATEMENT PROVIDED PREVIOUSLY, THE SELLER SHALL DELIVER A REVISED PROPERTY CONDITION DISCLOSURE STATEMENT TO THE BUYER AS SOON AS PRACTICABLE. IN NO EVENT, HOWEVER, SHALL A SELLER BE REQUIRED TO PROVIDE A REVISED PROPERTY CONDITION DISCLOSURE STATEMENT AFTER THE TRANSFER OF TITLE FROM THE SELLER TO THE BUYER OR OCCUPANCY BY THE BUYER, WHICHEVER IS EARLIER.

SELLER______________________________ DATE___________

SELLER______________________________ DATE___________

BUYER'S ACKNOWLEDGMENT: BUYER ACKNOWLEDGES RECEIPT OF A COPY OF THIS STATEMENT AND BUYER UNDERSTANDS THAT THIS INFORMATION IS A STATEMENT OF CERTAIN CONDITIONS AND INFORMATION CONCERNING THE PROPERTY KNOWN TO THE SELLER. IT IS NOT A WARRANTY OF ANY KIND BY THE SELLER OR SELLER'S

AGENT AND IS NOT A SUBSTITUTE FOR ANY HOME, PEST, RADON OR OTHER INSPECTIONS OR TESTING OF THE PROPERTY OR INSPECTION OF THE PUBLIC RECORDS.

BUYER_______________________________ DATE__________

____

BUYER_______________________________ DATE__________

____

3. Nothing in this article shall require a seller to undertake or provide for any investigation or inspection of his or her residential real property or to check any public records.

NORFOLK & WESTERN RAILROAD COMPANY V. AYERS— FEAR OF CANCER AS A CAUSE OF ACTION UNDER THE FEDERAL EMPLOYERS' LIABILITY ACT

by

J. L. Yranski Nasuti, J.D., LL.M.*

Asbestos litigation has long been a contentious issue for advocates of tort reform. This is partly the result of the extraordinary number of asbestos related lawsuits that have been filed since the 1960s and partly because of the variety of successful legal theories that have been employed by the plaintiffs' bar.[1] When the U.S. Supreme Court agreed to hear the case of *Norfolk & Western Railroad Company v. Ayers*[2], there was an expectation that the judiciary might finally provide some relief to the business and insurance company defendants. That hope was dashed when the Court held that railroad workers suffering from work related asbestosis could use the Federal Employers' Liability Act (FELA)[3] to recover mental anguish damages based on a fear of developing cancer. The clear message from the Court was that it did not intend to take the initiative away from Congress in this particular area of tort reform.

I.

Exposure to asbestos can cause a variety of illnesses including asbestosis and mesothelioma.[4] As in the case of many toxin exposure diseases, there is often a long period between the time when a person is exposed to asbestos and when any symptoms of a physical injury or illness appear.[5] The latency period for non-fatal asbestosis is substantially shorter than it is for the more serious mesothelioma. While a diagnosis of asbestosis does not necessarily guarantee that a patient will contract the fatal mesothelioma, it is an indicator of an increased risk of developing the disease. The risk of developing lung cancer also increases when the asbestosis sufferer engages in certain patterns of behavior such as smoking.[6]

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The fact that there is a significant lapse between the time of exposure to asbestos and the appearance of any symptoms of serious illness, such as mesothelioma, has created a variety of litigation problems. At the time that the original asbestos cases were filed, the traditional single-action rule was the norm. That meant that a plaintiff could only file one lawsuit for all damages arising out of a single negligent action by a defendant. As a consequence, the statute of limitations for all damages resulting from exposure to asbestos began to run once the plaintiff knew or should have known of any actionable injury. The fact that there might be multiple injuries (some of which were still latent) did not matter. A victim who had a less severe asbestos-related illness (such as pleural thickening) needed to file a lawsuit in a timely manner. That meant that he or she would risk the possibility of not being able to file an action in the future for a more serious claim of asbestosis or mesothelioma. The harshness of this result was ameliorated when the majority of jurisdictions abandoned the single action rule and allowed plaintiffs to file separate causes of actions for the different manifestations of latent injuries caused by a single negligent activity.[7]

The ability to bring sequential claims created a nightmare for defendants involved in asbestos litigation. In addition to filing claims for physical injuries and emotional distress related to those physical injuries, plaintiffs also began to file an alarming number of lawsuits based on stand-alone emotional distress claims that were unrelated to any actual physical injury. The rationale for these "fear of cancer" cases was that if you knew that your actual exposure to asbestos might eventually result in your developing cancer, then you should be compensated for the emotional distress caused by that uncertainty. There is no way for an asymptomatic person to know if he or she will develop cancer in the future as a result of having been exposed to asbestos. However, since the latency period of the illness is so long, the heightened vulnerability to developing cancer acts like the sword of Damocles—the person "knows it is there, but not whether or when it will fall."[8] Plaintiffs argue that the emotional stress caused by that uncertainty should be compensable even before there are any manifestations of the disease.

II.

The plaintiffs in the *Ayers* case were six former employees of the Norfolk & Western Railway Company. They alleged that Norfolk had negligently exposed them to asbestos during the course of their employment. As a result of that exposure, they contracted the occupational disease of asbestosis and suffered from an ongoing fear of developing cancer in the future. The case, which was filed in a West Virginia state court, was based on protections afforded under the Federal Employers' Liability Act (FELA). FELA, which was originally enacted in 1908, was one of the early progressive federal employment statutes. Its goal was to "shift part of the 'human overhead' of doing business from employees to their employers."[9] Under Section 1 of FELA, common carrier railroads are "liable in damages to any person suffering injury while . . . employed by [the] carrier" if the "injury or death resulted in whole or in part form the [carrier's] negligence."[10]

During the course of the trial, the court denied Norfolk's pre-trial motion to exclude all evidence referring to cancer as well as to two of its proposed instructions to the jury with regard to the fear of cancer allegations and the apportionment of damages. Although the trial judge allowed the admission of extensive evidence relating to cancer, he ultimately instructed the jury not to award any damages "for cancer or the increased risk of cancer" since none of the plaintiffs had demonstrated a reasonable certainty of developing the disease.[11] However, he did allow the testimony relating to cancer to be used by the jury "to judge the genuineness of the plaintiffs' claims based on a fear of developing cancer."[12] The jury was instructed that "any plaintiff who has demonstrated that he has developed a reasonable fear of cancer that is related to a proven physical injury from asbestos is entitled to be compensated for that fear as a part of the damages you may award for pain and suffering."[13] This instruction was quite different from Norfolk's rejected proposal that would have predicated the awarding of damages for a fear of cancer on a finding that the claimant had proved both "an actual likelihood of developing cancer" and "physical manifestations" of the alleged fear.[14] The court also denied Norfolk's request to instruct the jury to apportion damages between Norfolk and any other employers alleged to have contributed to the plaintiffs' injuries.[15]

The jury returned verdicts in favor of each of the plaintiffs.[16] After the trial court and West Virginia Supreme Court of Appeals denied Norfolk's motions for a new trial and a discretionary review, the U.S. Supreme Court granted *certiorari*. The two main issues to be decided by the Supreme Court were whether, under FELA, a valid claim could be made for mental anguish based on the fear of eventually developing cancer and whether the rule of joint and several liability was applicable. Among those filing *amici* briefs on behalf of Norfolk were the U.S. Chamber of Commerce and the Bush administration.

III.

The U.S. Supreme Court ruled in favor of the employees in the *Ayers* case in a 5-4 split decision that was not decided along traditional ideological lines. Justice Ruth Bader Ginsburg, writing for the majority, received the unanimous support of her colleagues in every aspect of her opinion except for the important section in which she affirmed the right of victims of asbestosis to recover additional pain and suffering damages if they could demonstrate a reasonable fear of cancer stemming from a present asbestos-related disease.[17]

Ginsburg decided the question of whether the appellees in the *Ayers* case could successfully pursue a fear of cancer claim by referring to the federal common law of negligence that was applicable to FELA. In the earlier cases of *Consolidated Rail Corporation v. Gottshall*[18] and *Metro-North Commuter R. Co. v. Buckley,*[19] the Court had established specific guidelines for FELA cases involving allegations of emotional distress. The plaintiff in *Gottshall* was a railroad employee who had witnessed the death of a co-worker. Although he suffered no physical injury himself, he did experience severe emotional distress as a result of the incident. In trying to decide whether his stand –alone claim should be allowed, the Supreme Court expressed a concern that an unchecked recognition of claims for negligently inflicted emotional distress would "hold out the very real possibility of nearly infinite and unpredictable liability for defendants."[20] To minimize that result, the Court applied the common law zone-of-danger test to determine the proper scope of the employer's duty under FELA. Under that test, the plaintiff could prevail in an emotional distress claim if he could prove that he had either sustained a physical impact as a result of the defendant's negligent conduct or that he had been placed in an immediate risk of physical harm by that conduct.[21] In the latter case, the plaintiff would have to show that although he had escaped instant physical harm, he had been within the zone of danger of physical impact.

The Court also applied the zone-of-danger test in *Metro-North*, another FELA case. In that instance, the plaintiff, a pipefitter, had been exposed to asbestos over a three year period. At the time of the lawsuit, he had not exhibited any symptoms of physical illness. However, he did assert that his stand-alone claim should be allowed since exposure to asbestos at the worksite had placed him within the type of zone-of-danger that was referred to in *Gottshall*. The Court, once again expressing a fear of "unlimited and unpredictable liability,"[22] rejected the employee's claim on the grounds that exposure alone was insufficient to show "physical impact" under the zone-of-danger test.[23]

Gottshall and *Metro-North* described two possible types of emotional distress cases. One represented claims for stand-alone emotional distress that were not provoked by any physical harm. Recovery for those claims was only possible if the party could satisfy the zone-of-danger test. The other involved claims for emotional distress that were brought on by physical injury. In those instances, the claims for pain and suffering were permissible.[24] The reason for the U.S. Supreme Court's split decision in the *Ayers* case was a disagreement over whether the plaintiffs' claims were indicative of a stand-alone emotional distress case or an emotional distress claim linked to a physical harm. The dissenting judges concluded that the employees' fear of cancer claims were stand-alone claims that could not satisfy the zone-of-danger test. The majority, on the other hand, ruled that the emotional distress claims were valid since they were linked to an actual physical harm—asbestosis.

The Court cited a number of legal sources to describe the wide variety of situations in which emotional distress claims associated with a physical injury had been compensable. According to Restatement (Second) of Torts §456 (1963-1964), if a person's negligent conduct caused *any* bodily harm to another, that person was liable for the fright, shock, *or other emotional disturbances* resulting from the bodily harm or from the conduct which caused it. (Emphasis added.) A person who suffered mental anguish after suffering bodily harm did not have to allege physical manifestations of the emotional distress.[25] Emotional distress included the apprehension of future harm. If that future harm was genuinely feared, it did not have to be more likely than not to materialize.[26] Physically injured parties could recover for "reasonable fears" of a future disease.[27] The Court concluded by citing a long list of successfully litigated "fear of" cases—including a series of "fear of" cancer cases.[28]

The majority then addressed the specific question of whether victims of asbestosis could be compensated for "fear of" cancer claims. It began by noting that of the appellate courts that had considered the issue, a clear majority had concluded that recovery was possible.[29] The Court then addressed two arguments raised by Norfolk and its supporting *amici*. The first was whether the demise of the single-action rule meant that the plaintiffs had to reserve their fear of cancer claims until that time when they had actually developed symptoms of cancer and could file separate cancer-related causes of action. The second was whether the claimants' alleged cancer fears were too remote from their having asbestosis to be included in their pain and suffering awards.

