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

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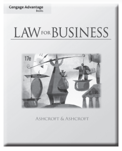

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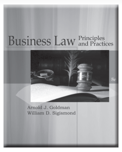

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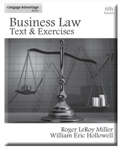

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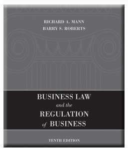

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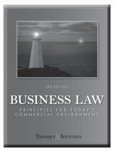

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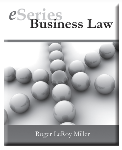

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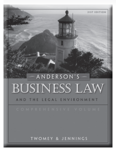

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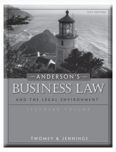

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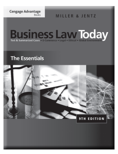

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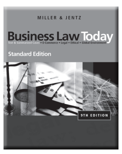

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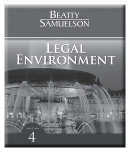

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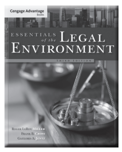

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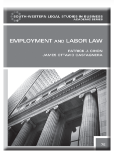

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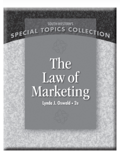

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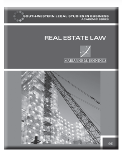

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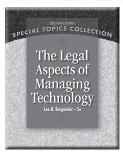

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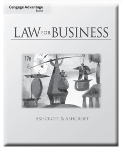

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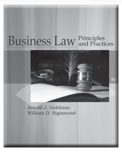

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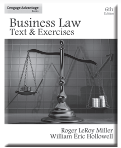

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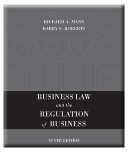

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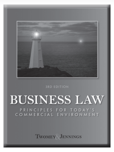

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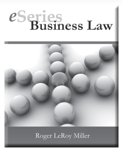

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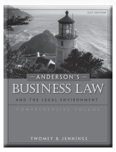

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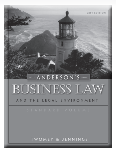

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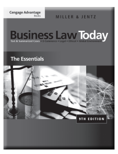

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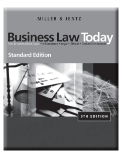

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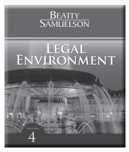

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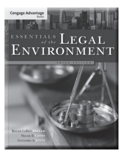

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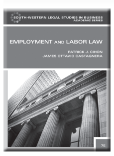

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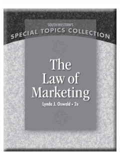

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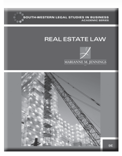

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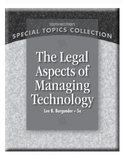

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ARTICLES

WYETH v. LEVINE: AN UNEXPECTED OUTCOME FOR "THE BUSINESS CASE OF THE CENTURY."

by

J.L. Yranski Nasuti, JD, LLM*

There was much anticipation in the business world as the U.S. Supreme Court prepared to announce its decision in the case of *Wyeth v. Levine.*[1] During the previous year, the court had ruled that, in most instances, state product liability claims could not be filed against manufacturers of medical devices that had been approved by the Federal Drug Administration (FDA).[2] The hope was that the pro-business justices would extend this immunity to pharmaceutical companies who marketed FDA approved drugs. The Chamber of Commerce, which underwrote a multimillion dollar lobbying campaign to push for federal preemption as a protection against state court actions, referred to *Wyeth* as the "business case of the century."[3] Professor Kathleen M. Sullivan, of Stamford University, noted that "corporate America has discovered that they would much rather be regulated by one government in Washington than by 50 state governments, or by the most aggressive of them."[4] It was, therefore, quite a disappointment to Wall Street when the court ruled that federal law did not preempt state law actions against manufacturers of FDA approved drugs.

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I. FEDERAL REGULATION OF PRESCRIPTION DRUGS

The Food and Drugs Act of 1906[5] was the first important federal legislation in the area of public health regulation to supplement the protection provided through state regulation and common-law liability by prohibiting the manufacture or interstate shipment of adulterated or misbranded drugs and by providing for the creation of the FDA to regulate the food and drug industries. Thirty-two years later, Congress passed the Food, Drug, and Cosmetic Act (FDCA)[6] in response to growing concerns about the continued distribution of unsafe drugs and the use of fraudulent marketing. Under the FDCA, a manufacturer could not engage in the interstate marketing of a new drug until the FDA had determined that it was "safe for use under the conditions prescribed, recommended, or suggested in the proposed labeling thereof".[7] The FDCA's premarket approval process required the manufacturer to submit a "New Drug Application" (NDA) to the FDA for each new drug it sought to market. If the FDA rejected a manufacturer's application because the drug was deemed to be unsafe for use as labeled, the manufacturer was prohibited from selling that product. If, on the other hand, the FDA approved the application or failed to act within 60 days after the application was filed, the new drug was eligible for sale.[8]

The FDCA were altered with the passage of the Drug Amendments of 1962 (the 1962 amendments).[9] One particularly significant change resulted in the shifting of the burden of proof so that the FDA no longer had to show that a drug would cause harm. The manufacturer now had the burden of establishing that its drug was both "safe and effective" and that its labeling was not "false and misleading." That meant that the sponsor had to demonstrate that the drug was "safe for the use under the conditions prescribed, recommended, or suggested in the proposed labeling"[10] and that there was "substantial evidence that the drug will have the effect it purports or is represented to have under the conditions of use prescribed, recommended, or suggested in the proposed labeling."[11]

While the Drug Amendments of 1962 increased the powers of the FDA, they also contained a savings clause that specifically addressed the issue of the federal preemption of state law claims. That provision stated that:

> Nothing in the amendments made by this Act to the federal Food, Drug, and Cosmetic Act shall be construed as invalidating any provision of State law which would be valid in the absence of such amendments unless there is a direct and positive conflict between such amendments and such provisions of State law. [12]

Prior to 1976,[13] the states had the primary responsibility for regulating new medical devices. The passage of the Medical Device Amendments of 1976 (MDA) not only authorized the FDA to regulate medical devices, as well as drugs, it also contained a federal preemption provision that expressly prohibited states and their political subdivisions from establishing, or continuing to give effect to, requirements relating to medical devices intended for human use that were either different from the requirements established under the MDA or which related to the safety or effectiveness of the device.[14]

While Congress had never enacted a preemption provision (similar to the one contained in the MDA) for prescription drugs, the FDA attempted to rectify that omission when it inserted a substantive preemption statement into the preamble of a seemingly benign regulation concerning "Requirements on

Content and Format of Labeling for Human Prescription Drug and Biological Products, Supplementary Information (the 2006 Regulation)."[15] The wording of the preamble, which preempted state tort claims involving FDA approved drugs, reflected an on-going policy of the Bush administration to insert preemption language into regulations relating to a variety of federally regulated products—including cars, mattresses, motorcycle brakes, and railroad cars.[16] The preamble specifically stated that:

> [The] FDA believes that State laws conflict with and stand as an obstacle to achievement of the full objectives and purposes of Federal law when a statement that FDA has considered and found scientifically unsubstantiated . . . [or when State law] purports to preclude a firm from including in labeling or advertising a statement that is included in prescription drug labeling.[17]

Congress overhauled the FDCA and attempted to strengthen the resources available to the FDA when it enacted the FDCA Food and Drug Administration Amendments Act of 2007 (FDAAA).[18] Under the new amendments, the FDA was authorized, under certain circumstances, to compel label changes in the event that negotiations with the manufacturers have been unsuccessful,[19] to require manufacturers to undertake additional safety studies even after a drug has received FDA approval,[20] and to require a manufacturer to change its drug label based on safety information that becomes available after the FDA has initially granted approval.[21] The FDAAA did not, however, include or endorse the preemption language contained in the preamble of the 2006 regulation.

II. THE FDA APPROVAL PROCESS

A. The Drug Application Process

The FDA's review of a New Drug Application (NDA) focuses on whether the drug is safe and effective for its intended use. Among the items included in the NDA are "the labeling proposed to be used for such drug"[22] (with "adequate directions for use" as well as "adequate warnings" against unsafe use and methods of administration),[23] "full reports of investigations which have been made to show whether or not such drug [was] safe for use and whether such drug [was] . . . effective in use,[24] and "a discussion of why the benefits exceed the risks [of the drug] under the conditions stated in the labeling."[25]

The wording of the label is of particular concern to the FDA since is a primary source of information for clinicians in making prescription decisions. A label typically includes a description of the drug's intended uses as well as its potential risks, contraindications, warnings, precautions and adverse reactions.[26] In the course of reviewing a NDA, the FDA and the manufacturer discuss, in detail, the wording of any proposed warnings. If the FDA approves an NDA, the manufacturer must market the drug with the specific final version of the drug's label.[27]

As a general rule, a manufacturer may not alter an FDA approved warning label unless the FDA approves the manufacturer's Supplemental NDA.[28] That having been said, the FDA's "Changes Being Effected" regulation (CBE regulation)[29] does allow a manufacturer to make some changes to a label after a supplemental application has been filed but prior to its approval by the FDA. The CBE regulation applies in those instances in which the manufacturer seeks to "add or strengthen a contraindication, warning, precaution, or adverse reaction" or to "add or strengthen an instruction about dosage and administration that is intended to increase the safe use of the drug product."[30]

B. The FDA Approval Process for Phenergan

Promthazine hydrochloride is an antihistamine, which was developed by Wyeth Pharmaceuticals, to treat nausea. The FDA originally approved Wyeth's NDA for the drug in 1955. Since then, Wyeth has sold the injectable drug under the brand name of Phenergan. Phenergan can be injected either intramuscularly or intravenously. An intravenous injection can be done by an "IV-push" method or an "IV-drip" method. The "IV-push" method allows the clinician to inject the drug directly into the patient's vein. The "IV-drip" method, on the other hand, requires the clinician to place the drug into a stream of saline solution flowing from a hanging intravenous bag. The solution then slowly drips through a catheter that has been inserted into the patient's arm.

After receiving its initial approval to market the drug, Wyeth continued to communicate with the FDA concerning issues relating to the text of the warning label for Phenegran. In 1973, 1975, and 1981, the company submitted three supplemental NDAs for the drug. The first two were approved after the FDA proposed a number of labeling changes. A third was submitted in 1981 in response to a new FDA drug labeling rule. Between 1981 and 2004, Wyeth and the FDA continued to communicate intermittently concerning the wording of the warning label. In 1987, the FDA suggested that the label be changed to address the risk of arterial exposure. Although the federal agency received a revised label[31] from Wyeth in 1988, it never responded to Wyeth's submission—and Wyeth continued to use the previously approved label. In fact, Wyeth did not hear from the FDA again about the warning label until 1996—when the FDA asked to see a copy of the then in-use label for Phenergan. After Wyeth complied with that request, it was instructed by the FDA "to [r]etain verbiage in current label"[32] as it related to intra-arterial injection and to make a few other changes—not related to intra-arterial injections. In 1998, the FDA finally approved Wyeth's 1981 application with the provision that the final printed label "must be identical" to the approved package insert.[33]

III. *LEVINE V. WYETH*—A STATE COURT ACTION

A. Background

Diana Levine, a professional musician who had played the electric bass guitar for bands such as the Re-Bops and Duke and the Detours, suffered from debilitating migraine headaches. On April 7, 2000, Levine went to the Northeast Washington County Community Health, Inc., a local health clinic in Vermont, and asked to be treated for a migraine and nausea. She was given Demerol for the pain and an intramuscular injection of Phenergan for the nausea. Later in the day, she returned to the clinic complaining of "intractable" migraines, "terrible pain," inability to "bear light or sound," sleeplessness, hours-long spasms of "retching" and "vomiting," and the failure of "every possible" alternative treatment.[34] Jessica Fisch, the physician's assistant, responded by administering a second dose of Phenergan—this time through a direct intravenous injection into Levine's arm by means of an "IV push" procedure. Phenergan, a corrosive drug that is meant for infusion into a person's vein, can cause irreversible gangrene if it inserted into a patient's artery. Unfortunately the Phenergan given to Levine entered her artery (either because Fisch inserted the needle directly into the artery or because the drug was injected into a vein and then escaped into surrounding tissue[35] where it came into contact with arterial blood.) In the following weeks, Levine developed gangrene—the tissue in her right forearm died, she experienced extreme pain, and her fingers slowly started to turn black. The doctors tried to stop the spread of the gangrene by amputating her right hand. When that did not work, they eventually had to amputate her entire forearm.