Norfolk's first argument was based on the premise that because the "separate disease rule" allows plaintiffs in asbestos lawsuits to file claims sequentially and to be subject to different statutes of limitations, a fear of cancer claim had to be reserved until symptoms of cancer appeared and the party filed a lawsuit based on all cancer-related damages. According to the brief for the Bush administration, the question was not *whether* the asbestosis claimants could recover for fear of cancer, but *when*. The Court found no reason why the "separate disease rule" should prevent asbestosis claimants from seeking damages for the emotional distress caused by their present fear of developing cancer in the future. The purpose of the separate disease rule was to ensure that claimants would be able to recover for successive diseases as they developed. But, the claimants in this case were not seeking damages for a disease that was still latent. On the contrary, they were seeking "damages for a *current injury*, which they allege, encompasses a *present fear* that the toxic exposure causative of asbestosis may later result in cancer."[30] The Court found that the major flaw with the government's argument was that it would "exclude recovery for the fear experienced by an asbestosis sufferer who never gets cancer."[31] However, the Court cautioned that for a sufferer of asbestosis to prevail in a fear of cancer claim, he or she would have to prove that the alleged fear was "genuine and serious."[32]

Norfolk next argued that mental or emotional harm cannot be compensable unless it is "directly brought about by a physical injury."[33] Since asbestos exposure, and not asbestosis, is the cause of cancer, "fear of cancer is too unrelated, as a matter of law, to be an element of an asbestosis sufferer's pain and suffering."[34] The Court responded to this argument in a number of ways. The first was by pointing out that the language of Restatement §456(a) stated that once a party was liable for "any bodily harm," that negligent actor was answerable in damages for emotional disturbance "resulting from the bodily harm *or from the conduct which causes it*." (Emphasis added.) In the *Ayers* case, the negligent exposure to asbestos was the cause of the bodily harm and it was also the reason why the workers feared developing cancer in the future. The Court cited testimony provided by experts for both the appellant and the appellee that confirmed the undisputed relationship between exposure to asbestos sufficient to cause asbestosis and asbestos related cancer.[35] Finally, the Court distinguished the asymptomatic exposure-only plaintiff in the *Metro-North* case from the plaintiffs in the *Ayers* case. In the case before the Court, the plaintiffs had already suffered real physical harm as a result of contracting asbestosis. Under the precedent set by *Metro-North*, the Court could deny damages for mental distress to a worker who was exposed to asbestos but had suffered no physical injury. But, it could not deny damages for mental distress to a worker who also suffered from asbestosis.[36]

The second issue that the Court agreed to consider in the *Ayers* case was whether the trial court erred when it instructed the jury "not to make a deduction [from damage awards] for the contribution of non-railroad [asbestos] exposures" to the asbestosis claimants injuries.[37] On this issue of statutory interpretation, the nine justices were unanimous. Apportionment was not permissible. Section 1 of FELA specifically states that: "Every common carrier by railroad while engaging in [interstate commerce], shall be liable in damages to any person suffering injury while he is employed by such carrier ... for such injury ... *resulting in whole or in part* from the negligence of . . . such carrier." (Emphasis added.) The Court noted that "nothing in the statutory text instructs that the amount of damages payable by a liable employer bears reduction when the negligence of a third party also contributed in part to the injury-in-suit."[38] In addition, to read §1 in a way that would allow the apportionment requested would go against FELA's goal of "shift[ing] part of the 'human overhead' of doing business from employees to their employers."[39] The Court suggested that an unnecessary tension would result if the statute were read in the way suggested by Norfolk.[40] The fact that the statute expressly provided for the apportionment of responsibility between employer and employee based on comparative fault and said nothing about the apportionment of damages between the railroad and nonrailroad tortfeasors was a further indication that FELA accepted the traditional rule of joint and several liability.

IV.

The approach of the majority in the *Ayers* case might be characterized as one of moderation. It did not speculate on social policy issues or economic consequences when it made its decision. On the contrary, it limited itself to the consideration of two matters. The first was whether railroad workers who suffered from asbestosis had a statutory or federal common law basis for winning fear of cancer cases. The second was whether damages awarded to successful FELA cases could be apportioned between railroad and non-railroad tortfeasors. The majority acknowledged that there was an "elephantine mass of asbestos cases" pending in state and federal courts.[41] But unlike the dissenting justices, the majority refused to base its decision on the ability of the railway industry to pay such claims or the possibility that those payments for fear of cancer cases would deplete the available funds and cause persons with more serious asbestos related illnesses from ever receiving any compensation. The Court acknowledged that there was a problem with the administration of mass tort asbestos cases. But, it cautioned that "courts . . . must resist pleas of the kind Norfolk has made, essentially to reconfigure established liability rules because they do not serve to abate today's asbestos litigation crisis."[42] In the end, the majority concluded that national legislation, and not judicial administration, would be the more appropriate way to untangle the social policy concerns relating to asbestos litigation.[43]

ENDNOTES

[1] According to the Rand Institute for Civil Justice, there were 21,000 claims based on asbestos exposure in 1982. By 2002, that number had risen to 700,000 claims. Alex Bereson, *Asbestos Accord Is Said To Be Near,* N.Y. TIMES, April 24, 2003, at A1, C6.

Courts grant relief to plaintiffs who have demonstrated symptoms of an actual illness as well as to plaintiffs who are completely asymptomatic but anticipate an injury. The front-loaded theories of tort recovery include claims for emotional distress caused by a fear of an increased risk of contracting cancer as well as for the cost of medical surveillance to promptly detect and treat a possible disease. See Andrew Klein, *Fear of Disease and the Puzzle of Future Cases in Tort,* 35 U.C. Davis L. Rev. 965 (April 2002); James A. Henderson, Jr. & Aaron D. Twerski, *Asbestos Litigation Gone Mad: Exposure-Based Recovery for Increased Risk, Mental Distress, and Medical Monitoring,* 53 S.C.L.REV. 815 (Summer 2002).

[2] 123 S. Ct. 1210; 155 L.Ed. 2d 261; 2003 U.S. LEXIS 1956 (2003).

[3] 35 Stat. 65, as amended, 45 U.S.C. §§ 51-60.

[4] Asbestosis is a noncancerous scarring of the lung by asbestos fibers and manifests itself in symptoms such as shortness of breath, coughing, and fatigue. Mesothelioma is a fatal cancer of the lining of the lung or abdominal cavity.

[5] The latency period for asbestos related mesothelioma is generally 20-40 years from exposure. RAND Institute for Civil Justice, S. Carroll et al., *Asbestos Litigation Costs and Compensation: An Interim Report* 17 (2002).

[6] *Supra* note 2, *Ayers* at 1215.

[7] *Supra* note 1, Henderson at 820-821.

[8] *Alley v. Charlotte Pipe & Foundry Co.*, 159 N.C. 327, 331, 74 S.E. 885, 886 (1912).

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[9] *Consolidated Rail Corporations v. Gottshall*, 512 U.S. 532, 542; 114 S.Ct. 2394 (1994) (quoting *Tiller v. Atlantic Coast Line R. Co.*, 318 U.S. 54, 58; 63 S.Ct. 444 (1943).

[10] *Supra* note 3, §51. FELA also abolished a number of common-law defenses including the fellow-servant rule, the doctrine of contributory negligence, and the assumption of risk defense and it prohibited employers from exempting themselves from FELA through contract. §§51-55.

[11] *Supra* note 2, *Ayers* at 1216, quoting Tr. 573.

[12] *Id.*

[13] *Id.*

[14] *Id.* at 548.

[15] The denial of the request for an apportionment of damages among all possible tortfeasors was particularly disturbing to the defendant since one of the plaintiffs have been exposed to asbestos for only three months while working at Norfolk and for thirty-three years while working for a previous employer. A second plaintiff had been exposed to asbestos for several years while working at auto-body shops.

[16] The original individual awards ranged from $770,000 to $1.2 million. However, three of the awards were reduced because of the claimants' comparative negligence from smoking and because of other settlements with non-FELA entities. Since neither side had requested a special verdict, it was impossible to determine how much, if any, of each award was for fear of cancer damages.

[17] Justices Stevens, Scalia, Souter, and Thomas joined Ginsburg in the entire opinion. Chief Justice Rehnquist and Justices O'Connor and Breyer joined Justice Kennedy, in a separate opinion that concurred in part and dissented in part. In addition, Justice Breyer filed an opinion concurring in part and dissenting in part.

[18] *Supra* note 9.

[19] 521 U.S. 424, 117 S.Ct. 2113 (1997).

[20] *Supra* note 9, *Gottshall* at 546.

[21] *Id.* at 547-548.

[22] *Supra* note 19, *Metro-North* at 435.

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[23] *Id.* at 430.

[24] *Supra* note 2, *Ayers* at 1224.

[25] D. Dobbs, *Law of Torts* 822 (2000).

[26] Minneman, *Future Disease or Condition, or Anxiety Relating Thereto, an Element of Recovery,* 50 A.L.R. 4th 13, 25 §2[a], (1986).

[27] *Supra* note 25, at 844. The classic "fear of" case is that of *The Lord Derby*, 17 F. 265 (E.D. La. 1883), in which the plaintiffs, who had been bitten by dogs, were able to recover damages for the pain of the wounds and for their fear that the bites might someday result in rabies or tetanus.

[28] *Supra* note 2, *Ayers* at 1219-1220. "Fear of" cases included: *Goodmaster v. Houser*, 225 Conn. 637, 647, 625 A.2d 1366, 1371 (1993); *Laxten v. Orkin Exterminating Co.*, 639 S.W.2d 431, 434 (Tenn. 1982); *Baylor v. Tyrrell,* 177 Neb. 812, 824-826, 131 N.W.2d 393, 401-402 (1964); *Schneider v. Chalfonte Builders, Inc.*, 11 Bucks 122 (Pa.Ct. Common Pleas 1961); *Figlar v. Gordon*, 133 Conn. 577, 585, 53 A.2d 645, 648 (1947); *Southern Kansas R. Co. of Texas v. McSwain,* 55 Tex.Civ.App. 317, 319, 118 S.W. 874, 875 (1909); *Butts v. National Exchange Bank,* 99 Mo.App. 168, 173, 72 S.W. 1083, 1084 (1903). "Fear of cancer" cases included: *Alley v. Charlotte Pipe & Foundry Co.*, 159 N.C. 327, 331, 74 S.E. 885, 886 (1912); *Sterling v. Velsicol Chemical Corp.*, 855 F.2d 1188, 1206 (C.A.6 1988); *Clark v. Taylor*, 710 F.2d 4, 14 (C.A.1, 1983); *Dempsey v. Hartley,* 94 F.Supp. 918, 921 (E.D.Pa. 1951); *Zieber v. Bogert*, 565 Pa. 376, 383, 773 A.2d 758, 762 (2001); *Anderson v. Welding Testing Laboratory, Inc.*, 304 So.2d 351, 353 (La. 1974); *Lorenc v. Chemirad Corp.*, 37 N.J. 56, 76, 179 A.2d 401, 411 (1962); *Ferrara v. Galluchio,* 5 N.Y.2d 16, 20-21, 152 N.E.2d 249, 252-253, 176 N.Y.S.2d 996 (1958); *Coover v. Painless Parker, Dentist,* 105 Cal.App. 110, 115, 286 P. 1048, 1050 (1930).

[29] *Id.* at 1219-1220. *Jackson v. Johns-Manville Sales Corps.*, 781 F.2d 394, 413-414 (C.A.5 1986); *Bonnette v. Conoco, Inc.*, 2001-2767 (La. 1/28/03), __ So.2d __, __, 837 So.2d 1219, 2003 La. LEXIS 119, 2003 WL 183764; *Wolff v. A-One Oil, Inc.*, 216 App.Div. 2d 291, 292, 627 N.Y.S.2d 788, 789-790 (1995); *Capital Holding Corp. v. Bailey,* 873 S.W.2d 187, 194 (Ky.1994); *Mauro v. Raymark Industries, Inc.*, 116 N.J. 126, 137, 561 A.2d 257, 263 (1989); *Lavelle v. Owens-Corning Fiberglass Corp.*, 30 Ohio Misc.2d 11, 14, 30 Ohio B. 223, 507 N.E.2d 476, 480-481 (Ct. Common Pleas, Cuyahoga Cty. 1987).

[30] *Id.* at 1221.

[31] *Id.* at 1221.

[32] *Id.* at 1223. The Court implied that the trial attorneys for Norfolk may have been negligent in failing to file a sufficiency of the evidence objection in this particular case. See *id.* at 1224.

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[33] *Id.* at 1221, citing Brief for Petitioner 15 (quoting *Gottshall*, *supra* note 9, at 544).

[34] *Id.* at 1221, citing Tr. of Oral Arg. 11.

[35] *Id.* at 1222.

[36] The separate dissenting opinions of Justices Kennedy and Breyer disagreed with the majority in part because of a social policy concern and in part because of legal concerns. The social policy concern was based on the fact that the funds currently available for compensation in asbestos cases are nearly exhausted. To allow plaintiffs with asbestosis to recover substantial awards for fear of cancer claims would mean that future plaintiffs with asbestos-related cancer would inevitably face judgment-proof defendants.

The minority opinions also took exception with what they saw as a misapplication of common law rules. They were particularly upset with the way that the Court interpreted the requirement that a pain and suffering for emotional distress award is only appropriate when it is a direct consequence of an injury. The dissenting judges argued that since the plaintiffs did not prove a causal link between asbestosis and cancer, they could not use their having developed asbestosis as the basis for fear of cancer claims.

[37] *Supra* note 2, *Ayers* at 1225.

[38] *Id.* at 1225.

[39] *Supra* note 9, *Gottshall* at 542.

[40] The tension would be created in large part because FELA was one of the first federal statutes to protect employees. *Supra* note 10.

[41] *Supra* note 2, *Ayers* at 1228.

[42] *Id.* at 1228.

[43] In the months following the Court's decision, Congress increased its efforts to establish an asbestos trust fund that would handle all asbestos claims. The fund, which would be financed by insurance companies and business and would be administered by the federal government, would pay people with asbestos-related diseases according to a set payment schedule. However, Congress has still not been able to legislate a way out of the asbestos quagmire.

The Growth of Problem-Solving Courts: Are They Solving Any Problems?

by

Arthur M. Magaldi*

The courts have operated in a consistent way for many years. Theoretically, the criminal courts have meted out punishments to fit crimes. Also, theoretically, the wrongdoers have received their punishments, "taken their medicine", so to speak, and reformed and changed their ways. Unfortunately, this has been far more theory than reality. In actuality, many of the underlying problems of the convicted remain after they receive their punishment and they continue to commit the same and also additional different crimes. The high degree of recidivism of the drug addicted and drug dependent, the mentally ill, the perpetrators of domestic violence, and the quality of life offenders has caused great societal consternation. How to deal with these types of offenders has posed a thorny problem which society has not successfully answered. This paper concerns itself with four new types of courts - drug courts, mental health courts, domestic violence courts, and community courts – which attempt to deal in pro-active and creative ways with these seemingly intractable problems.

For centuries the role of judge in criminal court has been that of an impartial, somewhat aloof referee presiding over the combat between prosecutor and defense attorney and their respective clients, the people of the state and the particular defendant. The image of the somewhat stern and generally aloof judge garbed in dark robes maintaining little contact with either side is a fairly popular stereotype. Indeed, judges are generally thought to be focused on the matter at hand free from the help and hindrance of the outside world, e.g., they rarely seek the counsel of outside parties. Judges are generally perceived to be models of stability and continuity representing the establishment and applying the law to the case at hand. Judges are expected to be neutral and impartial. In criminal matters, the judge traditionally deals with the particular defendant, but does not deal to any great extent with

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the larger reason, e.g., drug addiction, the defendant committed the offense. Despite occasional lip service to the idea of rehabilitation, judges generally impose their sentences realistically feeling that sentences are clearly more punishment than rehabilitation. Since crime rates are high, judges, particularly in urban settings, are also under pressure to dispose of cases, clear calendars, and move the system along. In doing their work, in our system courts traditionally make great use of precedent and tradition, the well known concept of *stare decisis*.

In the last decade or so, some criminal courts have attempted to go beyond their traditional roles. The so-called problem-solving courts take a different, more expansive approach. Problem-solving courts are a kind of judicial experiment which seeks "to help defendants address their problems, help victims, and improve public safety."[1]

At present, problem-solving courts are composed of community courts, drug courts, domestic violence courts, and a smattering of mental health courts. In drug courts and mental health courts, the judges try to craft a sentence, often an alternative sentence to incarceration, which helps the offender deal with the underlying problem which contributed to the commission of the crime, e.g., mental health courts seek to substitute long term treatment for incarceration. Community courts attempt to deal with quality of life crimes in a manner which causes the wrongdoer to repay the community and appreciate the effect of the crime on the community. Domestic violence courts focus on the protection of the victim and prevention of further harm to the victim. "What do all of these initiatives have in common? What each shares is an underlying premise: that courts should do more than just process cases. That at the end of the day, the goal is not just to make it through the calendar, but to make a difference in the lives of victims, the lives of defendants and the lives of neighborhoods. In one way or another, all of the new judicial experiments are attempting to solve the kinds of cases where social, human and legal problems intersect."[2]

Characteristics of Problem-Solving Courts

It isn't possible to group all problem-solving courts together and conveniently describe characteristics which uniformly fit all of them. The prototype of community courts is the Midtown Community Court in New York City. Those courts modeled after it are similar, but may not have exactly the same resources and facilities. There are, however, certain characteristics shared by most problem-solving courts.

Perhaps the key characteristic of problem-solving courts is the pro-active stance of judges. In problem-solving courts, judges take an expanded and more active role and go far beyond their traditional roles of neutral guardian of proper courtroom procedure and imposer of sentences. Judges in problem-solving courts frequently impose non-traditional sentences and engage in post-sentencing follow-up to determine whether the offender has made progress in dealing with the underlying problem. "Tradition dictates that judges serve as neutral arbiters and that their work focuses on process and penalties. But in a problem-solving court, judges are asked to focus on other issues, such as the underlying problems that bring defendants to court, the impact of criminal behavior on victims and the implications of crime for a community. In short, in a problem-solving court, context matters in a way that it doesn't in most conventional courts."[3] Simply put, the judges take on more and more varied responsibility. Generally, the judges make an attempt to have defendants change their lives and life styles. In doing so, the judges are aware that they are tackling problems which have often defied solutions, e.g., drug abuse, prostitution, and mental illness. In many cases, they are also taking on a role as part social worker for which they have not been formally trained. Since the judges often impose alternative sentences, judges may be susceptible to charges that they are "soft on crime" or coddling criminals, "but many problem-solving judges actually argue that their courtrooms are tougher than conventional courts."[4] Defenders of problem-solving courts believe that they are the most accountable courts because defendants are followed up closely by judges who see them more often and follow them more closely in their expanded roles. Defendants are required to return to court frequently to report on their progress in meeting the sentence. Problem-solving judges stay involved after sentencing in the progress, or lack of progress, of defendants and attempt to use their powers as judges to force defendants to obey court orders. "Instead of passing off cases after rendering a sentence – to other judges, to probation departments, to community-based treatment programs or, in all too many cases, to no one at all – judges at problem-solving courts stay involved with each case over the long haul."[5]

Drug Courts

The conduct of judges in drug courts is illustrative of the new problem solving attempts. Former United States Attorney General Janet Reno is credited with starting the first drug court in 1989. Since then, hundreds more have sprung up. A main focus of drug courts is to get non-violent felony drug offenders into long-term treatment rather than jail or prison. Drug addicts who plead guilty to their charges may have the charges dismissed upon successful completion of their treatment or they may receive a conditional discharge, the condition being that they successfully complete a long-term rehabilitation program. In this attempt to rehabilitate and cure instead of just punish, judges will closely monitor the defendant offering praise, reproach, threats, and encouragement as the defendant makes his/her way through the required treatment. The judges often attempt to also solve other problems related to the defendant's addiction, e.g., housing, since drug addicted defendants often have a multitude of social problems. The theory is that the defendant may need help in other areas of life to avoid drugs and the crime that comes with drug dependency.

One of the benchmarks of the problem solving court is that the defendant's conduct after alternative sentencing is monitored. The defendant will be mandated to return to court numerous times during the course of treatment. Obviously, the judge will to a certain extent get to know the defendant. "Heartfelt words of congratulation from the judge and a round of applause from court spectators typically mark an addict's successful completion of treatment at the Brooklyn Treatment Court."[6] The attempt to encourage, force, and cajole defendants into seeking long-term help for addiction is a departure from judges' usual roles, but it can also be seen as an attempt to deal in a new way with an epidemic that seems to be growing bigger. "Or look at substance abuse: research tells us that two out of every three criminal defendants tests positive for drugs at the time of arrest.[7] In some cases, community courts will also offer defendants charged with misdemeanors the opportunity for sentencing to drug rehabilitation in lieu of other punishment. Community courts frequently sentence quality of life defendants, e.g., turnstile jumpers, graffiti writers, those who urinate in public, and prostitutes to community service, the performance of which is monitored by the judge. In this way, the offended community is thought to be paid back in a small way for the offense.

Community Courts

Community Courts are criminal courts designed to deal with low-level quality of life crimes at the arraignment stage. Quality of life crime has effects which go beyond the individual, if indeed there is an individual defendant, and affect entire communities and the stakeholders in those communities. Quality of life crimes include, but of course are not limited to, petty larceny, graffiti writing, public urination and defecation, disturbance of the peace, prostitution, vandalism, fare-beating, violation of open container laws, and low-level drug use and sale.

For many years, quality of life crimes were not viewed seriously. Quality of life crimes increased along with the general increase of crime which occurred during the 1960's through the early 1990's and little progress was made in dealing with these types of crimes. It was common for the same wrongdoer to be arrested numerous times and receive no meaningful sanctions. Typical sentences included being sentenced to time served awaiting trial, adjournments in contemplation of dismissal wherein the case was adjourned on the promise of the defendant to "sin no more" during a stated period of time, short jail and prison sentences. There is a great deal of background on the approaches of the system to quality of life crimes. Violent crime rates had skyrocketed and the system was preoccupied with dealing with those matters. The courts were almost overwhelmed with unprecedented numbers of cases demanding to be resolved.

There were philosophical underpinnings for the treatment of low-level, quality of life wrongdoers. A theory developed that these were "victimless" crimes, the implication being that they did not deserve much punishment or that there was not much of a wrong to be righted. The matters were generally thought to be vexatious but not serious. Those who felt there were possible serious consequences also had no effective options with which to deal with these cases. Society simply had no effective responses to quality of life crimes and took some solace in deeming the crimes to be victimless crimes which implicitly.