B. Vermont Superior Court

Levine originally sued the health center and the physician's assistant for her pain and suffering, substantial medical expenses, and the loss of her livelihood as a professional musician. Both lawsuits were settled out of court. Levine then filed a complaint against Wyeth Pharmaceutical, the manufacturer of Phenergan, in the Vermont Superior Court, based on state common-law actions of negligence and failure-to-warn product liability.[36] The complaint alleged that the label on the Phenergan product was defective, not because it failed to warn of the danger of gangrene and amputation following an inadvertent intra-arterial injection, but, because it failed to instruct clinicians to use the IV-drip method of intravenous infusion rather than the more dangerous IV-push method.[37] According to Levine, "Phenergan is not reasonably safe for intravenous administration because the foreseeable risks of gangrene and loss of limb are great in relation to the drug's therapeutic benefits."[38]

Wyeth filed a motion for summary judgment based on the argument that the plaintiff's failure-to-warn claims were preempted by federal law. The trial court rejected both the defendant's field preemption and conflict preemption arguments and concluded that the record up until that point "lack[ed] any evidence that the FDA set a ceiling on this matter."[39] When the case proceeded to trial, the plaintiff presented expert evidence in support of her assertion that the risk of either intra-arterial injection or perivascular extravasation is almost completely eliminated when the drug is administered by IV-drip rather than IV-push.[40] She also submitted into evidence the correspondence between Wyeth and the FDA regarding possible changes to Phenergan's label. The five day trial ended with the judge giving two key instructions to the jury. The first was that although the jury could consider the evidence that Wyeth had compiled with the FDA requirements, it did not have to conclude that compliance necessarily meant that the warnings had been adequate. The second crucial instruction was that FDA regulations "permit a drug manufacturer to change a product label to add or strengthen a warning about its product without prior FDA approval so long as it later submits the revised warning for review and approval."[41] The jury, in response to the questions on a special verdict form, found that Wyeth was liable for negligence, that Phenergan was a defective product since its warnings and instructions were inadequate, and that there was no intervening cause to disrupt the causal connection between the defendant's negligent actions and the plaintiff's injuries. The jury awarded the plaintiff a final damage award of $7,400,000 (which was reduced by the amount of the previous settlements with the physician's assistant and the health center).

The defendant then filed a motion for judgment as a matter of law—which was based on preemption arguments. On August 3, 2004, the trial judge rejected the motion on three grounds. The first was that there was no direct conflict between FDA regulations and Levine's state-law claims. Not only did the FDA regulations permit strengthened warnings without its approval on an interim basis but Wyeth had been aware of at least 20 reported cases of gangrene amputations similar to Levine's since the 1960's. The second ground was that Levine's state tort liability claim did not obstruct the FDA's work. In fact, the federal agency had not spent much time addressing the question of whether to warn against the I-V push administration of Phenergan. Finally, the court emphasized the compensatory function of the state law action that was absent from the federal regulation.[42]

C. Supreme Court of Vermont

On appeal to the Supreme Court of Vermont, Wyeth claimed that the trial judge erred in allowing the jury to consider the plaintiff's claims (since they conflicted with the defendant's obligations under federal law and were therefore preempted) and in failing to properly instruct the jury on the issue of damages. In a 4-1 decision, the appellate court affirmed the lower court decision in its entirety--rejecting the defendant's preemption arguments on the grounds that Wyeth could have changed the warning concerning the IV-push administration of Phenergan without prior FDA approval and that the "federal labeling requirements create a floor, not a ceiling, for state regulation."[43]

In order to determine if the doctrine of preemption applied in this case, the majority relied on the following analytical model:

> Congress' intent may be explicitly stated in the statute's language or implicitly contained in its structure or purpose. In the absence of an express congressional command, state law is preempted if that law actually conflicts with federal law, or if federal law so thoroughly occupies a legislative field as to make reasonable the inference that Congress left no room for the States to supplement it.[44]

It also noted that the presumption against preemption (absent a clear congressional intention to supersede state law, including state common law duties)[45] has "added force" when there is a "long history of tort litigation" in the area of state common law at issue.[46] Since Wyeth had conceded that Congress had not expressly preempted state tort actions through the FDCA and did not intend the FDCA to occupy the entire field of prescription drug regulation, the court only considered whether it was "impossible for the private party [Wyeth] to comply with both state and federal requirements" and whether Vermont's common-law "stands as an obstacle to the accomplishment and execution of the full purposed and objectives of Congress."[47]

The court found no conflict, in general, between federal labeling requirements and state failure-to-warn claims based on the ability of the manufacturer, under the provisions of the CBE regulation, to add to and strengthen its already approved warnings.[48] This finding was supported by the nearly unanimous conclusion by other courts that failure-to-warn claims are permissible in state courts.[49] Wyeth's attempt to draw a comparison to medical devise cases was unsuccessful since the FDCA's preemption clause only applied to medical devises and not to prescription drugs.[50] The majority also rejected the argument that it should follow the conflict preemption precedent established by U.S. Supreme Court in the case of *Geier v. American Honda Motor Co.*[51] In that instance the plaintiff's state tort claim was held to be in direct conflict with Department of Transportation's specific phase-in plan for safety devices and its intent to broaden the range of safety options available to consumers. The key difference between *Geier* and drug warning label cases was that "the FDA and the state share the purpose of encouraging pharmaceutical companies to alter their drug labels when they are inadequate to protect consumers."[52]

The court then considered whether the specific facts in the case before it justified a preemption of the state claims based on an impossibility of compliance claim. Wyeth had asserted that it could not comply with state law requirements since the FDA had approved the label in use at the time of Levine's injury. The court noted that the approval of the Phenergan warning label should not preclude a jury from finding that the label was insufficient since the company had the possibility, under the CBE regulation, to strengthen its warning with respect to the IV-push administration of Phenergan.[53] It also rejected Wyeth's suggestion that when the FDA approved the label in 1998, with the instruction to "[re]etain the same verbiage" (rather than with the changes suggested by Wyeth in 1988), it was stating its opinion that the stronger warning was unnecessary. The problem with Wyeth's argument was that the label changes that it proposed in 1988 were no more adequate than the original label in warning against the IV-push administration of Phenergan.[54]

Wyeth was also unpersuasive in its claim that the Vermont common-law liability in this case would be an obstacle to the purposes and objectives of Congress. The court found that primary goal of the FDCA was to protect consumers from dangerous products[55] and the purposes and objectives of Congress in the regulating the marketing of prescription drugs was merely to set the minimum standards under which a manufacturer must comply.[56] The fact that the 1962 amendments expressly limited the preemptive effect of the statute unless there is a "direct and positive conflict" between state and federal law enabled the court to conclude that "where it is possible to comply with both state law and the FDCA, the state law is consistent with the purposes and objectives of Congress."[57]

The discussion of the preemption issue concluded with an analysis of the preemption statement that the FDA had inserted into the preamble to the 2006 regulation. Although the court acknowledged that it is ordinarily required to defer to an agency's interpretation of the statute that it administers, it refused to do so in this case.[58] Deference is appropriate when a statute is "silent or ambiguous with respect to the specific issue"—it is not appropriate when it contradicts the "unambiguously express intent of Congress."[59] In this case, Congress had spoken on the issue. The FDCA provided for the express preemption of state laws (in drug regulation matters) only if it was impossible for a manufacturer to comply with both federal and state requirements. Since the CBE regulation already allowed a manufacturer to unilaterally add or strengthen a label warning, the issue of impossibility was not present.

In his dissenting opinion, Chief Justice Reiber argued that Levine's common-law claims were in conflict with federal law for two reasons. The first was that it would be impossible for Wyeth to comply with both the state and federal requirements. The FDA had approved the administration of Phenergan by the IV method and it had required Wyeth to list the IV administration on its label. If Wyeth altered the label to comply with state law it would have to eliminate an FDA approved use from the label—and that would make it impossible for the company to comply with the state and federal laws.[60] The second was that allowing the plaintiff's state law claims to go forward would present an obstacle to federal purposes and objectives. While the goal of the FDA is to ensure that the drugs in the marketplace are safe, it does so knowing that no drug is without risks. When the FDA considers whether to approve a NDA, it engages in a risk-benefit analysis with the intention of maximizing the availability of beneficial treatments. A state court jury, on the other hand, "does not engage in a measured and multi-faceted policy analysis. Rather, a jury views the safety of the drug through the lens of a single patient who has already been catastrophically injured."[61] The result is that a jury's verdict that a drug was unreasonably dangerous can frustrate the FDA's wider public health assessment that the drug is safe and effective.

IV. *WYETH V. LEVINE*—U.S. SUPREME COURT DECISION

A. Majority Decision

The U.S. Supreme Court, in a six to three decision, with two concurrences and one dissent, affirmed the lower court decisions in favor of the plaintiff.[62] The issue that Wyeth presented on appeal was "whether prescription drug labeling judgments imposed on manufacturers by the Food and Drug Administration . . . pursuant to FDA's comprehensive safety and efficacy authority under the Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 301 *et seq.*, preempt state-law product liability claims premised on the theory that different labeling judgments were necessary to make drugs reasonably safe for use,"[63] Justice John Paul Stevens, writing for the majority, addressed the somewhat different issue of whether the FDA's approval of Phenergan provided Wyeth with a complete defense to Levine's common-law negligence and strict liability claims--and answered the question in the negative.[64]

Before discussing the preemption issue, Stevens highlighted two important findings of fact that had been decided at the trial level and identified two legal principles that were essential to his analysis of the case. The first factual finding was that

Levine's arm would not have developed gangrene if the Phenergan label had adequately warned of the risks of administering the drug by the IV-push method. The fact that the physician assistant's administered a greater than recommended dose of the drug (which may have inadvertently entered an artery rather than a vein) was a foreseeable intervening force—and the inadequate label was both a but-for and a proximate cause of Levine's injuries.[65] The second jury finding was that the lack of an adequate warning about the risks of an IV-push administration of Phenergan was the critical defect in its warning label.[66] That the jury found the warning to be insufficient did not, however, mean that it had mandated a particular replacement label nor did it require the contraindicating of IV-push administration.[67]

Stevens then summarized the two legal cornerstones of preemption jurisdiction. The first was the principle that "the purpose of Congress is the ultimate touchstone in every preemption case."[68] The second was that in those preemption cases in which Congress has legislated in a field traditionally occupied by the States, the court "starts with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."[69]

Wyeth had argued that Levine's state tort actions were preempted because of the impossibility of complying with a state-law duty to modify the drug's label without violating federal law and because a state tort action created an unacceptable "obstacle to the accomplishment and execution of the full purposes and objectives of Congress"[70] since it allowed a jury's decision about a drug label to trump the expert judgment of the FDA. Stevens found both arguments to be without merit.