In the early 1980's, sentiment began to change and people now having dealt with a substantial amount of "victimless" crime began to think themselves and their entire communities assaulted by such conduct. One did not have to be a social scientist to realize that something was wrong when prostitutes harassed passersby, graffiti made building ugly, and customers were greeted with the smell of urine on doors to business. For example, there came a time in the 1980's when it was virtually impossible to see out or through a window on a New York City subway, so filled were they with graffiti.

Although the sentiment shift to viewing quality of life crimes in a serious manner began to take place in the 1980's, it wasn't until the 1990's that a clear judicial initiative was begun to deal with the problem. The Midtown Community Court, the country's first community court, opened in 1993. It is situated in the Times Square section of Manhattan and is designed to deal with quality of life crimes committed in that area.

Community courts reflect a newer philosophy on quality of life crimes. A bedrock principle of the community court movement is that there are absolutely no victimless quality of life crimes. The community in which the crime is committed and the relevant people involved in that community are felt to be the victims of all such crimes. The community court movement holds that quality of life crimes, despite the fact that they are generally considered low level misdemeanors, do in fact diminish the quality of life for the stakeholders of the affected community. An accompanying principle is that those convicted of quality of life crimes should repay or compensate the community in some manner for the wrong done to it. This repayment or compensation is generally accomplished by sentencing the wrongdoer to dome sort of community service.

Community courts generally operate at the arraignment stage and seem to be most effective for those who plead guilty to the charges. One of the key innovations of the movement is to involve the community in reaching community justice. This may be done through Impact Panels in which the wrongdoer meets with community representatives who attempt to sensitize the wrongdoer to their feelings and make certain that the wrongdoer is aware of the negative effects of the conduct in question, that this conduct is not victimless, but hurtful. Community advisory boards are also part of the community justice attempt. These boards meet regularly with the judge and court personnel to make them aware of community service projects that would benefit the community and be suitable for offenders.

Community service as alternative sentencing is a hallmark of the community courts. At the Midtown Community Court, the community service may vary from cleaning and maintaining the court building, removing graffiti, pruning and caring for trees, clearing garbage from empty lost, and recycling cans and bottles. Those sentenced are often mandated to fulfill their service immediately and are taken from the court to the appropriate agency to begin their sentence. They are physically walked to the location.

Community service of itself is not an innovation because other courts have made use of this type of sentence, but the manner in which the sentences are coordinated and monitored is innovative. Community groups may supervise the community service and report back to the court. Where community representatives are unable to supervise or where the defendant is a high risk, the judge may order community service to be performed in the court building itself. Of course, those deemed unsuitable for community service the sanction of incarceration is available. Work performed in the community gives community representatives the opportunity to determine whether the punishment fits the crime.

In the community courts, strong efforts are made to help the wrongdoers also. This generally takes the form of referral of the wrongdoer to social services organizations designed to help with problems. The courts are attempting to solve both the problem of the community and of the wrongdoer. In many cases, the wrongdoer receives an alternative sentence which involves enrollment in a program with a social services organization, e.g., a literacy or drug program, an Alcoholics Anonymous program, a program for domestic batterers, or one to aid the homeless. Prostitutes may be referred to health counseling. The key is that in community courts they make certain that the referred actually make contact with the agency and receive the services. In the Midtown Community Court, the court has been set up in an ideal way with the social services agencies housed right in the court building itself. The clients are actually walked up to the agency representative to begin the process.

High-Tech Coordination

Another key characteristic of problem-solving courts is a high and relatively sophisticated use of technology. The use of computer and internet technology enhances the opportunity to monitor the defendant's actions during treatment, but it does much more. Consider the information available on the judge's computer screen in the Midtown Community Court which targets quality of life offenses. As the case of a defendant is called, the judge has the opportunity to look at his computer on the bench and see on one assessment screen the age, sex, and native language of the defendant, whether there are open warrants or open cases, whether the defendant is on parole or probation, whether the defendant is on drugs and any past history of drug use, whether the defendant requests drug treatment, and whether the defendant is working and has a home. Other information on the screen will include the educational level of the defendant including ability to read, and date of last conviction and compliance with prior orders of the court. In addition, the availability of drug treatment facilities is downloaded by pre-trial support staff. "As each case is called, the judge's computer screen lights up in red to alert the judge that treatment may be a relevant disposition in the case at hand."[8] The judge is no longer guessing about whether the defendant is on drugs and whether there is an appropriate place to send the defendant for long-term care. Accordingly, judges can make informed decisions on the question of referral or sentencing to drug rehabilitation. So in the pre-sentencing stage, the judge has relatively complete information with which to craft a sentence.

Equally important, technology use allows judges to monitor whether the defendant complies with alternative sentencing. By use of compliance tracking screens, judges may keep close tabs on whether the defendants pass urine tests at the assigned facility and generally conform to treatment requirements. By consulting their computers, the police may learn the disposition of arrests made by them when a police link is established. Where the judge determines that there is non-compliance with alternative sentencing, a warrant may be speedily issued for arrest. In this regard, problem-solving courts are thought to be highly accountable in that they keep informed of the fulfillment of the sentences imposed. Links to the probation department allow probation officers to know of the sentencing of offenders and any special concerns. Of course, probation violations may be reported to the judge for appropriate action.

Domestic Violence Courts

There are approximately 300 domestic violence courts in the United States, the first having been begun in Quincy, Massachusetts, in 1987. In these courts, emphasis is placed on keeping the victim safe and little, if any, emphasis is placed on rehabilitation of defendants. In regard to the latter, domestic violence courts are something of a departure from other problem-solving courts. Domestic violence presents a unique set of problems, e.g., the perpetrator may be a family member or lover, a person the victim lives with or has financial reliance on, the father of the child of the victim, or have another substantial tie to the victim. Historically, domestic violence matters were routinely disregarded or given small attention by the courts, but over time it became clear that domestic violence was a serious problem that required a specialized response. The thinking of the problem-solving Domestic Violence Courts is to have social workers and providers of social services present in the courtroom and court building in order to provide the victim prompt and supportive access to immediate help, for example, a shelter for battered women or an agency to support abused children. These are difficult and complex problems, but traditional sentences have not done enough to solve the problem. "The thinking was simple: that the unique nature of domestic violence cases demanded a unique set of skills and knowledge from judges, attorneys and social workers. By aggregating these cases in a single courtroom, it would be possible to do a better job of prosecuting and protecting victims."[9] Technology allows the judge to keep abreast of the case. An order of protection is not simply issued and forgotten. Monitoring of compliance with court orders is essential to the future safety of victims. In the past, it was common for offend- ers to routinely violate orders of protection and further abuse victims. Productive use of technology allows the judge to be made aware quickly of violations of orders of protection. Likewise where the perpetrator is assigned to a program for domestic violence, the court may monitor compliance and attendance. Generally, defendants are brought back to court numerous times. Referring to procedures at the Brooklyn Domestic Violence Court it has been observed, "...the court wouldn't adjourn cases for months at a time, but require defendants to return on a regular basis, if only to impress upon them that the court was closely watching them...And there would be extra staff to work with victims and provide them services, such as safe houses, financial aid and job training."[10]Computer technology facilitates the checking for available help for victims also.

Additional Personnel

Problem-solving courts will generally have more personnel to aid the judge in decision-making. There are, therefore, new players and new voices to help the judge reach an appropriate decision. Included among the parties working with the judge in attempting to solve the problems which the court deals may be: a coordinating team, assessment team, social service providers, a community advisory board, and an outcome research unit.

The resource coordinator reviews all pre-trial information on the case utilizing the computer system of the Court. The research coordinator is advisory to the judge and may confer with the prosecutor and defense attorney to gain more information. A key player in the disposition of cases, the resource coordinator makes a sentencing recommendation to the judge and may attempt to match a defendant with social services, community service or other sanctions. In many ways, the research coordinator may be a liaison between parties in the court as a constructive solution is sought. As the name resource coordinator indicates, this party should be fully familiar on an up to the minute basis with all the resources available to the court to deal with particular defendants and victims. Upon the advice of the resource coordinator, the court may offer the defendant a certain deal or may sentence the defendant to a treatment meant to be corrective of the defendant's condition, or more constructive than traditional punishment for the defendant and/or the community affected by the defendant's conduct.

The ideal for social services providers is to have them housed in some part of the court building. This is the situation in the Midtown Community Court which is the prototype for community courts where social services and community service departments are housed on one floor. A defendant sentenced to community service is personally escorted to the alternative sanctions floor to meet with representatives. In many cases, the community service is begun on the very date of sentencing. A similar result obtains when the defendant is referred to social service providers. Again, the defendant is personally escorted to the appropriate contact person housed within the court building. No longer may the defendant later complain that he/she could not find or reach the agency. As indicated earlier, compliance is monitored through computer-based communication.

The Community Advisory Board is a group of interested and involved community members who help the court understand the impact of certain crimes on the community; help to craft community service sentences to repay the community, and generally advise the Court on matters of community concern. Judges in problem-solving courts commit to working with advisory boards and often have regularly scheduled meetings.

Mental Health Courts

The newest attempt at problem-solving courts concerns defendants with mental illness. There are far fewer individuals institutionalized for mental illness today than in the past. In 1955, there were 560,000 institutionalized mental patients, but in 1999 the number had fallen to less than 80,000.[11]Unfortunately, the numbers of prisoners in jails and prison swelled during that time to approximately 1.6 million and 16 percent of those complained of mental illness or prior mental health hospitalization.[12]Many of those released from mental hospitals are now incarcerated in prisons and jails. "Preliminary results from a recent study in Brooklyn suggest that as many as 30 percent of all arraigned defendants may have a serious mental illness."[13]If these figures are approximately accurate, this means that thousands of mentally ill people are spending time in jail or are long-term prisoners. Even a casual observer in criminal court can see that many of the defendants seem to have serious mental problems. Many of these inmates have the additional problem of drug abuse having what are called co-occurring disorders. In the present state of the court system nationwide, these troubled individuals do not receive much help.

Mental health courts are the newest innovation in the problem-solving courts arena. Modeled after drug courts, they also began in Florida, when the first mental health court came into being in 1997 in Broward County. There are now approximately a dozen in operation throughout the U.S. They are a product of dissatisfaction with the current handling of mentally ill defendants and an attempt to reduce recidivism. They attempt to substitute long-term, judicially-supervised mental health treatment for the punishment of incarceration. As with drug courts, offenders return to court numerous times during the course of treatment and meet with the judge. For those who accept treatment, the judge may offer rewards and impose sanctions during the period of time of treatment.

Procedures vary from jurisdiction to jurisdiction, but common steps in the process may be identified. Generally, mental health courts deal with defendants who exhibit symptoms of severe mental illness and are charged with misdemeanors of a non-violent nature. The mental illnesses must also fall within certain designated categories. "In linking defendants with mental illness to treatment alternatives, many mental health courts see themselves as practicing 'therapeutic jurisprudence'. In one way or another, mental health courts are testing the extent to which the law can be a therapeutic agent – a social force producing positive life changes for defendants."[14]Mental health courts are trying to fill a void in the present system. "The bottom line is that there is a severe shortage of treatment for people with mental illness while they are incarcerated."[15]

Again, there is no single procedure common to all mental health courts, but there is generally an identification process during the twenty-four hour period following arrest. Jail staff, the defendant him/herself, family members, defense attorneys, and court personnel may identify the defendant as a person who may profit from referral to mental health treatment. The judge, again in a non-traditional role, may convene a meeting with the prosecutor, defense attorney, mental health professionals who form part of the court's staff, and service providers. If the conclusion is reached that the defendant is an appropriate candidate for treatment instead of the usual criminal court sanctions, the defendant may be offered treatment. If the defendant has not been found guilty of any crime, i.e., the defendant is offered the mental health option and participation is voluntary. In general, non-violent misdemeanor cases are chosen. The usual situation requires that the defendant agree to involve him/herself in treatment for a stated minimum amount of time, e.g., one year, an amount which often far exceeds the amount of jail term the defendant would have faced. This recognizes the fact that treatment for mental health problems requires time to be effective. In certain cases after a defendant has pled guilty or been found guilty of a charged crime, the court may order treatment. The voluntary approach seems to be the more prevalent. Since many of the defendants are already familiar with the prison and court systems however, the voluntariness of participation is an encouraging sign. Many defendants realize they would serve little, if any, jail time for low-level misdemeanors. They also understand that they may be involved with treatment for a considerably longer period, so choosing treatment is an encouraging first step.

Mentally ill defendants pose particular problems for problem-solving courts. "Building on the drug court model, some mental health courts apply a series of graduated sanctions and rewards to help improve compliance with treatment mandates."[16] Sometimes the possibility of the sanction of incarceration for failure to complete treatment is explained to the defendant at the time the deal is struck. Mentally ill people may, however, not fear incarceration or there illness may make following treatment regimens difficult. Treatment medicines may also have uncomfortable side effects which defendants eventually choose to avoid. Despite these difficulties, the judge in concert with the previously mentioned staff will try to monitor the defendant/patients's progress by return trips to court, discussion with the judge and staff members, and computer monitoring of reports supplied by the mental health professionals involved in the case. Concurrently, the judge working with staff and agencies may be seeking to solve some of the defendant's accompanying problems, e.g., the defendant may not have a home, may need a job, may need access to medical care other than that pertaining to mental health. These are relatively new roles for judges who are now active in a problem-solving world.

Results

The mental health courts are so new that clear results are not available. "What does the record show about mental health courts? Are they working? The short answer is that it is too early in the development of mental health courts to say whether they are achieving their goal of reducing the recidivism of participating defendants – there's simply not enough evidence to make the case one way or antoher."[17]Early and modest studies appear favorable. A study of one mental health court found that those who opted in to the program had a sharply reduced rate of new arrests as compared to those who chose not to participate. Similarly, those who chose participation spent fewer days in detention than those who did not.[18]

Information on community courts is more available and is clearly encouraging. For purposes of analysis, the Midtown Community Court in New York City, generally thought to be the mother of community courts, provides the most information on results. This court emphasizes sentences of community service and/or mandated social services. "Approximately 70 percent of defendants whose cases are disposed of at the Court receive community service and/or social service sentences – more than double the rate of other criminal courts in New York City."[19]As previously noted, these service agencies are housed within the court building itself and defendants are escorted to their representatives, often beginning service the day of sentencing. Some community service is performed within the court building. Additionally, they meet with nurses from the Department of Health for counseling and diagnosis regarding potential medical problems. Off premises community service is often supervised by community representatives for defendants deemed not to be a threat.

Compliance with community sentences is approximately 75 percent compared with a compliance rate elsewhere within the city of 50 percent.[20]Also important, the business as usual tone of misdemeanor sentencing in the city has been changed. Where defendants were typically sentenced to "time served", conditional discharge with no real conditions being attached, and "adjournments in contemplation of dismissal" with again no conditions involved, the Community Court imposed meaningful sentences and reduced dramatically the use of the former ineffective sentences. For example, the imposition of the generally ineffective sentences discussed above fell to 5 percent from 39 percent for drug offenses, from 23 percent to 6 percent for petit larceny, from 55 percent to 1 percent for prostitution.[21]Jail sentences fell with a 73 percent reduction for prostitution and a 50 percent reduction for petit larceny being illustrative.

There is careful monitoring of community service and alternative sentences. "If a defendant fails to report for service, the Court sends out a warning letter within two days. Within a week, the judge will sign a warrant for the defendant's arrest."[22]Clearly the emphasis is not on jail sentencing, but when jail sentences are imposed, they are generally for a longer duration than other courts in the city dealing with similar crimes reflecting the Court's philosophy of increasing the consequences for recidivism.[23]

Within the context of dealing with a huge problem, drug courts are considered relatively successful. Large numbers of the defendants have completed treatment and moved on to more productive lives. Drug courts are now a fixture in virtually every state due to the success and hope generated through them. "The expansion of the drug court movement has been driven by results: drug courts from Florida to California have succeeded in moving thousands of addicted offenders from substance abuse to sobriety.

In the process, drug courts have encouraged courts to change the way they do business, adopting a problem-solving approach and building partnerships with government and non-profit treatment providers outside of the criminal justice system."[23]

There is less information available on domestic violence courts, but the evidence suggests that they are having some positive effect. In 1994, a special office within the Department of Justice was formed to provide funding to criminal justice agencies throughout the country dealing with domestic violence.[24]One of the responses was the formation of a number of domestic violence courts. From 1989 to 1998, domestic violence complaints increased by 178 percent, an indication that the abused are coming forward in an effort to obtain help. Domestic violence courts with one judge following and monitoring the safety of the victim and the actions of the abuser provide hope for the future. While in the past, these complaints were dismissed at early stages with little or no help to the complainant, today there is greater awareness and attempts to deal with the problems as real and dangerous.

Perhaps the greatest testimony to problem-solving courts is the great number of endorsements they receive from communities and criminal justice professionals. "... in 2000 all 50 state court chief judges (together with all 50 state court administrators) unanimously passed a resolution endorsing problem-solving justice. One reason for this sea change in judicial attitudes is the research that has been published to date about the results that problem-solving courts have achieved. While there is certainly a need for additional study, the early findings suggest that problem-solving courts are making strides toward achieving their goals. This includes community court research that reports reduced local crime and disorder; drug court studies that document reduced drug use and recidivism among drug court participants; and domestic violence court research that tracks significant reductions in dismissal rates for domestic violence offenders."[25]

Conclusion

In a sense, society is always behind the curve playing catch-up as new needs and challenges evolve. "In recent decades, the state courts have increasingly become the public institution of choice for dealing with numerous social problems: drug-fueled crime, family dysfunction, repeated petty assaults against property and social order in urban communities. Not surprisingly, traditional litigation approaches can yield distinctly unsatisfactory outcomes when applied to these non-traditional issues."[26] Problem-solving courts are making necessary attempts to deal with a host of societal problems for which there have heretofore been no satisfactory answers. It seems fair to conclude that they are making progress. For example, it is difficult to argue against emphasizing victim safety in Domestic Violence courts by use of an on-site advocate to help frightened victims receive needed services. Likewise who can argue against the ongoing monitoring of the defendant to guard against further violence?

Similarly, since incarceration of low-level criminals involved with drugs has generally failed to help them or society on a long-term basis, the new approaches of the drug courts seem reasonable. "National research has shown that drug court participants have much lower re-arrest rates, and the long-term savings are substantial."[27] As with drug courts, mental health courts, though in their incipience, offer similar promise to actually help defendants with problems rather than to just punish behavior.

The community courts have clearly made progress in dealing with low-level quality of life crime and have reversed the culture of acceptance of such crime. Communities are being restored in part through the sentencing of such individuals. In general, it would have to be concluded that these judicial experiments and innovations are both successful and worthwhile.

ENDNOTES

[1] Greg Berman, John Feinblatt, Center for Court Innovation, Problem-Solving Courts (2001), p.9.
[2] Id. at 4
[3] Greg Berman, John Feinblatt, Center for Court Innovation, Judges and Problem-Solving Courts (2002), p.9.
[4] Id. At 11.
5 Id. At 6.

[6] Greg Berman, David Anderson, Center for Court Innovation, Drugs, Courts and Neighborhoods (1999), p.7.
[7] John Feinblatt, Greg Berman, Center for Court Innovation, Informed Decisions (1999), p.2
[8] Id.. at 2.
[9] Supra note 3 at 6.
[10] Supra note 3 at 8.
[11] Derek Denckla, Greg Berman, Center for Court Innovation, Rethinking The Revolving Door (2001), p.3
[12] Id.
[13] Id. at 6.
[14] Id. at 9.
[15] Id. at 3.
[16] Id. at 12.
[17] Id. at 10.
[18] Id.
[19] Eric Lee, Jimena Martinez, Center for Court Innovation, How It Works (1998), p.4.
[20] Michael Sviridoff, David Rottman, Brian Ostrom, Richard Curtis, Center for Court Innovation, Dispensing Justice Locally (1997), p.6
[21] Id.
[22] Supra note 19 at 6.
[23] Supra note 19 at 4.
[23] Supra note 6 at 15.
[24] Supra note 3 at 7.
[25] Supra note 3 at 25.
26Susan K. Knipps & Greg Berman, *New York's Problem-Solving Courts Provide Meaningful Alternatives to Traditional Remedies. 72 NYS Bar Journal* 8, *Vol. 72,(2000).*
27 Id. At 10.

ENJOYMENT RETAINED OVER TRANSFERRED PROPERTY BOOSTS ESTATE TAX TAB

by

Martin H. Zern*

INTRODUCTION

The value of a property interest is frequently the subject of controversy. The issue can come up in a number of contexts, such as equitable distribution in a marital breakup, shareholder disputes, mergers and acquisitions, and so on. And, of course, there is the stock market. As those who were caught up in the vortex of the market's boom and bust can attest, purported experts were daily proclaiming erudite valuation opinions. Unfortunately, most of the predictions proved to be irrationally exuberant.

Valuation issues also consistently come up in the realm of estate and gift taxation. As contrasted with the income tax, which taxes income determined over a period of time, the foundation of the estate and gift tax is the determination of value at a point in time. More specifically, the estate and gift tax is based on the value of the property owned at the time of death, or in the case of the gift tax, the value at the date of the gift.[1] The only divergence from this underlying rule is that, for purposes of the estate tax, an election may be made to value the property included in the gross estate at an alternate valuation date, which generally is six months after the decedent's death.[2]

In more detail, the estate tax is imposed on the value of the taxable estate, which is
defined as the value of the gross estate less the deductions permitted.[3] The gift tax is imposed on the transfer of property by gift,[4] more specifically on "taxable gifts."[5] Taxable gifts are defined as the total amount of gifts made during the calendar year, less allowable deductions.[6] If a gift is made in property, the value

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at the date of the gift is considered the "amount of the gift."[7] Accordingly, it is fundamental that the key to calculating the amount of estate and gift taxes owed is valuation.

The Regulations interpreting the Internal Revenue Code ("I.R.C.") have long contained language concerning the valuation of property in the context of the estate tax:

> The value of every item of property includible in a decedent's gross estate...is its fair market value at the time of the decedent's death.... The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.... All relevant facts and elements of value are to be considered in every case.[8]

Language similar to the above is contained in the gift tax regulations, except that the time for determining value is the date of the gift.[9]

THE FAMILY LIMITED PARTNERSHIP

The *cutting edge* of estate planning in recent years has been the promotion of stratagems to transfer property (e.g., marketable securities, real estate, a closely-held business) at a discounted value, and consequently a reduced gift and/or estate tax burden. In general, the procedure used to realize this goal is to fragment property interests by transferring fractional parts of the property, and/or to die owning only a fractional part. In some planning situations, a family limited partnership ("FLP") or, more currently, a family limited liability company ("FLLC") is formed to facilitate the transfer of fractional parts.[10]

When utilizing a FLP, typically property will be transferred, usually by a parent or parents, in exchange for a small general partnership interest and larger limited partnership interests. Quite often, for liability reasons, the general partner is a corporation. When utilizing a FLLC, property is transferred for membership interests. Limited partnership interests in the FLP, or membership interests in the FLLC, are then gifted, perhaps over time, to family members, or trusts for their benefit.[11] The partnership or membership interests being gifted are valued independently of one another utilizing various discount valuation theories fashioned by estate planners over the years.