1. Impossible to Comply

Wyeth's impossible to comply argument was based on the premise that, once the FDA has approved a drug warning label, the manufacturer could not change the wording of the label until a supplemental application was filed with, and approved by, the FDA. Wyeth argued that it could not have relied on the CBE regulation to unilaterally change the warning label for Phenergin since the CBE regulation had been amended so that it only applied to cases in which the labels would "reflect newly acquired information."[71] Since Levine presented no new evidence (which the FDA had not already considered) concerning the risks of the IV-push administration, Wyeth claimed that it would have been impossible to change the label to meet state-law obligations without violating federal law.

Stevens dismissed Wyeth's argument as a "misapprehens[ion] both of the federal drug regulatory scheme and its burden in establishing a pre-emption defense."[72] He found no need to consider the merits of Wyeth's contention that the 2008 amendment of the CBE regulation was consistent with the FDC and the regulation in effect at the time of Levine's injection since the "newly acquired information" that is referred to in the regulation applies to "new analyses of previously submitted data" and not just to new data.[73] According to the amended CBE regulation:

> [I]f the sponsor submits adverse event information to FDA, and then later conducts a new analysis of data showing risks of a different type or of greater severity or frequency than did reports previously submitted to FDA, the sponsor meets the requirements for newly acquired information.[74]

The majority opinion acknowledged that the trial record was "limited concerning what newly acquired information Wyeth had or should have had about the risks of IV-push administration of Phenergan."[75] There was, however, evidence of at least 20 instances in which a Phenergan injection had resulted in gangrene and amputations. Wyeth had notified the FDA after the first case came to its attention in 1967—and had worked with the FDA to change the label. The court suggested that after it became aware of the additional amputations, Wyeth could have analyzed the accumulating data and added a stronger label warning about the IV-push method of administration.

Stevens presented also two reasons for rejecting Wyeth's assertion that its unilateral change to the warning label would have constituted an unauthorized distribution and misbranding of the drug. The first was that Wyeth was incorrect when it assumed that a drug would be considered a new drug (without an effective application) if a change had been made to its label. Under the FDCA, the unilateral strengthening of an already approved warning label would not, in fact, change the drug into a new drug.[76] The second problem was Wyeth's failure to understand that the mislabeling provision of the FDCA did not focus on the alteration of an FDA approved label but rather on the substance of the label—including its failure to include "adequate warnings."[77] Whether a drug has been misbranded is a matter for a federal jury to ultimately decide.[78] And, neither Wyeth nor the government, in its *amicus curiae* brief, was able to identify even one instance in which the FDA had initiated an enforcement action against a manufacturer for strengthening a warning label as provided for under the CBE regulation.

The Supreme Court credits "Wyeth's cramped reading of the CBE regulation and its broad reading of the FDCA misbranding and unauthorized distribution provisions"[79] to the company's suggestion that the FDA, and not the manufacturer, has the primary responsibility for the content of a drug label. Such a suggestion is in opposition to the central premise of federal drug regulation. Both the amendments to the FDCA and FDA regulations designate the manufacturer as the party responsible for "crafting an adequate label and [for] ensuring that its warnings remain adequate as long as the drug is on the market."[80] The passage of the FDAAA, in 2007, may have authorized the FDA, under some circumstance, to order manufacturers to revise their labels but it also reaffirmed the manufacturer's obligations—including those specifically referred to in the CBE regulation.[81] Consequently, Wyeth had an obligation to change its warning label to adequately describe the risk of gangrene from IV-push injections of Phenergan—and was permitted to do so, under the CBE regulation, even before it received FDA approval.[82]

While it is true that the FDA may ultimately reject unilateral labeling changes made pursuant to the CBE regulation, there was no evidence that it would have done so for changes in the Phenergan label. Wyeth did not allege that it was prohibited by the FDA from trying to give the kind of warning that the Vermont jury sought. The Vermont Superior Court found, as a matter of fact, that there was "no evidence in the record that either the FDA or the manufacturer gave more than passing attention to the issue of" the IV-push versus IV-drip administration of Phenergan.[83] The Vermont Supreme Court also concluded that there was no record of the FDA's intention to either preserve the IV-push method or to prohibit the manufacturer from strengthening the warning with regard to the IV-push method.[84] Finally, Wyeth itself never alleged that it had supplied the FDA with an evaluation or analysis of the specific dangers associated with the IV-push method. Consequently, the U.S. Supreme Court rejected Wyeth's claim that it would have been impossible to comply with the state and federal requirements since there is no evidence that the FDA would have prevented it from adding a stronger warning to the Phenergan label.

2. Obstruction of Purposes and Objectives of Regulation of Congress

Wyeth's second preemption argument was based on the theory that if it complied with the state-law duty (to provide a stronger warning on the Phenergan label), it would, in fact, obstruct the purposes and objectives of the federal regulatory scheme (including the need for FDA officials to use their expert knowledge to strike a balance between competing objectives of safety and efficiency).[85] Stevens rejected this claim on the grounds that it was faulty in its interpretation of congressional intent and represented an overboard view of the agency's power to preempt state law.

Congress enacted the Food and Drug Act and the FDCA to supplement, but not replace, the protections already available to consumers under state laws.[86] Neither the acts nor their subsequent amendments provided any federal remedies to injured consumers. Stevens suggested two reasons for this omission. The first was that widely available state remedies already provided appropriate relief. The second was that the possibility of costly state remedies promoted consumer protection by motivating manufacturers to be more vigilant in producing safe products with adequate warning labels.[87]

Another significant matter contributing to the majority's decision was the fact that Congress had never amended the FDCA to expressly preempt state law suits involving prescription drugs. Congress could have drafted a general preemption clause for the FDCA when it included the specific preemption provision in the Medical Devices Amendments in 1976. The fact that it was silent on the issue at a point in time (when it was certainly aware of the prevalence of state court litigation) convinced Stevens that Congress "did not intend the FDA oversight to be the exclusive means of ensuring drug safety and effectiveness."[88]

Wyeth had suggested that one of the ways that state lawsuits obstructed the purposes and objections of the federal regulation of drugs was that they did not take into account the balancing of risks and benefits that inform the FDA in its decision making process. The FDA itself had stated in the preamble to the 2006 regulation that the FDCA established "both a floor and a ceiling" for the regulation of drugs.[89] It then proceeded to articulate its conclusion that state laws and state law actions, including failure-to-warn claims, were an obstacle to achievement of the full objectives and purposes of the federal regulatory law since they "threaten FDA's statutorily prescribed role as the expert Federal agency responsible for evaluating and regulating drugs."[90]

Stevens found Wyeth's reliance on the FDA's preamble to the 2006 regulation to be less than convincing. While it is true that a federal regulation may preempt conflicting state laws,[91] preemption is not guaranteed if the agency acts without congressional authorization. An agency's mere assertion that state law has been preempted because it is an obstacle to statutory objectives cannot survive a judicial determination to the contrary. One of the problems with the FDA's preamble statement was that it directly contradicted the FDA's notice of proposed rulemaking for the 2006 regulation. That notice specifically stated that the rule "would not contain policies that have federalism implications or preempt State Law."[92] Consequently, when the FDA finalized the rule with its new articulation of the FDCA's preemptive effect in the preamble, it did so without giving the states or other interested parties notice of the proposed change or opportunity to comment it.[93]

The preamble was also suspect since it reversed two of the FDA's longstanding positions (that the federal labeling standards were a floor upon which the states could build and that the FDA would not attempt to preempt failure-to-warn claims) without providing a reasoned explanation for the change.[94] Prior to 2006, both Congress and the FDA have treated state law as a complementary form of drug regulation and had traditionally relied on state tort suits to "uncover unknown drug hazards and provide incentives for drug manufacturers to disclose safety risks promptly."[95]

The court also rejected Wyeth's claim that the alleged conflict between federal and state law in the present case was analogous to the one that supported the car manufacturer's preemption claim in the *Geier v. American Honda Motor, Co.*.[96] In that case, the Department of Transportation had formulated the regulatory scheme (which allowed car manufacturers to satisfy a safety requirement by choosing from a range of passive restraint devices) after it had conducted a formal rulemaking and then adopted a phase-in plan. Unlike the FDA's nonexistent record to explain the basis for the changes announced in the 2006 preamble, the Department of Transportation's contemporaneous record "revealed the factors the agency had weighed and the balance it had struck."[97]

For all of the above reasons, Stevens concluded that preamble of the 2006 regulation did not merit deference, that it was possible for Wyeth to comply with the state and federal laws, and that Wyeth's obstruction of purposes and objectives claims were insufficient to preempt Levine's common law claims.

B. Concurring Opinions

1. Justice Breyer

The Justice Stephen Breyer's concurring opinion was very brief. His primary concern was to emphasize that the reason the majority arrived at its opinion was because there was "no occasion in this case to consider the preemptive effect of a specific agency regulation bearing the force of law."[98] As such, this decision would not preclude the court from deciding in the future that FDA had sought to determine whether and when state law acts had become a hindrance to achieving the congressional goal of safe drug-related medical care and had embodied those determinations in lawful regulations that had a preemptive effect.

2. Justice Thomas

Justice Clarence Thomas filed an opinion that concurred in the judgment but did not join the majority's implicit endorsement of a far-reaching implied preemption doctrine that "routinely invalidates state laws based on perceived conflicts with broad federal policy objectives, legislative history, or generalized notions of congressional purposes that are embodied within the text of federal law."[99] His approach was based on his more traditionally conservative view of the "delicate balance of power mandated by the Constitution."[100]

The recurring theme in Thomas' concurring opinion was his conviction that the question of preemption had to turn on whether state law conflicted with the text of the relevant federal statute or with the federal regulations authorized by that text. Since the texts of the statutory and regulatory scheme did not guarantee that a company was insulated from liability under state law once it received an FDA-approval for a particular drug label, there was no "direct conflict" between the federal law and state law and a judgment based on the state law could not be preempted.[101]

C. Dissenting Opinion

In his dissenting opinion, Justice Samuel Alito characterized the *Wyeth* case as an illustration of the proposition "that tragic facts make bad law."[102] Alito found it incomprehensible that the majority would allow a state tort jury, rather than the FDA, to have the ultimate responsibility for regulating the warning labels for prescription drugs. Such a result was possible only because the Court had ignored its own precedent in the case of *Geier*[103] and had disregarded the general principles of conflict preemption.