The concept underlying use of a FLP or FLLC in estate planning is that due to discounting the sum of the value of the separate interests being transferred is less than the value of the entity as a whole (or the property held by such entity). The discount theories that have gained credibility are: lack of marketability, lack of control (minority interest), blockage (the inherent difficulty in selling large blocks of stock in one fell swoop), transferability restrictions, discount for dependence of the business on a key person and, more recently, a discount for built-in capital gains tax.[12] Moreover, the mere exchange of assets for partnership or membership interests arguably results in a reduction in value (i.e., the interests received are worth less than the transferred property) where restrictions are placed on the assignment of the limited partnership interests.

In addition to valuation discounts that may be applicable in a gift situation, it is important to recognize that valuation discounting may be relevant where the property interest being valued is included in a decedent's gross estate. For instance, it would be appropriate to apply a minority discount (and perhaps an additional marketability discount) to a minority interest owned at death, even where the deceased had given away the majority interest during lifetime.

Although the Internal Revenue Service ("IRS") has challenged discounting, overall it has fared rather badly in the courts. As a result, the IRS seems to have accepted the concept of valuation discounting, albeit reluctantly, at least for the time being.[13] Accordingly, when an estate or gift tax return is audited, the taxpayer is fairly well assured that some type of discount(s) will be allowed for fractional interests that have been transferred or that are held at death; it will be just a matter of negotiating the appropriate discount percentage to apply. If a settlement cannot be reached and the matter is litigated, it seems that the courts have a tendency to *cut the baby in half* or close thereto, frequently coming up with a valuation somewhere between the valuation proposed by the taxpayer's expert and that proposed by the IRS's expert. Whether or not utilization of a FLP is successful in obtaining a discounted value on the transfer of property interests will depend on the terms of the partnership agreement, the provisions of state law, the provisions of the Internal Revenue Code and, perhaps most importantly, the particular facts and circumstances.

Remedial legislation to restrict the use of FLPs and FLLCs presently does not seem to be in the cards with both a Republican administration and Congress in power, and especially since the estate tax laws are set for repeal in the year 2010. Of course, whether repeal in fact occurs is anyone's conjecture. Accordingly, reducing estate and gift tax values through discounting in general, and in particular utilizing FLPs and FLLCs, seems to be an estate planning technique – the IRS might argue a tax evasion scheme or sham – that is alive and doing quite well. However, in an important new decision by the Tax Court, filed in September of 2002, the utilization of a FLP to obtain valuation discounts in a non-business scenario was severely restricted. The impact of this decision is the primary focus of this paper.

ESTATE OF THOMPSON

In *Estate of Thompson,*[14] the Tax Court held that the full date-of-death value of assets that the decedent transferred from his revocable trusts to family limited partnerships was includable in his gross estate without any discount whatsoever.

Relevant Facts

Theodore Thompson ("the decedent") died on March 15, 1995, at the age of 97, survived by his two children, Robert and Betsy, their spouses, grandchildren and great-grandchildren.

About two years prior to his death, the decedent formed two limited partnerships and two corporations: The Turner Partnership and the Turner Corp. were formed under the laws of Pennsylvania, and the Thompson Partnership and the Thompson Corp. were formed under the laws of Colorado. The Turner Partnership was set up as a limited partnership with Turner Corp. as the general partner. Similarly, the Thompson Partnership was set up as a limited partnership with the Thompson Corp. as the general partner. The registered office and place of business of both Turner entities was the residence of Betsy and her husband, George. The registered office and place of business of both Thompson entities was a ranch owned by Robert.

At the time of its formation, the decedent held a 95.4% limited partnership interest in that Turner Partnership, his son-in-law, George, held a 3.54% limited partnership interest and the Turner Corp. as the general partner held the remaining 1.06%. At the time of its formation, the decedent held a 62.27% limited partnership interest in the Thompson partnership, his son, Robert, held a 36.72% interest and the Thompson Corp. as the general partner held the remaining 1.01%.

With respect to the general partner Turner Corp., 1000 shares were issued: The decedent was issued 490 shares, his daughter, Betsy, and her husband, George, were each issued 245 shares and an unrelated foundation was issued 20 shares. With respect to the general partner Thompson Corp., 1000 shares were also issued:

The decedent and his son, Robert, were each issued 490 shares; 20 shares were issued to an unrelated party.

From a revocable trust, the decedent contributed to the Turner Partnership approximately $1,286,000 of listed securities and notes receivable from Betsy's children in the amount of $125,000. George contributed $1,000 cash and some Vermont property valued at $49,000, which generated income from timber sales. With respect to the Thompson Partnership, the decedent contributed approximately $1,118,500 of listed securities and notes receivable from Robert's children in the amount of $293,803. Robert contributed mutual funds valued at approximately $372,000 and his ranch appraised at $460,000.

1. Operation of the Partnerships

Prior to forming the partnerships, the decedent and his children had agreed that the decedent would be taken care of financially. They also had agreed that the decedent could access assets in the partnerships in order to continue making annual exclusion gifts to family members.[15] During 1993, the partnerships distributed $40,000 to the decedent to allow him to make Christmas gifts. In 1995, further distributions of approximately $45,000 from each of the partnerships were made to allow the decedent to make Christmas gifts. Also, in 1994/1995, the decedent made gifts of partnership interests, reporting taxable gifts of about $9,000 with respect to the Turner Partnership and $10,000 with respect to the Thompson Partnership. So that the decedent would have enough assets to meet personal obligations, the Thompson Partnership distributed $12,500 to him in 1995.

a. Activities of the Turner Partnership:

Securities. The investment strategy maintained while the decedent's securities were in his revocable trust – specifically little trading – continued on after the transfer of the securities to the partnership.

Real estate. In 1994, Betsy and George transferred their farm and adjacent property to the partnership. They used the farm, which was non-income producing, as their personal residence. The value at the time of contribution was not specified. It was sold in 1997 for $550,000. Betsy and George kept the net proceeds from the sale except for about $12,000 allocated to the partnership, which was its basis for the property. Also, in 1994, Betsy and George transferred their interests in a real estate partnership, Woodside Properties, to the partnership. Woodside consisted of six residential apartment units in two buildings; however, after the transfer of Betsy's and George's interests in Woodside to the partnership, the underlying property remained titled in the name of Betsy and her daughter. As noted, at the time of the formation of the partnership, George contributed timber property in Vermont valued at $49,000. However, after the transfer, George kept all the proceeds from timber sales. Finally, in 1993, the partnership became involved in a modular home construction venture ultimately investing $186,000. The venture was sold in 1995 for a loss of about $60,000.

Loans. Another activity of the partnership involved making loans to family members, which in total amounted to about $73,000. In this regard, the court commented that no loans were made to non-family members, that interest payment were often either late or not made at all and that principal was payable on demand, and, if made, the loan was often re-amortized. It also observed that no enforcement action was taken if payments were not made.

Life Insurance. The partnership owned life insurance on the lives of George ($237,500) and Betsy ($200,000). It paid annual premiums of about $16,000 and $4,000, respectively.

b. Activities of the Thompson Partnership

With respect to the ranch contributed to the partnership at the time of its formation, it was noted that Robert continued to live on the ranch under a lease that obligated him to pay rent of $12,000 per year. The ranch was never run as a business either before or after the transfer. Robert raised and trained mules on the ranch; however, any income from the sale of mules went to Robert individually, not the partnership. On several occasions, the partnership paid the rent to Thompson Corp. as part of a management fee. In turn, the management fee was largely paid out to Robert and his wife as a salary. In addition, Thompson Corp. paid certain personal expenses of Robert and his wife, with the major item being health insurance premiums.

2. The Decedent's Estate

At the time of his death, the decedent held a majority interest in both the Turner and Thompson Partnerships as well as stock in the corporate general partners. His other assets consisting of stock, mutual funds and a promissory note totaled about $98,000. The value of the assets in the Turner Partnership came to about $1,752,000 and in the Thompson Partnership about $2,580,000.

After the decedent's death, the partnerships, after selling off some securities, paid $493,000 into a checking account to fund specific bequests in the decedent's will. Partial interests in the Turner Partnership were also used to fund bequests.

The decedent's estate tax return reported that, at the time of his death, he held an 87.65 percent interest in the Turner partnership and a 54.12 percent interest in the Thompson Partnership. The values reported for the partnership interests were, respectively, $875,711 and $837,691. The stock interests in Turner Corp. and Thompson Corp. were reported at values of $5,190 and $7,888, respectively. These values were calculated by applying a combined discount for minority interest and lack of marketability of 40% (20% minority and 20% marketability). The same discount was applied to prior adjusted taxable gifts in the amount of $19,324 required to be included in the estate tax base.[16]

It was not made clear in the case whether the decedent's estate took a minority discount for the limited partnership interests he owned at death. The fact of the matter was that he died owning a majority interest in the limited partnerships. Possibly, the minority discount was claimed only for the decedent's interest in the corporate general partners and for the adjusted taxable gifts. A discount for lack of marketability would have been appropriate for all interests, however, on the theory that a closely-held entity is not as marketable as one publicly traded, and where less than 100 percent of the entity can be transferred. Regardless of how it was parsed, however, an overall 40% discount was taken. Most likely, the decedent's estate claimed such a large discount simply as a starting point in expected negotiations with the IRS upon an audit.

The IRS, however, did not agree with the estate's valuations and issued a notice of deficiency of about $707,000. It determined that the values reported for the Turner Partnership and the Thompson Partnership should have been, respectively, $1,717,977, rather than $875,811, and $1,396,152, rather than $837,691. It therefore increased the decedent's taxable estate by $1,499,627. Some changes were also made with respect to the corporate interests, increasing the taxable estate by $4,993.

Court's Opinion

The court first referred to the basic statutory provision imposing a tax on the transfer of the estate of a decedent, which is based upon the value of the taxable estate plus lifetime taxable gifts.[17]

1. The Disagreement.

The decedent's estate maintained that the decedent's gross estate included the value only of his interests in the limited partnerships he held at death and the value of the stock he held in the corporate general partner of those partnerships, plus the value of the lifetime taxable gifts that he made in limited partnership interests. With respect to determining the value of the limited partnership interests (either held at death or transferred during lifetime), the decedent's estate first based the value on the decedent's proportionate share of the fair market value of the assets of the partnership at the date of transfer (that is, the date of gift or the date of decedent's death). However, with respect to all partnership interests the decedent's estate claimed an overall discount of 40% to reflect lack of marketability and lack of control.

On the contrary, The IRS argued that the *full fair market value of the assets contributed to the partnerships* were includable in the gross estate without any discount. The IRS asserted two theories for its position. First, it maintained that the partnerships were essentially shams because they lacked economic substance and therefore should be disregarded. Alternatively, it maintained that because the decedent retained economic benefit and control of the assets transferred to the partnerships, I.R.C. § 2036(a) was applicable, and that under that section the date-of-death value of the assets transferred to the partnership were includable in the gross estate. As a fallback position, the IRS maintained that if the partnerships were recognized and I.R.C. § 2036(a) were held inapplicable, then the discount allowable in valuing the partnerships was less than 40%.

2. Burden of Proof.

Generally, except as provided by statute or determined by the court, the burden of proof is on the taxpayer. However, the burden of proof is on the IRS with respect to any new matter not raised in the notice of deficiency, increases in the notice of deficiency, or affirmative defenses of the IRS.[18] In *Estate of Thompson*, the IRS in its notice of deficiency disallowed the 40% discount in its entirety. As a result, it increased the overall value of the decedent's interest in the partnerships and corporate general partners as reported on the estate tax return by approximately $1,500,000.

It was not until it submitted an amended answer to the estate's tax court petition, however, that the IRS raised its arguments that the partnerships lacked economic substance (i.e., they were shams) or, alternatively, that since the decedent retained sufficient control over the assets transferred to the partnership, the date of death value of such assets was includable in his gross estate under I.R.C. § 2036(a). Accordingly, the decedent's estate maintained that the burden of proof as to these issues was on the IRS, and the Tax Court agreed. The IRS, however, met the burden of proof.

3. The Reality of the Partnerships.

The Tax Court found that the partnerships were validly formed under state law and that potential buyers would not disregard them. Accordingly, without any major analysis, it promptly found that the partnerships should not be disregarded noting that " ' [m]ere suspicion and speculation about a decedent's estate planning and testamentary objectives are not sufficient to disregard an agreement in the absence of persuasive evidence that the agreement is not susceptible of enforcement or would not be enforced by parties to the agreement.' "[19]

4. The Applicability of I.R.C. § 2036(a).

The most basic tax law provision determining the gross estate for estate tax purposes is I.R.C. § 2033, which states that "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." However, a number of other sections, specifically I.R.C. §§ 2034 through 2045, include in the gross estate several narrowly defined classes of assets. Broadly speaking, these sections include in the gross estate property transferred during lifetime over which the decedent retained a certain level of control, and other assets received upon the decedent's death with respect to which the decedent provided the consideration.

Included among the sections where the decedent transferred property and retained a level of control is I.R.C. § 2036. In substance, this section brings into the gross estate property gratuitously transferred during the decedent's lifetime where the decedent has retained for life the possession or enjoyment of the property, the right to the income from it, or the right to designate the persons who shall possess or enjoy the property or any income from it.[20]

If applicable, I.R.C. § 2036(a) brings back into the gross estate the full fair market value of the property transferred, determined at the date of the decedent's death, and not merely the value of the retained interest. The legislative intent is to " 'include in the decedent's gross estate transfers that are essentially testamentary – i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime.' "[21] Thus, an asset transferred during lifetime will not be excluded from the gross estate if the transfer is made with too many *strings attached.*

5. The Applicability of I.R.C. §2036(a)(1).

The Court stated that "[a] transferor is deemed to retain enjoyment of property if there is an express or implied agreement at the time of the transfer that the transferor will retain the present economic benefits of the property, even if the retained right is not legally enforceable."[22]

In *Estate of Thompson*, the Court made a finding, based upon the facts and circumstances, that at the time of transfer to the partnerships, "there was an implied agreement or understanding that the decedent would retain the enjoyment and economic benefit of the property he had transferred."[23] Particularly relevant to the Court was the understanding that the decedent would be able to withdraw funds from the partnerships in order to make Christmas gifts each year to family members. As previously noted, funds were in fact distributed to the decedent for this purpose.

Another circumstance that the Court focused on was the fact that the decedent transferred almost all of his wealth to the partnerships, retaining enough for his support for only two years. In fact, by 1995, his holdings had diminished to under $32,000. As mentioned, the Thompson Partnership distributed $12,500 to the decedent in order for him to be able to meet his personal obligations. The combination of transferring the vast bulk of his assets to the partnerships while apparently retaining access to them if he needed funds for support also led the Court to conclude that there was an implied understanding that the decedent could dip into partnership assets whenever he desired to do so.

The Court acknowledged a formal change in the relationship of the decedent to his assets by the transferring of title to the partnerships. But it pointed out that the "practical effect of these changes during the decedent's life was minimal" and that the "[d]ecedent continued to be the principal economic beneficiary of the contributed property."[24] Another relevant fact was that the composition of the portfolio investments held by the partnerships changed little during the decedent's life.

Wrapping it up, the Court found that the partnerships were formed merely for estate tax planning purposes and not in connection with "any sort of arm's-length joint enterprise between partners."[25]

6. A Bona Fide Sale for Adequate and Full Consideration?

I.R.C. § 2036(a) provides that the section is inapplicable in the "case of a bona fide sale for an adequate consideration in money or money's worth." The decedent's estate argued that this exception pertained on the theory that the decedent received partnership interests in exchange for the assets he transferred, and that such interests were adequate consideration. The Court pointed out, however that "[t]he exemption under section 2036 is limited to those transfers where the transferor has received full consideration in a genuine arm's-length transaction," and that the exemption is "not allowed where there is only contractual consideration. . . ."[26] The Court pointedly mentioned that what was involved here was only a *recycling of value* since in reality the assets transferred by the decedent "were not invested in a business enterprise" and the transfers were not "motivated primarily by legitimate business concerns."[27]

The Court observed that, in contrast, it has validated transfers where the "decedent has transferred his or her assets into a valid functioning business enterprise" and that in those cases it "found the transfer was for full and adequate consideration." It also noted that "[i]n those cases, there was no expressed or implied agreement between the partners in the partnership that the decedent could continue to use, possess, or enjoy partnership property, within the meaning of section 2036(a)."[28]

The most important finding of fact in *Estate of Thompson* was the Court's conclusion that there was an express or implied understanding that the decedent had complete access to the assets he transferred to the partnerships. Other factors influencing the Court's decision were:

(i) None of the individual partners in either of the partnerships was engaged in operating an active business.

(ii) The decedent's children and his son-in-law did not actually pool their assets with those of the decedent. They arranged things so that the income from the assets they transferred to the partnership went to them directly (e.g., the sale of mules and timber).

(iii) There was no substantial change in investment strategy from the date of the transfer of the decedent's assets to the partnerships (principally stocks and bonds) until his death.[29]

7. The Final Analysis.

In summing up, the Court held that the partnerships were not conducted in a "business like manner," that there was no intent to "either form a business enterprise or conduct any business," that the partnerships did not "engage in transactions with anyone outside the family," and that "loans and gifts were made to family members only."[30]

Consequently, the Court held that the *full date-of death value* of the assets transferred to the partnerships was includable in the decedent's gross estate under I.R.C. §2036(a).[31]

CONCLUSION

It has become generally accepted, even by the IRS, that if an active business, or income-producing real estate, is transferred to a limited partnership, the gift of limited partnership interests thereafter may qualify for minority and marketability discounts, and that such discounts might also be applicable to any partnership interests held by the decedent at death. When it is a given that discounts are applicable, the argument then revolves around the exact amount of the discount.[32]

An open question, however, is whether discounts should be permitted where primarily portfolio investments are transferred to a limited partnership. It has been this author's experience that many law firms, promoting themselves as being on the cutting edge of estate planning – arguably, pushing the envelope – have been involved in creating limited partnerships with primarily portfolio investments and then claiming substantial discounts with respect to partnership interests gifted and partnership interests retained at death. The accepted wisdom seems to be to claim a significant discount and then negotiate with the I.R.S. So, if a 40% discount is claimed, as was the case in *Estate of Thompson*, a negotiated settlement might result in a 15-30% discount depending on the makeup of the portfolio and the particular facts and circumstances. Obviously, this is not a scenario with which the I.R.S. is contented.

Consequently, the I.R.S. victory in *Estate of Thompson*, relying on I.R.C. § 2036(a), was a significant triumph since the Court allowed no discount whatsoever and held that the full date-of-death value of the portfolio assets transferred to the partnerships were includable in the decedent's gross estate. As a consequence of this decision, there are two major considerations that estate planners should now ponder in deciding whether discounts will be allowed for family partnership interests where the assets transferred to the partnership are primarily portfolio investments.

First, is there an express or implied understanding that the assets transferred will be available to the decedent during his or her lifetime? In the present case, such a determination was made because the decedent transferred just about all that he owned retaining insufficient assets for his support and to make annual gifts. What the Court seemingly disregarded, however, was the decedent's age. At the time of the formation of the partnerships, he was 95 years of age. Perhaps he didn't expect to live long and felt that the relatively small amount he retained would be sufficient to meet his remaining lifetime needs.

What is striking about the Court's conclusion is that relative to the millions transferred to the partnerships, very little was pulled back out of them for the decedent's support and to sustain his gift giving. Nevertheless, the minimal amount withdrawn was sufficient to find an implied agreement that *all of the assets transferred to the partnerships* were available to the decedent, not just enough for support and gifts. This determination of the Court might lead estate planners to conclude that the parties were improperly advised, and that the result would have been different had the decedent kept sufficient assets for support and gifts and actually did not access partnership assets. Perhaps this will prove to be the case.

However, a second major consideration, which no doubt will cause estate planners some consternation, has to do with the activities of the partnership. An important finding in *Estate of Thompson* was that the assets transferred were not invested in a valid functioning business enterprise, and were only *recycled.* Since there were no legitimate business concerns prompting the transfer of the decedent's assets to the partnerships, the Court found that there was not adequate and full consideration received by the decedent for the transfers. Consequently, § 2036(a) was applicable.

The issue of whether adequate and full consideration has been received is pertinent only if I.R.C. § 2036(a) is first deemed applicable. As seen, in *Estate of Thompson*, I.R.C.§ 2036(a) was held applicable due to the finding of an implied understanding that all of the assets transferred to the partnerships were still available to the decedent for his enjoyment. Nevertheless, even if a decedent retains significant assets for his personal use, it is possible that a court might not recognize a partnership if it is not involved in the conduct of any active business or financial enterprise. Here, the opaque concept of *business purpose*, which is sometimes a contentious issue in the income tax arena, should be considered. Since a partnership is defined as an entity carrying on a business or financial operation,[33] a partnership formed merely to hold investment securities might not be recognized as a partnership, especially where there is sparse trading. In the instant case, the business purpose issue seems to have been dodged, or at least inadequately addressed. As mentioned, the Court seemingly accepted the existence of the partnerships without any major discussion as to their validity despite the IRS's assertion that the partnerships lacked economic substance and should be disregarded for transfer tax purposes. It may also be that the IRS did not assert the lack of business purpose argument forcefully enough. Possibly another court might look at things differently if the argument were made more compellingly.

In conclusion, estate planners who have been promoting limited partnerships consisting primarily of portfolio investments, and confidently asserting that discounts can be taken on the transfer (either during lifetime or at death) of limited partnership interests, might now want to hedge their bets in light of the decision in *Estate of Thompson*.

ENDNOTES

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[1] I.R.C. §§ 2031 and 2512. All references to "I.R.C." are to the Internal Revenue Code of 1986, as amended to date.

[2] I.R.C. § 2032. In the case of property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death, such property shall be valued as of the date of sale, exchange, or other disposition (I.R.C. § 2032(a)(1)). An election to use the alternate valuation date can only be made if it would decrease both the gross estate and the estate tax (I.R.C. § 2032(c)).

[3] I.R.C. § 2051.

[4] I.R.C. § 2501.

[5] I.R.C. § 2502.

[6] I.R.C. § 2503.

[7] I.R.C. § 2512.

[8] Reg. § 20.2031-1(b) (1965).

[9] Reg. § 25.2512-1 (1992).