The minority was convinced that the proper framing of the issue in this case should have been "whether a state tort jury can countermand the FDA's considered judgment that Phenergan's FDA-mandated warning renders its intravenous (IV) use "safe."[104] Alito emphasized the importance of a drug's warning label. Not only is it "the standard under which the FDA determines whether a product is safe and effective,"[105] it is also the "centerpiece of risk management" . . . "as it communicates to health care practitioners the agency's formal, authoritative conclusions regarding the conditions under which the product can be used safely and effectively."[106] When the FDA follows its statutory mandate and determines that a drug is on the balance "safe," its judgment should not be countermanded by a conflicting determination under state common-law. The conflict itself is the basis for federal preemption—even in those instances where Congress has not enacted an express preemption.[107]

Alito then went on to demonstrate how the court, in *Geier*, was able to apply the conflict preemption doctrine to a situation where the regulatory statute contained a savings clause.[108] A key factor in that case was the view of the Secretary that the Department of Transportation's decision to allow the auto makers to choose from a number of safety options was the best way to promote safety. "Because the Secretary determined that the menu of alternative technologies was "safe," the doctrine of conflict preemption barred [the plaintiff's] efforts to deem some of those federally approved alternatives "unsafe" under state tort law."[109] The minority thought the court should have applied its rationale in *Geier* to the present case--in which the FDA had deemed the methods of alternative administration provided in the menu on the Phenergan label to be "safe" and "effective."

The remainder of the dissenting opinion was devoted to a discussion of the three categories of reasons why the majority of the court failed follow its own precedent in *Geier*. The first was factual. The minority suggested that the court had willfully disregarded the fact that the FDA had considered (and struck a balance between) the costs and benefits attached to the IV push method.[110] The second was legal. The court had denied the existence of a federal-state conflict in this case;[111] it dismissed the FDA's articulation of its preemptive intent in the preamble to the 2006 regulation on the grounds that the interested parties were not afforded notice or an opportunity for comment;[112] it determined that the FDA's preamble, unlike the Department of Transportation's regulation, did not "bear the force of law;"[113] it "sandwiched" its discussion of *Geier* between its discussion of the "presumption against preemption" and its lengthy consideration of the traditional coexistence of state and federal law in the area of drug regulation;[114] and it appeared to completely disregard the FDA's explanation, in its *amicus* brief, with regard to the conflict between state tort cases and the federal labeling regime.[115] And, the third reason was judgmental. The court had decided to recklessly allow ill-equipped juries to perform the FDA's cost-benefit balancing functions.[116]

V. CONCLUSIONS

The Supreme Court's decision in *Wyeth v. Levine* was certainly disappointing to many in the business community. This was particularly true for companies producing commodities that are regulated by the federal government. If the court had preempted the state product liability actions against drug companies, there was hope that it would eventually extend that same preemption protection to product liability cases involving manufacturers of products as diverse as antifreeze, fireworks, popcorn, cigarettes, and light bulbs.[117] It would also have allowed companies to concentrate on complying with only one set of regulatory laws.

In recent years, business has found many sympathetic allies in Washington, D.C. The Bush administration "encouraged federal agencies to issue rules preempting state laws and declared that a single federal standard held sway."[118] The court used theories of express and implied preemption to limit the ability of injured parties to sue manufacturers in state court. There has, however, been some shifting of sympathies under the Obama administration. On January 20, 2009, a memorandum was sent to federal agency heads instructing them to stay pending or recently completed rules. On March 4, 2009, the Supreme Court rejected the preemption arguments of Wyeth (and the Bush administration's *amicus* brief in support of Wyeth). A week later, the Office of Budget and Management issued a statement that it had taken note of the principles in *Wyeth* and intended to provide adequate notice and comment periods for federal regulations and to instruct federal agencies to preempt state tort laws only when Congress intends it to do so.[119] Finally, on May 20, 2009, President Obama issued a revised Executive Order 13132 instructing federal agency heads to roll-back the prior administration's attempts to issue regulations that were designed to protect companies from state court lawsuits and that were not justified.[120]

ENDNOTES

1 129 S. Ct. 1187 (2009).

2 *Riegel v. Medtronic, Inc.*, 128 S. Ct. 999 (2008).

3 Alicia Mundy and Shirley S. Wang, *In Drug Case, Justices Weigh Right to Sue*, WALL ST. J., October 27, 2008, *available at* http://online.wsj.com/article/SB122506300017470355.html.

4 Adam Liptak, *Justices Return to Work, With a Less Meaty Docket for This Term*, N.Y. TIMES, October 5, 2008, *available at* http://www.lexisnexis.com/us/lacademic/frame.do?tokenKey=rsh-20.390402.194906315.

5 Pub. L. No. 59-384, 34 Stat. 768 (1906).

6 Pub. L. No. 75-717, 52 Stat. 1040 (1938).

7 *Id.* at § 505(a), (d), 52 Stat. 1052.

8 *Id.* at § 505(c), 52 Stat. 1052.

9 Drug Amendments of 1962, Pub. L. No. 87-781, 76 Stat. 780, 781-82 (1962) (codified at 21 U.S.C. § 321(p)(1)-(2) § 355(b)-(d) (2000).

10 *Id.* at § 102(d), 104(b), 76 Stat. 781, 784.

11 *Id.* at § 102(d), 76 Stat. 781.

12 *Id.* at § 202, 76 Stat. 793.

13 21 U.S.C. § 360c *et. seq.*

14 21 U.S.C. § 360k(a). "Except as provided in subsection (b) of this section, no State or political subdivision of a State may establish or continue in effect with respect to a device intended for human use any requirement—(1) which is different from, or in addition to, any requirement applicable under this chapter to the device, and (2) which relates to the safety or effectiveness of the device or to any other matter included in a requirement applicable to the device under this chapter."

15 71 Fed. Reg. 3922 (Jan. 24, 2006).

16 Alicia Mundy and Brent Kendall, *Shift Toward State Rules on Product Liability*, WALL ST. J., May 21, 2009, at A3. The Bush administration

also attempted to preempt state tort law actions for the following products regulated by the FDA: skin bleaching products, OTC drugs in trial sample packages, OTC analgesics, sunscreen products, fatty acids, pregnancy and lactation labeling, noncarcinogenic sweeteners, OTC dandruff products, OTC laxatives, dietary sweeteners, OTC contraceptives, skin protectant drug products, soluble fiber (used for coronary heart disease.) http://www.atlanet.org/resources/ summary_of_Bush_Admin_regs_-_as_of_Jan_7_final.pdf.

[17] *Supra*, n. 15, at 3935.

[18] Pub. L. No. 110-85, 121 Stat. 823 (2007).

[19] *Id*. at Tit. IX, § 901(a), § 505(o)(4), 121 Stat. at 924-26. This can only be done if the FDA promptly notifies the manufacturer that it has become aware of new safety information that the FDA has determined needs to be included on the label. The manufacturer then has 30 days to either submit a supplement with proposed labeling changes that reflect the new safety information or to notify the FDA that it does not think that a new label is necessary. If the FDA either rejects the manufacturer's proposed wording or if the manufacturer claims that no change is needed, the FDA must attempt to work out some kind of agreement with the manufacturer. Should that fail, the FDA may then issue an order requiring the manufacturer to make the changes that the FDA has recommended. Although there is an agency appeal process, the FDA clearly has the ability to make the final determination with regard to the wording of the label.

[20] *Id.* at Tit. I, § 104, § 736A, 121 Stat. 823, 832-40.

[21] *Id*. at Tit. IX, § 901(a), *id*. at 924-926.

[22] *Supra*, n. 6, at § 505(b), 52 Stat. at 1052; (codified at 21 U.S.C. § 355(b)(1)(F); see 21 C.F.R. 314.50(c)(2)(i) and (e)(2)(ii).

[23] *Id.* at §§ 201(p), 301(a), 502, 505(a), (d), 52 Stat. at 1041-1042, 1050-1052 (codified as amended at 21 U.S.C. §§ 321(p), 331 (a), 352, 355(a), (d).)

[24] *Id.* at 21 U.S.C. 355(b)(1)(A).

[25] 21 C.F.R. 314.50(d)(5)(viii); see 21 C.F.R. 314.50(c)(2)(ix).

[26] 21 U.S.C. § 355(d) (2005).

[27] 21 U.S.C. § 355(b)(1)(F) (2000).

[28] 21 C.F.R. § 314.70(b)(2)(v)(A).

[29] 21 C.F.R. § 314.70 (c)(6).

[30] 21 C.F.R. § 314.70(c)(6)(iii)(A), (C).

[31] Wyeth's proposal for a revised warning label read in relevant part:

INADVERTANT INTRA-ARTERIAL INJECTION: There are reports of necrosis leading to gangrene, requiring amputation, following injection of

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[Phenergan], usually in conjunction with other drugs; the intravenous route was intended in these cases, but arterial or partial arterial placement of the needle is now suspect.

There is no established treatment other than prevention:

1. Be aware of close proximity of arteries and veins at commonly used injection sites and consider the possibility of aberrant arteries.
2. When used intravenously, [Phenergan] should be given in a concentration no greater than 25 mg/ml and a rate not to exceed 25 mg/minute. Injection through a properly running intravenous infusion may enhance the possibility of detecting arterial placement. In addition, this results in delivery of a lower concentration of any arteriolar irritant.

[32] *Supra,* n. 1, at 1192, citing App. at 395.

[33] *Id.* at 1192, citing App. at 382.

[34] *Id.* at 1226, citing App. 40 (testimony of Dr. John Matthew; *id.*, at 103, 106, 109 (testimony of physician's assistant, Jessica Fisch).

[35] Through the process of perivascular extravasation.

[36] Failure-to-warn cases, brought by consumers who have been injured by dangerous drugs, have their roots in common-law cases that established a high degree of responsibility for those businesses that sold food for human consumption. *Restatement (Second) of Torts* § 402A cmt. b. (1965).

[37] The 2002 warning on the Phenergan label read in relevant part:

"INADVERTENT INTRA-ARTERIAL INJECTION: Due to the close proximity of arteries and veins in the areas most commonly used for intravenous injection, extreme care should be exercised to avoid perivascular extravasation or inadvertent intra-arterial injection. Reports compatible with inadvertent intra-arterial injection of [Phenergan], usually in conjunction with other drugs intended for intravenous use, suggest that pain, severe chemical irritation, severe spasm of distal vessels, and resultant gangrene requiring amputation are likely under such circumstances. Intravenous injection was intended in all the cases reported but perivascular extravasation or arterial placement of the needle is now suspect. There is no proven successful management of this condition after it occurs . . .

When used intravenously [Phenergan] should be given in a concentration no greater than 25 mg per ml and at a rate not to exceed 25 mg per minute. When administering any irritant drug intravenously it is usually preferable to inject it through the tubing of an intravenous infusion set that is known to be functioning satisfactorily."

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[38] *Supra*, n. 1, at 1192, citing App. 14-15.
[39] *Id.*, at 1192.
[40] This is in part because the IV drip begins with a saline drip that will only flow if the catheter is in a vein and will not work if the saline fluid is attempting to enter an artery or surrounding tissue.
[41] *Supra*, n. 1, at 1193, citing App. at. 228.
[42] *Id.* at 1193, citing App. at 249-252.
[43] *Levine v. Wyeth*, 183 Vt. 76, 84; 944 A. 2d 179 (2006).
[44] *Id.* at 84, citing *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504 , 526, 112 S. Ct. 2608 (1992) (quoting *Maryland v. Louisiana*, 451 U.S. 725, 746, 101 S. Ct. 2114 (1981).
[45] *Id.* at 85, citing *Metronic Inc. v. Lohr*, 518 U.S. 470, 485; 116 S. Ct. 2240 (1996).
[46] *Id.* at 85, citing *Bates v. Dow Agrosciences LLC*, 544 U.S. 431, 449; 125 S. Ct. 1788 (2005).
[47] *Id.* at 85, citing *Freightliner Corp. v. Myrick*, 514 U.S. 280, 287; 115 S. Ct. 1483 (1995).
[48] *Id.* at 87.
[49] *Id.* at 88, citing *McNellis v. Pfizer, Inc.*, 2005 U.S. Dist. LEXIS 37505, 2005 WL 3752269 (D.N.J.) (rejecting conflict preemption of failure-to-warn claims for cases involving Zoloft); *Eve v. Sandoz Pharm. Corp.*, 2002 U.S. Dist. LEXIS 23965, 2002 WL 181972 (S.D. Ind.) (regarding the drug Parlodel); *Caraker v. Sandoz Pharm. Corp.*, 172 F. Supp. 2d 1018 (S.D. Ill, 2001) (same); *Bryant v. Hoffman-La Roche, Inc.*, 262 Ga. App. 401, 585 S.E.2d 723 (Ga. Ct. App. 2003) (heart medication); *Bell v. Lollar*, 791 N.E.2d 849 (Ind. Ct. App. 2003) (prescription pain medication); *Kurer v. Parke, Davis & Co.*, 2004 WI App 71 ¶ 21, 272 Wis. 2d 390, 679 N.W.2d 867 (oral contraceptive).
[50] *Id*. at 89-90.
[51] 529 U.S. 861; 120 S. Ct. 1913 (2000). In *Geier*, the Court preempted state tort claims based on manufacturer's failure to provide airbags in its cars since the Department of Transportation had specifically designated a range of permissible safety options, including those that did not involve the use of an airbag, as a way of gradually phasing in auto safety requirements.
[52] *Supra*, n. 43, at 90.
[53] *Id*. at 91.
[54] *Id*. at 93. See n. 31 and n. 37.
[55] *Id.* at 93-94, citing *Untied States v. Sullivan*, 332 U.S. 689, 696; 68 S. Ct. 331 (1948).
[56] *Id.* at 93, citing *McNellis*, *supra*, n. 49.
[57] *Id.* at 95.

[58] *Id.* at 97, citing *Chevron, U.S.A., Inc. v. Natural Res. Def. Council,* 467 U.S. 837, 844; 104 S. Ct. 2778 (1984).
[59] *Id.* at 97, quoting *id., Chevron,* at 842-843.
[60] *Id.* at 104.
[61] *Id.* at 112.
[62] The majority decision was delivered by Justice John Paul Stevens and joined by Justices Anthony Kennedy, David Souter, Ruth Bader Ginsburg, and Stephen Breyer. Justice Breyer filed a concurring opinion and Justice Clarence Thomas filed an opinion concurring in the judgment. The dissenting opinion was filed by Justice Samuel Alito and joined by Chief Justice John Roberts and Justice Antonin Scalia.
[63] Pet. For Cert. at i.
[64] *Supra,* n. 1, at 1191.
[65] *Id*. at 1194.
[66] *Id.* at 1194.
[67] The importance of this clarification by Stevens is to remove from the discussion the question of whether a state rule proscribing intravenous administration is preempted.
[68] *Supra,* n. 1, at 1194, citing *Metronic, supra,* n. 45, at 485.
[69] *Id.* at 1194-1195, citing *Metronic*, *supra,* n. 45, at 485 (quoting *Rice v. Santa Fe Elevator Corp.,* 331 U.S. 218, 230, 67 S. Ct. 1146 (1947)).
[70] *Id.* at 1193, citing *Hines v. Davidowitz*, 312 U.S. 52, 67, 61 S. Ct. 399 (1941).
[71] 73 Fed. Reg. 49603, 49609. Even though the regulation was not changed until 2008, Wyeth contended that it simply reaffirmed the interpretation of the regulation that was in effect when the present case was tried in Vermont.
[72] *Supra*, n. 1, at 1196.
[73] *Id.*, at 1197.
[74] *Id*. at 1197.
[75] *Id.* at 1197. (During the course of the trial, Wyeth had not argued that such information was required for a CBE labeling change.)
[76] *Id.* at 1197. See 21 U.S.C. § 321(p)(1) (defining “new drug”) and 21 CFR § 310.3(h).
[77] *Id.* at 1197. See 21 U.S.C. § 352(f).
[78] *Id.* at 1197. See 21 U.S.C. §§ 331, 332, 334 (a)-(b).
[79] *Id.* at 1197.
[80] *Id.* at 1198, citing 21 CFR §201.80(e) (requiring the manufacturer to revise a label “to include a warning as soon as there is reasonable evidence of an association of a serious hazard with a drug”); 21 U.S.C. 314.80(b)

(placing responsibility for postmarketing surveillance on the manufacturer); 73 Fed. Reg. 49605 ("Manufacturers continue to have a responsibility under Federal law . . . to maintain their labeling and update the labeling with new safety information.")

[81] The FDAAA specifically states that the manufacturer retains the responsibility "to maintain its label in accordance with existing requirements, including subpart B of part 201 and sections 314.70 and 601.12 of Title 21, Code of Federal Regulations (or any successor regulations.)" 121 Stat. 925-926.

[82] *Supra*, n. 1, at 1198.

[83] *Id.* at 1199, citing App. 249.

[84] *Id.* at 1199, citing *supra*, n. 43, at 93.

[85] *Id.* at 1199.

[86] *Id.* at 1199, citing *Kordel v. United States,* 335 U.S. 345, 349; 69 S. Ct. 106 (1948); *Sullivan*, *supra*, n. 55, at 696.

[87] *Id.* at 1199-1200.

[88] *Id.* at 1200.

[89] *Supra*, n. 15, at 3934-3935.

[90] *Id.* at 3935.

[91] *Supra*, n. 1, at 1200, citing *Geier*, *supra*, n. 51, at 861; *Hillsborough County v. Automated Medical Laboratories, Inc.*, 471 U.S. 707, 713, 105 S. Ct. 2371 (1985).

[92] 65 Fed. Reg. 81103.

[93] *Supra*, n. 1, at 1201.

[94] *Id.* at 1201-1202.

[95] *Id.* at 1202.

[96] *Supra*, n. 51.

[97] Supra, n. 1, at 1203.

[98] *Id.* at 1204.

[99] *Id.* at 1204.

[100] *Id.* at 1206.

[101] *Id.* at 1211.

[102] *Id.* at 1217.

[103] *Supra*, n. 51.

[104] *Supra*, n. 1, at 1217.

[105] 50 Fed. Reg. 7470 (1985).

[106] 71 Fed. Reg. 3934 (2006).

[107] *Supra*, n. 1, at 1220.

[108] *Id.* at 1221.

[109] *Id.* at 1221.

[110] *Id*. at 1222.

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[111] *Id.* at 1227.
[112] *Id.* at 1227.
[113] *Id.* at 1228.
[114] *Id.* at 1228.
[115] *Id.* at 1229.
[116] *Id.* at 1229.
[117] Adam Liptak, *No Legal Shield in Drug Labeling*, N. Y. TIMES, March 5, 2009, *available at* http://www.lexisnexis.com/us/lnacademic/frame.do?tokenKey=rsh-20.424144.442316702.
[118] Alicia Mundy and Brent Kendall, *Shift Toward State Rules on Product Liability*, WALL ST. J., May 21, 2009, at A3.
[119] *OMB Process Should Embrace Supreme Court's Wyeth Decision; Provide Note and Comment Period to Improve Regulatory Transparency*, STATE NEWS SERVICE, March 16, 2009, *available at* http://www.lexisnexis.com/us/lnacademic/frame.do?tokenKey=rsh-20.22069.6862490300.
[120] One Bush administration preemption regulation stopped California from enforcing a law limiting greenhouse gas emissions. Others involved mortgage law. Philip Rucker, *Obama Curtails Bush Policy of 'Preemption; It Let Federal Rules Override State Laws*, WASH. POST, May 22, 2009, *available at* http://www.lexisnexis.com/us/lnacademic/frame.do?tokenKEY=rsh-20.597772.842588199.

TAX COURT DECISIONS ON FAMILY LIMITED PARTNERSHIPS AID BOTH TAXPAYERS AND IRS

by

Martin H. Zern*

I. INTROUDUCTION

In the complex arena of estate and gift taxation, controversies frequently arise between taxpayers and the Internal Revenue Service (IRS) concerning the value of property gifted or owed at death. Since the estate and gift taxes are based upon the valuation of property – determined at the time of death or at the time of the gift – taxpayers generally attempt to minimize values whereas the IRS attempts to maximize them.[1]

A sophisticated estate planning structure for minimizing values, or at least endeavoring to do so, is the family limited partnership. Typically, property is transferred to a newly formed limited partnership by a well-to-do taxpayer followed by transfers of partnership interests to children or other family members as gifts. Often, the property transferred to the partnership consists partly or entirely of publicly traded securities for which market values are readily available. The transfer of partnership interests may be outright, to custodial accounts or in trust. A valuation discount for the gifts of the partnership interests is then claimed for their alleged lack of marketability, which is based partly upon restrictions on

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transferability contained in the partnership agreement. A further discount is claimed for the fact that the partnership interests gifted are minority interests. Accordingly, the claimed value of the gift is based not upon the value of the publicly traded securities transferred to the partnership, but the allegedly considerably lower value of the partnership interests resulting from minority and marketability discounts. The IRS has attacked the family limited partnership divide over the years with mixed results using a variety of Internal Revenue Code provisions.[2] It particularly frowns on the transfer of publicly traded securities to a family limited partnership, especially where the creation of the partnership, the transfers of the securities to it and the gifts of the partnership interests occur practically simultaneously. Two Tax Court cases of fairly recent vintage, one decided in 2000 and another in 2004, favored the IRS position. The IRS was less successful, however, in a Tax Court case decided in May of 2008, *Hollman v. Commissioner*,[3] and in a follow up case with similar facts decided in September of 2008, *Bianca Gross v. Commissioner*.[4]

II. EARILER TAX COURT DECISIONS FAVORING THE IRS.

A Tax Court decision in 2000, *Shepherd v. Commissioner*, was affirmed by the Eleventh Circuit in 2002.[5] In *Shepherd*, the taxpayer transferred real property and shares of publicly traded stock to a newly-formed limited partnership in which he was a 50% owner and each of his two sons were 25% owners. Rather than allocating the value of the property transferred to the taxpayer's capital account, the value was allocate, pursuant to the partnership agreement, pr rat based on ownership. Accordingly, 50% was allocated to the taxpayer's capital account and 25% was allocated to each of the capital accounts of his two sons. The transfer of the property to the partnership and the transfers of the interests in the partnership occurred on the same day. The IRS asserted that the transfer of the property to the partnership was an indirect gift of the property itself to the sons and not a gift of the partnership interests (with a claimed discounted value). Because the noncontributing partners' capital accounts were enhanced by the contribution of the taxpayer, the Tax Court held that the transfers were indirect gifts by the taxpayer to his sons of undivided 25-percent interests in the real property and shares of stock. No discounts were allowed for minority and marketability discounts on the gifts of the partnership interest to the sons.

A Tax Court decision in 2004, *Senda v. Commissioner*, was affirmed by the Eight Circuit in 2006.[6] In *Senda*, the taxpayers transferred shares of publicly traded stock to two family limited partnerships, coupled with transfers of limited partnership interests to their children. As in *Shepherd*, the transfers took place the same day. The Tax Court found: "At best, the transfers were integrated (as asserted by respondent) and, in effect, simultaneous." The transfers of the shares of stock to the partnerships were held to be indirect gifts of the shares to the children. Again, no minority and marketability discounts were allowed.