[10] A FLP or FLLC is often used because direct fractional transfers of property may not be feasible or advisable. For instance, a FLP or FLLC would be necessary where the property desired to be transferred at a discount is marketable securities. Although fractional parts of real estate may be transferred, this would subject the property to a partition action, which would not be the case if the property was held by a FLP or FLLC.

[11] In a FLP, the transferors usually keep control through ownership of a general partnership interest. In a FLLC, control may be exercised by having the transferor named as manager in the operating agreement. Note that there must be at least two transferors to set up a FLP since by definition a partnership requires at least two partners. Most states, including New York, permit a FLLC to be formed by one person. *See*, Treas. Reg. § 301.7701-3. All references herein to "Treas. Reg. §" are to U.S. Treasury Department regulations interpreting the Internal Revenue Code of 1986, as amended. To avoid a *substance over form* charge that what is being gifted is really undivided interests in the property transferred to the entity, it is advisable for there to be a hiatus (commentators have suggested at least 6 months) between the transfer of the property and the gifting of the partnership or membership interests.

[12] Eisenberg v. Commissioner, 82 AFTR 2d 98-5757 (2nd Cir. 1998); Estate of Davis, 110 T.C. No. 35 (1998).

[13] As a caveat, in order to better ward off an IRS challenge to the validity of a FLP or FLLC, there should be well-documented valid reasons, other than tax

reduction, for forming the entity. There are numerous valid non-tax reasons for forming such an entity, which are beyond the scope of this paper.

[14] Estate of Thompson v. Commissioner, T.C. Memo 2002-246, 2002 Tax Ct. Memo LEXIS 254 (U.S. Tax Court, 2002).

[15] For the relevant years in *Estate of Thompson*, individuals could make gifts without being subject to gift tax, and without dipping into their lifetime exemption amount ($600,000), in the amount of $10,000 per person per year, which is referred to as the annual exclusion amount (I.R.C. § 2503). If a split gift election is made, half the gift is deemed to come from the husband and half from the wife, effectively increasing the annual exclusion amount to $20,000 (I.R.C.§ 2513). The annual exclusion amount for 2003 is $11,000 due to a cost of living adjustment (I.R.C. § 2503(b)(2)). The lifetime exemption amount for 2003 is $1,000,000 and is due to increase incrementally through 2009, in which year it peaks at $3,500,000.

[16] I.R.C. § 2001(b).

[17] In general, I.R.C. § 2001 provides for a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. However, if taxable gifts were made by the decedent during lifetime that are not includable in the gross estate, such gifts must be added to the estate tax base against which the estate tax rates are applied. The taxable estate is computed by determining the value of the gross estate and subtracting those deductions provided for in I.R.C. §§ 2053 through 2056.

[18] Tax Court Rule 142(a). A notice of deficiency must show the basis for the tax deficiency (I.R.C. §7522). In some situations, the failure to describe the basis for the increased tax asserted in the notice of deficiency results in new matter being raised under Rule 142(a). *See, e.g.*, Shea v.Commissioner, 112 T.C. 183, 197 (1999) and Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500, 507 (1989)

[19] Estate of Thompson v. Commissioner, 2002 LEXIS 254, *42, *43 (2002), citing Estate of Strangi, v. Commissioner, 115 T.C. 478, 485, (2000), affd. on this issue, revd., and remanded, 293 F.3d 279, 282 (5th Cir. 2002) and Hall v. Commissioner, 92 T.C. 312, 335 (1989).

[20] In pertinent part, § 2036 reads as follows:

Sec. 2036. TRANSFERS WITH RETAINED LIFE ESTATE.

(a) General Rule. – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death –

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(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

[21] Estate of Thompson v. Commissioner, 2002 LEXIS 254, *45 (2002), citing Philadelphia Trust Co. v. Rothensies, 324 U.S. 108 (USSC 1945) and United States v. Estate of Grace, 395 U.S. 316 (USSC 1969).

[22] Estate of Thompson v. Commissioner, 2002 LEXIS 254, *46 (2002). The Court referred to Estate Tax Regs. § 20.2036-1(a) and several cases.

[23] Estate of Thompson v. Commissioner, 2002 LEXIS 254, *47 (2002).

[24] *Id.* at *50.

[25] *Id.* at *52.

[26] *Id.* at *53.

[27] *Id.* at *54, citing Estate of Harper v. Commissioner, T.C. Memo 2002-121 (2002) and Estate of Schauerhamer v. Commissioner, T.C. Memo 1997-242 (1997).

[28] Estate of Thompson v. Commissioner, 2002 LEXIS 254, *54, *55 (2002), referring to *Estate of Harper* and Estate of Michelson v. Commissioner, T.C. Memo1978-371 (1978).

[29] Estate of Thompson v. Commissioner, 2002 LEXIS 254, *56 (2002).

[30] *Id.*

[31] In computing the estate tax, adjusted taxable gifts made during lifetime are included in the estate tax base (I.R.C. § 2001). However, if the property gifted is later brought back into the estate at date of death value – for example, under I.R.C. § 2036 – the gifted property is not added into the estate tax base as adjusted taxable gifts, and the Court so noted (*Id.* at *61).

[32] *See, e.g.*, Estate of Jameson, T.C. Memo 1999-43 (1999), Estate of Mellinger, 112 T.C. 26 (1999) and Eisenberg v. Commissioner, 155 F.3d 50 (2nd Cir. 1998).

[33] I.R.C. § 761(a).

BASIC TAXATION AND OTHER IMPLICATIONS OF PENSION PLAN DISTRIBUTIONS

by

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This article deals with the various taxation and other implications of distributions of pension plans. Special emphasis has been given to the regulations of the Internal Revenue Service.

The distributions of a qualified pension plan are generally taxable upon receipt, which normally occurs upon retirement and are calculated pursuant to annuity rules.[1]

The purpose of minimum distribution rules for retirement plans is to force the owner or participant of the pension plan to withdraw money from the plans, thus triggering an income tax on these monies. On April 16, 2002 the Internal Revenue Service issued final regulations as to these distributions.

Under the regulations is to have the owner or participant of the pension plan will begin taking the money out of the pension plan beginning at the later of when he finishes working or age 70.5. One purpose of this is to insure that these monies will be subject to income tax prior to the death of the owner.

The Internal Revenue Service provides a life expectancy table to provide a minimum payment from the pension plan depending upon the age of the owner or participant of the pension plan when he is required to begin taking distributions.

An owner or participant of the pension plan has the right to designate a beneficiary who will receive his pension benefits, if the plan so allows. Previously, the administrator could be informed of the choice of the beneficiary up to December 31 of the year following the owner or participant of the plan's death.

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To allow the plan administrators and custodians more time to make their calculations the due date for this selection was moved back three months to September 30.[2] This does not hold true if the beneficiary is a trust. In this case, October 31 is the date to designate the beneficiary.[3] These dates are important for pension plan planning.

If one wants to have separate accounts for each beneficiary one must notify the plan administrator or custodian by December 31.[4] This will be useful for ease of accounting and different investment desires.

If a plan is rolled over the transferring plan makes the required minimum distribution for the year and transfers the balance.[5] This is used to determine one of the consequences of rolling over of monies.

If a trust is the beneficiary it is not clear whose life expectancy should be used. It is possible that the life expectancy of the oldest beneficiary of the trust should be used.[6] This is detrimental since it will force the largest possible minimum distribution. Hence the importance of planning to keep as much money as possible in the plan to enjoy the tax benefits.

If the owner or participant of the pension plan dies after the required beginning date of distribution, the life expectancy of the designated beneficiary will be used. If there is no designated beneficiary, the five year rule is used.[7] For this reason a contingent beneficiary should always be designated.

If the owner or participant of the pension plan dies during the year, his life expectancy is used to determine the required minimum distribution for that year.[8] Although this is counter-intuitive, it does provide a tax benefit.

If a non-spouse beneficiary dies during the year before she becomes a designated beneficiary. Her life expectancy (as computed by the Internal Revenue Service tables) will be used by the other beneficiaries to determine the required minimum distribution.[9]

If a surviving spouse beneficiary dies during the year before she becomes a designated beneficiary the life expectancy of the surviving spouse's beneficiary will be used by the other beneficiaries to determine the required minimum distribution.[10]

In computing the life expectancy for the amount of required minimum distributions a contingent beneficiary must be included in the calculation, while a successor designated beneficiary need not be.[11]

If the owner or participant of the pension plan is younger than the designated beneficiary and the owner or participant of the pension plan dies after the required beginning date and before the designated beneficiary, the designated beneficiary can use the life expectancy (according to the Internal Revenue Service tables) of the deceased the owner or participant of the plan.[12]

After the death of the owner or participant of the pension plan his spouse can roll over the plan if she is the sole beneficiary of the owner or participant of the plan's IRA.[13]

If a beneficiary had incorrectly chosen a five year minimum payout this can be corrected.[14] By recomputing what the minimum distribution would have been had it been chosen at the beginning and making what would have been that distribution from the beginning date to the date of correction. This course should be chosen so as to minimize the required distribution.

If the owner or participant of the pension plan is younger than the designated beneficiary and the owner or participant dies after the required beginning date and before the designated beneficiary, the designated beneficiary can use the life expectancy (according to the Internal Revenue Service tables) of the deceased the owner or participant of the plan.[15]

As of 2003 all administrators and custodians had to determine or offer to determine the minimum required distribution for the owner or participant of the pension plan. This is most useful for the common beneficiary since he would not be capable of performing this calculation.

Beginning in 2004 the administrator or custodian has to inform the Internal Revenue Service if the owner or participant of the pension plan must receive a minimum required distribution. This amount does not have to be computed by the administrator or custodian.[16] Once again, the Internal Revenue Service has made the accountant an enforcement officer for the government by reason of this provision.

The regulations issued on April 16, 2002 must be used for all distributions beginning in 2003.[17]

The various provisions stated in this article must be used to have the proper planning, distributions and requirements followed to prevent potentially large interest and penalties from being imposed by the Internal Revenue Service.

ENDNOTES

[1] Section 72 of the Internal Revenue Code of 1986, as amended.

[2] Internal Revenue Service Regulation 1.401(a)(9)-4, A4.

[3] Internal Revenue Service Regulation 1.401(a)(9)-4, A-6(b).

[4] Internal Revenue Service Regulation 1.401(a)(9)-8, A3.

[5] Internal Revenue Service Regulation 1.401(a)(9)-7, A-1 & 1.401(a)(9)-10, A-4.

[6] Internal Revenue Service Regulation 1.401(a)(9)-4, A-5(c).

[7] Internal Revenue Service Regulation 1.401(a)(9)-3, A-4(a).

[8] Internal Revenue Service Regulation 1.401(a)(9)-5, A-4(a).

[9] Internal Revenue Service Regulation 1.401(a)(9)-4, A-4(c).

[10] Internal Revenue Service Regulation 1.401(a)(9)-3, A-4, a-4(b) and A-5.

[11] Internal Revenue Service Regulation 1.401(a)(9)-5, A7.

[12] Internal Revenue Service Regulation 1.401(a)(9)-5, A-5(a)(1).

[13] Internal Revenue Service Regulation 1.401(a)(9)-10, A-5.

[14] Internal Revenue Service Regulation 1.401(a)(9)-1, A-2(b).

[15] Internal Revenue Service Regulation 1.401(a)(9)-5, A-5(a)(1).

[16] Internal Revenue Service Regulation 1.401(a)(9)-10, A-10.

[17] Internal Revenue Service Regulation 1.401(a)(9)-1, A-2(b).