III. HOLLMAN v. COMMISSIONER

The Tax Court decided the *Hollman* case[7] in May, 2008. The case has stirred up some controversy, but should give aggressive estate and gift tax practitioners some hope of successfully asserting minority and marketability discounts if the estate plan is structured correctly. On the other hand, the discounts allowed probably will not be as much as sought.

A. Facts

The taxpayers, husband and wife, had four minor children. The husband, Thomas Hollman (Tom), was employed by Dell Computer Corp. (Dell) from 1988 through November of 2001. During the course of his employment, Tom received substantial stock options, some of which he exercised. Additionally, he purchased shares of Dell Stock. As the wealth of the taxpayers increased, they became concerned with managing it, particularly as to how it might affect their children. With this in mind, beginning in 1996 and continuing into 1999, they transferred Dell stock to custodial accounts (Under the Texas Uniform Transfers to Minors Act) for each of their three daughters. Tom's mother (Janelle) ultimately wound up as the custodian after Tom resigned.

In 1997, the taxpayers met with an estate planning attorney who advised them of the gift tax savings from valuation discounts of gifts of limited partnership interests rather than of gifts of the property contributed to the limited partnership. In 1999, following the advice of the attorney, the taxpayers formed an irrevocable trust (the trust), naming themselves as grantors, Janelle as trustee and their children as beneficiaries. The taxpayers executed the trust on September 10, 1999, Janelle executed it on November 4, 1999, and the trust stated it was effective September 10, 1999. One hundred shares of Dell stock and $10,000 were transferred into the trust. The taxpayers also executed a limited partnership agreement on November 2, 1999.[8] Janelle executed it thereafter. On November 2, 1999, Janelle, as trustee, transferred the 100 shares of Dell stock to the limited partnership in exchange for a partnership interest. On the same date, the taxpayers transferred 70,000 shares of Dell stock to the partnership in exchange for partnership interests.

Tom testified that the reason for setting up the family limited partnership was long-term growth, asset protection and preservation. He stated his concern that a direct gift to his children might de-motivate them: "We did not want our daughters to just go blow this money." He also stated he was concerned about protecting the assets from friends, spouses and potential creditors and wanted something to educate his daughters on business matters.

On November 8, 1999, the taxpayers made a gift of limited partnership interests to Janelle, both as custodian under the state's Uniform Gifts to Minors Act (UGMA) and as trustee. On December 13, 1999, further transfers of Dell stock, in exchange for partnership interests, were made from custodial accounts for the taxpayers' children set up under UGMA. As a result of the transfers, the trust wound up owning about 49% of the partnership interests, custodial accounts wound up owning about 40% of the partnership interests, and the taxpayers wound up owning general and limited partnership interest comprising the other 11%. Considerably less significant transfers to partnership interests were made in 2001 and 2002.

The limited partnership agreement contained a number of restrictive provisions that the taxpayers claimed affected the value of the partnership interests. The more salient were: (1) restrictions on withdrawing from the partnership, (2) restrictions on assigning partnership interests, (3) a provision requiring unanimous consent of all partners to dissolve the partnership and wind up its affairs, and (4) a reacquisition provision giving the partnership the option to acquire non-permitted assignments on favorable terms. An important finding of the Tax Court was that upon formation of the partnership, Tom had no immediate plans for it other than to hold Dell stock. At no time did the partnership have a business plan and its assts consisted solely of Dell stock. Furthermore, the partnership had neither employees nor a telephone listing.

The taxpayers filed gift tax returns for 1999 making a split gift election.[9] On this basis, Tom and his wife each claimed a gift of $601,827. This amount was based upon an independent appraisal of the limited partnership interests transferred with the appraiser applying a hefty 49.25% discount from the value of the underlying Dell shares themselves. The value reported for each of the taxpayers on the 2000 gifts of partnership interests, after the same discount, was $40,000, and likewise for the 2001 gifts.

On audit of the gift tax returns, the IRS claimed that the transfer of the Dell stock to the limited partnership was in substance an indirect gift of the stock to the other partners within the meaning of IRC § 2511.[10] As an alternative argument, the IRS claimed that the partnership was more analogous to a trust than to an operating business, and should be valued as such. The IRS also claimed that the restrictive provisions contained in the partnership agreement should be disregarded for valuation purposes pursuant to IRC § 2703(a)(2).[11] As another alternative argument, in the event the indirect transfer argument was not upheld, the IRS allowed a discount of only 28%, valuing each of the split gifts at $871,971. Similar adjustments were made for the 2001 and 2002 gift tax returns. Overall, the IRS increased the value of the gifts by over $660,000.[12]

B. Tax Court Analysis

The Court noted that it was asked to compare the facts at hand to the *Senda* and *Shepherd* cases. It observed that in both of those cases the transfer of the stock and the transfer of the partnership interests occurred on the same day and were thus integrated transactions. The facts in the instant case were held to be distinguishable. On November 2, 1999, the partnership was formed and the taxpayers transferred 70,000 Dell shares to it. Also, on that date, Janelle transferred 100 Dell shares to the partnership. In exchange, the taxpayers and Janelle received partnership interests proportionate to the number of shares transferred. It was not until November 8, 1999, 6 days later, that the taxpayers made gifts of partnership interests to Janelle both as a custodian and trustee of the trust. Since there were no simultaneous transfers as in the *Shepherd* and *Senda* cases, those cases were distinguished as being materially different on the facts.

Having differentiated the Shepherd and Senda cases, the Court moved on to an alternative argument of the IRS, namely, that the transfers were indirect gifts under the "step transaction doctrine." Although the step transaction doctrine has been applied mostly in income tax cases, it has been applied in estate and gift tax cases.[13]

Referring to a prior Tax Court decision,[14] the Court observed that the step transaction doctrine combines a series of integrated, interdependent steps into one step if the series of steps are focused on a particular result. It noted that although there is no universal test as to when and how the step transaction doctrine should be applied, the courts have used three alternative tests: (1) binding commitment, (2) interdependence and (3) end result. Although the IRS did not explicitly state which of these tests it was relying upon, the Court believed that it was arguing that the "interdependence" test was applicable.

Under the interdependence test the courts look to whether the separate steps each have legal significance or are so intertwined that they have significance only as part of a larger transaction. The IRS noted that a Treasury Department regulation dealing with indirect gifts is specifically in point.[15] Its argument in substance was that for the taxable year 1999, the separation in time between the first two steps (formation of the partnership and funding of it) and the third step (the gift of the partnership interests) served no purpose other than to avoid making an indirect gift per the regulation.[16] The Court refused to automatically conclude, however, that the hiatus of only about one week between formation and funding of the partnership and the gifts of the partnership interests resulted in the transactions being so intertwined that one step without the other would have been fruitless.

In its arguments, the IRS relied heavily on *Senda*,[17] where funding of the partnership and gifts of partnership interests occurred on the same day. The Court found *Senda* distinguishable: "The passage of time may be indicative of a change in circumstances that give independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another." Highly relevant was the Court's observation that stock values could significantly change within one week. In fact, the Dell stock went down 1.316 percent within one week. Although this may not seem like much, based on the time elapsed, the rate of change was noted to be greater than the changes that took place in subsequent longer relative periods. The IRS even conceded that a two-month delay from funding to gifts would give independent significance to the two steps. The Court did not draw any "bright line" test as to how much time must elapse between the funding of a partnership and a gift of partnership units for there to be economic risk of a change in the value of the partnership units gifted.[18] Based on the facts of the case, it concluded that the 1999 gifts of partnership units was not an indirect gift of Dell shares.

After determining hat there was no indirect gift of Dell Shares, but rather a gift of limited partnership interests, the Court next concentrated on valuing the interests. In this regard, it focused on Internal Revenue Code (I.R.C.) § 2703. In pertinent part, I.R.C. § 2703(a) provides that the value of gifted property is determined without regard to any restriction on the right to sell or use such property. However, I.R.C. § 2703(b) states that I.R.C. § 2703(a) shall not apply if the restriction meets each of three requirements:

> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer the gifted property to members of the decedent's[19] family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

The partnership contained several relevant restrictions: (1) with limited exceptions, a restriction on assigning a partnership interest without consent of all of the partners, (2) an option to reacquire the interest transferred in the event of a non-permitted assignment, and (3) restrictions on payouts to reacquire a non-permitted assignment. The taxpayers argued that these restrictions served a bona fide business purpose by preventing interests in the partnership from passing to non-family members citing a number of cases in support of their argument.[20] The IRS on the other hand argued that the transaction was not a bona fide business arrangement since "carrying on a business" requires more than holding securities and keeping records, citing a 1941 Supreme Court income tax case, *Higgins v. Commissioner*.[21] Moreover, it observed that the taxpayers primary purpose in forming the partnership, to preserve their wealth and educate their children about it, were both personal and business goals.

The Court observed that I.R.C. § 2703 does not contain a definition of the phrase "bona fide business arrangement." However, the Court noted that there could be a bona fide business arrangement without an actively managed business, citing *Estate of Amlie v. Commissioner*.[22] In that case, the Court held that a fiduciary's efforts to hedge risk and planning for liquidity needs of a decedent's estate constitute business purposes under I.R.C. § 2703(b)(1). The Court then went on to observe that although buy-sell agreements serve a legitimate purpose in maintaining control of a business, this does not necessarily exclude the possibility that such an agreement is a tax-avoidance testamentary divide to be disregarded in valuing the property interest.

Reviewing the legislative history of I.R.C. § 2703(b)(1), the Court concluded that the restrictions in the partnership agreement in this case did not constitute a bona fide business arrangement. First of all, there was no closely held business to protect. The restrictions served principally to discourage dissipation by the children of the family wealth. This was different than the value fixing arrangements in *Estate of Amlie*,[23] which involved a conservator seeking to exercise prudent management of investments for his ward and to provide for the liquidity needs of her estate.

The Court then focused on whether the second requirement for disregarding the restrictions in the partnership agreement, I.R.C. § 2703(b)(2), was met. This provision mandates that the restriction not be a divide to transfer property to members of the decedent's[24] family for inadequate consideration. The Court concluded that the restrictions were such a divide. The purpose of the partnership restrictions was to discourage the taxpayer's children from dissipating the wealth transferred to them. If a child made an impermissible transfer, the child would not realize the difference between fair market value of his partnership unit and the unit's proportionate share of the partnership's net asset value. Further, if a child made an impermissible transfer, the partnership could redeem the interest transferred from the transferee for less than the net asset value proportionate to the impermissible transferee's interest in the partnership. The difference in value would inure to the benefit of the remaining children and therefore be a redistribution of wealth from a child pursuing an impermissible transfer to the remaining children, an impermissible "device."

The third requirement that must be met for restriction to be disregarded in valuation, I.R.C. § 2703(b)(3), is that the restriction be comparable to similar arrangements entered into by persons in an arm's-length transaction. Comparability is determined at the time the restriction is created.[25] In this regard, there was a battle between expert witnesses. The IRS expert, a law professor, testified that in his opinion – based upon his experience and conversations with numerous practitioners – it was unlikely that a person in an arm's-length transaction would accept the pertinent restrictions in the partnership agreement.

The taxpayers called another law professor as its expert who had practiced, written and lectured about partnership taxation and law for more than 20 years, and who had drafted numerous limited partnership agreements. His testimony was that the restrictions were comparable to provisions often found in partnership agreements among unrelated partners or were not out of the mainstream. Here, the Court seemed to fudge a little, stating that even if it found that the restrictions were similar to arrangement entered into in an arm's length transaction satisfying I.R.C. § 2703(b)(3), it would still not disregard the restriction since they did not constitute a bona fide business arrangement under I.R.C. § 2703(b)(1), and were a prohibited device under I.R.C. § 2703(b)(2). Accordingly, it determined that it did not have to decide whether the IRS or the taxpayer was correct in applying the arm's-length standard of I.R.C. § 2703(b)(3).[26]

As a final matter, the Court had to address to what extent minority and marketability discounts should be allowed, disregarding any marketability discount attributable to restrictions in the partnership agreement. Since the contending parties agreed that such discounts should be allowed, the battle then became one of the expert witnesses as to the specific discount percentages. The Court then went into lengthy discussion of the testimony and methodologies of the experts. The minority discounts claimed by the experts different for each o the three years at issue. Following are the respective discounts claimed by the parties and the amount ultimately allowed by the Court.

Year	IRS Expert	Taxpayer Expert	Court
1999	11.2%	13.4%	11.32%
2000	13.4	16.3	14.34
2001	5.0	10.0	4.63

With respect to a marketability discount, the amount claimed by the parties did not differ from year to year. The expert for the taxpayers testified that his analysis supported a marketability discount of at least 35%, settling on that amount as his testimony, whereas the IRS expert estimated that the marketability discount should be only 12.5%. The Court adopted the latter figure. Accordingly, it is clear that the opinion of the IRS expert as to both minority and marketability discounts held greater sway with the Court. In dollar terms, the discounts allowed reduced the size of the taxable gifts by approximately $607,000.

IV. BIANCE GROSS v. COMMISSIONER

As noted earlier, the Tax Court decided *Bianca Gross v. Commissioner*[27] in September of 2008, a few months after its *Hollman* decision. The decision in *Biance Gross* was rendered by the same judge.

Over a period of about three months in 1998, the taxpayer transferred in excess of $2 million of publicly traded stock to a limited partnership she had formed. Eleven days after the final transfer to the partnership, the taxpayer gifted 22.5 percent partnership interests to each of her two daughters. The taxpayer was the sole general partner. She testified that the purpose for forming the limited partnership was to have her two daughters working together in handling the family wealth. A combined minority and marketability discount of 35% was claimed on the gifts of the partnership interests. The IRS asserted that no discounts should be allowed raising essentially the same argument that it had asserted in *Hollman*, namely, that there was an indirect gift of the securities themselves. Again, the IRS also raised its “step transaction” argument.

Applying its *Hollman* rationale, the Court held that the 11 days that transpired between the funding of the partnership and the gifts of partnership units posed a real economic risk that the partnership’s value would change during this time. This was especially true since the property transferred to the partnership was heavily-traded, volatile common stocks. The IRS had stipulated to the taxpayer’s 35% discount if it lost on the indirect gift argument and this is the discount that the Court adopted. It should be noted that the combined discount ultimately adopted by the Court in *Hollman* with respect to the major gift of partnership units in 1999 came to only about 25%. It is not clear why the IRS stipulated to a higher percentage.

V. CONCLUSION

Overall, *Hollman* is a significant taxpayer victory although the IRS got in its licks winning the I.R.C. § 2703 argument. Siding with the taxpayers, the Court held that the gifts were of limited partnership interest rather than indirect gifts of stock. This finding resulted in the Court accepting that minority and marketability discounts of the limited partnership gifts were appropriate. Favoring the IRS, however, no discount was allowed for the restrictions in the partnership agreement since I.R.C. § 2703 was found applicable mandating that these restrictions be disregarded. Consequently, the taxpayers did not get as large of a minority and marketability discount on the limited partnership interest gifted as they claimed. One may speculate though that the taxpayers did not expect to get the discounts claimed and perhaps hoped that the judge would proverbially “split the baby in half.” As noted, however, the Court for the most part sided with the IRS on the amount of discounts to be allowed mostly adopting those offered by the IRS expert. Significantly, the IRS was successful in interposing I.R.C. § 2703 as being applicable to the *Hollman* type of situation involving publicly traded securities. Restrictions in a limited partnership agreement are often put in for the principal purpose, or at least a major one, of increasing the amount claimed for a marketability discount. So, although some discount was allowed for marketability in *Hollman*, the effect of disregarding such restrictions was to reduce the amount of discount.

Hollman may perhaps present a roadmap for obtaining discounts on transfers of publicly held stock into a limited partnership followed by gifts of the partnership interests.

Clearly, there must be a hiatus between the two events. In *Hollman*, the break was about one week. The Court in a footnote, however, noted that its decision might have been different if the property being transferred were less volatile, such as preferred stock or treasury bonds. The Court did not give any guidance as to how long the hiatus must be, although as noted, the IRS seems to conclude that a two-month delay would suffice. In this regard, the IRS did not dispute that a sufficient period of time had elapsed between the formation of the limited partnership and the gifts of the partnership units in 2000 and 2001. Clearly, a taxpayer's position is stronger the longer the delay between the two events, taking into account the volatility of the securities transferred. In *Bianca Gross*, the taxpayers were, of course, on even more stable ground where the hiatus was 11 days.

ENDNOTES

[1] Internal Revenue Code (I.R.C) § 2501(a) imposes a gift tax on the transfer of property by gift during the year, based upon the value of the gifts made during the year. The gift tax regulations (Treasury Regulation (Reg.) § 25.2511-2(a)) provide that the value of property gifted is determined by the value of the property passing from the donor and not necessarily the measure of enrichment to the donee. The gift tax applies whether the gift is direct or indirect (I.R.C.§ 2511). Also, *see* Reg. .§ 25.2511-I(h)(l) concluding that a transfer to a corporation for less than full and adequate consideration is an indirect gift to the other shareholders of the corporation. There is a gift tax exclusion per donee per year of $12,000 in 2008, which is indexed for inflation to the next lowest multiple of

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$1000 (IRC § 2503(b)). Effective January 1, 2009, the annual exclusion was adjusted upward to $13,000. Also excludable are certain gift transfers for educational or medical expenses (IRC § 2503(e)). A split gift election by husband and wife double the amount excludable (IRC § 2513). Over and above the annual gift tax exclusion, there is a lifetime gift tax credit that in effect exempts $1,000,000 in value of property gifted from gift tax liability (IRC § 2505). The comparable estate tax exemption was $2,000.000 through 2008 and rose to $3,500,000 effective January 1, 2009 (IRC § 2010). Gifts over the annual exclusion made during lifetime effectively reduce the estate tax exemption. Under current law, there is no estate tax in 2010, but it reinstates in 2011 reverting to an exemption of $1,000,000. Legislation in 2009, however, will probably change all this since a new Administration and Congress have taken over. Current speculation is that the $3,500,000 exemption will be made permanent, that the estate tax will not be repealed for 2010, and that the top estate and gift tax rate will be capped at 45%.

[2] The other Code provisions that the IRS has used to attack family limited partnership divide are beyond the scope of this paper. For background, however, *see* Edward A Renn and N. Todd Angkatavanich, *The Resurrection,* Trusts and Estates Magazine, October 2008, at 20.

[3] 130 T.C. 112.

[4] T.C. Memo. 2008-221.

[5] 115 T.C. 376 (2000), *aff'd*. 283 F.3d 1258 (11th Cir. 2002).

[6] T.C. Memo 2004-160, *aff'd*. 433 F.3d 1044 (8th Cir. 2006).

[7] *Supra*, Note 3.

[8] Technically, the partnership was formed on November 3, 1999, when a certificate of limited partnership was filed with the secretary of state.

[9] Treating gifts made as being made one-half by each spouse (I.R.C. § 2513).

[10] I.R.C. § 2511 imposes a gift tax whether the transfer is in trust or otherwise, and whether the gift is direct or indirect.
[11] I.R.C. § 2703(a)(2) provides that the value of any property shall be determined without regard to any restriction on the right to sell or use such property. The IRS initially also relied on I.R.C. § 2704(b), which provides that certain restrictions on liquidation of a partnership shall be disregarded in valuing it; however, it abandoned its reliance on this section.
[12] It may be noted that the unified exclusion amount in 1999 was $650,000, and in 2000-2001 it was $675,000. The case did not indicate whether prior gifts had been made dipping in to the exclusion amount. In any event, to the extent the exclusion amount is used to offset lifetime gifts, that much less remains as an estate tax exclusion. The taxpayers thus had an interest in using up less of their unified exclusion amount.
[13] *See, e.g.*, Daniels v. Commissioner, T.C. Memo 1994-59.
[14] Santa Montica Pictures, L.L.C. v. Commissioner, T.C. Memo 2005-104.
[15] If none of the individual events occurring between the contribution of the property to the partnership and the gifts of partnership interests had any significance independent of its status as an intermediate step in the donors' plan to transfer their assets to their donees in partnerships form, the formation, funding, and transfer of partnership units pursuant to an integrated plan is treated as a gift of the assets to a partnership of which the donees are the other partners (Reg. § 25.2511-1(h)(1)).
[16] The IRS conceded that there was sufficient hiatus for the 2001 and 2002 gifts of partnership interests for them to be treated as separate transactions.
[17] *Supra*, Note 6.
[18] The Court noted that the Dell stock was a heavily traded, relatively volatile common stock and that it might view the impact of a six day hiatus differently if the property being

transferred were preferred stock or a long-term Government bond.

[19] Since I.R.C. § 2703 is applicable both to estate and gift taxes, the section should have used the term "taxpayer's family" rather than "decedent's family." *Also, see* Reg. § 25.2703-1(b)(1)(ii), which substitutes "the natural objects of the transferor's bounty" for the phrase "members of the decedent's family" apparently because I.R.C. § 2703 is interpreted as being applicable to both transfers at death and during lifetime.

[20] Citations omitted.

[21] 312 U.S. 212 (1941).

[22] T.C. Memo 2006-76.

[23] *Id*.

[24] *Supra*, Note 19.

[25] Reg. § 25.2703-1(b)(1)(iii).

[26] Actually, the Court did not have to consider the applicability of I.R.C. § 2703(b)(2) either since I.R.C. § 2703(b)(1) was failed. Each of the provisions, (b)(1), (b)(2) and (b)(3) have to be met for I.R.C. § 2703 to be disregarded. For some reason the Court reviewed the applicability of I.R.C. § 2703(b)(2) although technically it did not have to. Perhaps it felt that failing two out of the three requirements for disregarding I.R.C. § 2703 buttressed its holding. In any event, the restrictions in the partnership agreement were disregarded in valuing the partnership units gifted.

[27] *Supra*, Note 4.

I'M SICK TO DEATH OF "FRIVOLOUS LAWSUIT" RHETORIC! WHO CAN I SUE?

(A RUBRIC FOR TEACHERS, POLICYMAKERS AND FOR REFORMATION OF THE PUBLIC DISCOURSE)

by
Mark J. DeAngelis*

I. INTRODUCTION

The only way to have missed the reports of the purported present and ongoing crisis in America resulting from the proliferation of "frivolous lawsuits" is to have been in a prolonged coma. Media commentary and editorializing about frivolous lawsuits, junk lawsuits, lawsuit abuse, greedy trial lawyers, suit-happy shysters, a litigious society, lack of personal responsibility, and other plague-like legal disorders are as ubiquitous as news reports of young female actresses behaving badly. Even syndicated news reports of recently filed lawsuits highlight the ridiculous and the lurid to steer even the most discriminating reader toward a negative characterization while burying the explanatory facts.[1] Add to this notoriety the vast unregulated realm of the blogosphere, websites, *YouTube*, and the more traditional letters-to-the-editor, and there is no end to the expression of opinions about the evils of frivolous lawsuits and the manipulations of fact to create the impression of an epidemic of frivolity.

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With such a vast and dangerous lurking evil about, it is hardly surprising that policymakers have put forth a plethora of proposals to save a somnolent society from certain destruction at the hands of litigious lawyers. These diverse and far-ranging scattershot plans fall loosely together under the umbrella designation of "tort reform." Exceptional, indeed, is the bureaucratic regime that is not in need of reform; and the civil justice system can claim no such exception. However, meaningful reform requires, in the first instance, a clear identification of the deficiencies that need to be remedied. Too many tort reform proposals affect all lawsuits regardless of where the lawsuit falls on the spectrum of "frivolity." As a society, we cannot make ourselves free of frivolous lawsuits until we can define those qualities that render a lawsuit frivolous. This article proposes a method to identify and categorize lawsuits by the qualities of their elements to isolate and identify those which should rightly be the target of proposed reform. Conversely, proposed reforms may be compared to the lawsuit rubric to determine their potential effectiveness in limiting or affecting "frivolous" suits without burdening bona fide suits. If reform for the sake of social improvement is the goal, then "tort reformers" must show the ability get past the rhetoric and seek to remove the "frivolity" rather than the "suit" from "frivolous lawsuits."

Many students enter Business Law class with some opinions on these issues. These opinions tend to be somewhat loosely formed and based on generalizations and stereotypes. This article proposes a more rigorous examination of the nature of a lawsuit that may be used as a pedagogical tool to guide students in a more disciplined exploration of this important public policy issue. Likewise, it is suggested that lawmakers who make the policy in this area and political commentators who shape the public discourse on this subject would be well served to employ this rubric to explore real, focused and effective reform rather than rhetoric.

There will be no attempt in this article to analyze or categorize suggested reforms. That is a likely exercise for the future, once this rubric has been conceptualized and tested. This article looks at the lawsuit that might be saddled with the unfortunate "frivolous" label and attempts to determine what aspect of its make-up might cause it to earn that designation.

II. THE LEGAL STANDARD OF "FRIVOLOUS"

The "frivolous" designation that this paper addresses is the colloquial or political or rhetorical label (one hesitates to use the word "standard," under the circumstances). This designation is a wholly separate and distinct consideration from the legal standard of "frivolous" as embodied in Rule 11 of the Federal Rules of Civil Procedure and the relevant cases. State courts have likewise adopted rules similar to Rule 11 which allow the sanctioning of lawyers who bring frivolous claims.[2] Obviously, any lawsuit that falls so far below the legal standard of viability so as to warrant the imposing of sanctions is a lawsuit that the legal system recognizes as problematic and has already taken steps to discourage through these rules. Whether one believes those rules to be effective may be another issue to explore. However, for purposes of this article, it is assumed that these lawsuits, the legally frivolous lawsuits, are not the ones that are a significant target of tort reformers. These suits, typically easy targets for dismissal early in the process, are not the lawsuits that are alleged to be bankrupting business through the generation of exorbitant legal fees or runaway verdicts.

III. THE NEED FOR A RUBRIC

Supreme Court Justice Potter Stewart dealt with the problematic task of defining "pornography" by famously writing, "I know it when I see it."[3] Unfortunately, in labeling a lawsuit as frivolous, Justice Stewart's subjective and amorphous test has too often been the standard of definition. In its broadest sense the designation "frivolous" has been appended to lawsuits in order to designate a lawsuit with which someone disagrees. "If you sue me, your lawsuit must be frivolous." "If you sue my friends, your lawsuit is frivolous." "If you sue anyone in my industry, the lawsuit is frivolous." "If you sue a business, the lawsuit is frivolous." Continuing in this fashion, "frivolous" means nothing more than a claim that adversely affects someone's interests.

The frivolous lawsuit therefore becomes the straw man target for all complaints about the legal system. No one can credibly disagree with reforms which target "frivolous" lawsuits. It would be absurd for anyone to support the promotion of "frivolous" lawsuits. One could hardly scoff at the righteousness of a chivalrous knight's plan to battle invading ferocious giants. That is, until the giants targeted by the hapless Don Quixote are exposed as harmless and functional windmills. The attempt here, then, is to map out the range of lawsuit characteristics, so that policymakers may more readily identify those lawsuits which are problematic for society and for which the present system does not provide sufficient protection or redress. This rubric can minimize future tilting at windmills, or, with more effect, expose the frivolous lawsuits for their true nature.

IV. THE RUBRIC

This method identifies three variables that contribute to the characterization of a lawsuit: strength of the law supporting the claim; strength of the facts supporting liability; extent of the injury or damage. For ease of reference, we will label them respectively: Law, Liability, and Damages and assign them to axes along which their values may be plotted or conceptualized.

Law = x
Liability = y
Damages = z

The measure of the strength of each variable is suggested to be the same measures used in grading scales in classroom (A-F, from the highest or strongest value to the lowest or weakest value). Recognizing that the strength of any variable will be a designation that lies somewhere along the grading continuum, for ease of discussion and conceptualization, this paper will use only the end points of the continuum, designating a variable's strength as either "A" or "F." Therefore the possible values are:

AAA

AAF AFA FAA

AFF FFA FAF

FFF

A. Law (x axis)

What is evaluated here is the strength of the legal theory that is relied upon in bringing the action. The McDonald's coffee case still heads many publicized lists of frivolous suits.[4] The legal theories of negligence and product liability, as evidenced by the facts of the case,[5] are supported by a mature and rational history of common law decisions. Consequently, The McDonald's coffee suit would likely garner a value of "A" on the Law (x) axis.

Finding an example of a case that warrants an "F" value on this axis is a bit more difficult. The legal system contains a number of fail-safe mechanisms that discourage the bringing of lawsuits based on weak legal theories. Most notably, the complexity of the system encourages the assistance of counsel and the contingent fee system discourages counsel from bringing lawsuits based on weak legal theories. Perhaps an example might be a civil rights lawsuit filed under 42 U.S.C. sec. 1983 on behalf of two female high school basketball players at Catholic High Schools who were prevented from playing for a season as the result of school transfers.[6] A section 1983 claim must be based on "state action." The defendants in this case were a Catholic Archdiocese and other Catholic school administrators. The case was dismissed for failure to state a claim, earning an "F" on the Law (x) axis.

Another candidate for an "F" value might be the "Fear Factor" lawsuit.[7] The pro se plaintiff sued NBC after dizzily running into a doorjamb in his house as a result of spiking blood pressure, nausea and vomiting induced by watching contestants eat rats on the network's "Fear Factor" program. The legal basis for the suit is not clearly evident (negligent infliction of emotional distress, perhaps, but is there a duty owed?). Without further clarification, the Fear Factor plaintiff's claim earns the lowest grade on the Law (x) axis.

B. Liability (y axis)

This variable probably presents the greatest diversity and wealth of opportunity for evaluation. It is not unusual for a lawyer to file an action that rests on sound legal theory but attempts to stretch that theory to reach facts previously not included within the range of recovery. In January of 2008 it was reported that an inmate in a county jail in Colorado sued the Sherriff's Department after the inmate fell 40 feet and suffered serious injuries in his second escape attempt.[8] The legal theory lies in a combination of negligence and intentional torts. The plaintiff claims that the guards and other inmates beat him mercilessly so that he had no option but to attempt to escape, a circumstance which the sheriff's department should have anticipated. Aware that the inmate needed to attempt to escape, he alleges that the sheriff's office should have rendered the jail more secure. In fact, the plaintiff's allegations apparently claim that the building was so poorly secured that its condition constituted an "open invitation" to escape.[9] While the lawyer who filed this suit is certainly acting within the parameters of zealous representation, his case earns an "F" value on the Liability (y) axis.

Another example of a case with a low y axis value might be that of the plaintiff who sued a strip club after suffering a whiplash when the stripper, "flung [her breasts] in his face, knocking his head backwards"[10] His legal theories of recovery in negligence, intentional tort and *respondeat superior* would appear to have merit. And while we cannot determine the extent of his physical injury from a brief news report; it is certainly possible for a whiplash to have serious repercussions. However, the facts lack an element of sufficient wrongdoing on the alleged tortfeasor and an inference of plaintiff's own participation, if not invitation (assumption of the risk, perhaps) to engage in this conduct. The case earns an "F" value on the y axis.

C. Damages (z axis)

If the Law (x) axis presents the least and most difficult options for value determination and the Liability (y) axis provides the most diverse, then it is likely that the Damage (z) axis provides us with the easiest value determinations. While there may be disagreement as to the precise value a certain damage claim may earn along the spectrum of the axis, the extremes tend to be more easily identified. According to news reports, the hapless would-be escapee in Colorado mentioned in the previous analysis, suffered "serious" injuries.[11] Stella Liebeck, the elderly plaintiff in the McDonald's coffee case suffered third degree burns to "6 percent of her body, including her inner thighs, perineum, buttocks, and genital and groin areas."[12] Both of these cases may fairly earn the value of "A" on the Damage (z) axis.

On the lower end of the scale there is the lawsuit filed by a pair of Chicago attorneys against Penthouse Magazine.[13] The lawyers' clients had apparently been disappointed when the nude pictures that appeared in Penthouse turned out not to be tennis star Anna Kournikova, as advertised, but a clever look-alike. Each client had shelled out $8.99 for the issue which, apparently, was rendered valueless by the magazine's misrepresentation. Plaintiff's also sued for the value of their "disappointment." This case conceivably comes out well on the law (x) axis (fraud), and may also do well on the liability (y) axis (*scienter*), but earns the "F" score here on the Damages (z) axis.

V. LIMITATIONS TO THE RUBRIC

A. Challenges to the propriety of certain legal theories

In considering the value of the "law" along the x axis, this rubric does not make allowance for any public policy challenges of the law, itself. That is, the rubric seeks to evaluate the relative strength or weakness of the legal theory upon which the case is based without making a judgment as to the public policy value of the law allowing or denying recovery. There are any of a number of lawsuits reported where would-be burglars have come upon a booby-trapped home and suffered injury as a result.[14] Negligence legal theory generally allows an avenue for recovery. However, a tort reformer might feel that the law should not provide even a potential avenue for recovery. This type of reform would involve a statutory change in the common law of tort rather than a procedural change to discourage or weed out cases with low y axis values (Assuming death or serious injury resulted, the burglar cases probably warrant an AFA designation).

B. Subjectivity

Where one person sees strength, another sees weakness. Or, more specifically, what one person considers strong law or facts may be perceived as less compelling by another. Part of that is the inherent subjectivity that comes from different upbringings, education, understandings of the world, prejudices, beliefs, etc. that "the law" seeks to battle with objectifying concepts such as *stare decisis*.

However, the greater part of the subjectivity of assigning values can be eliminated by research and understanding of the applicable facts. For example, recently a student wrote railing about the absurdity of the verdict against McDonald's "just because the coffee cup didn't warn against its contents being hot" (this was before she was exposed to the actual facts and the basis for liability). Of course, upon exposure to the real facts, her objection waned.

A better example probably comes from the "Naked Cowboy" suit. In February 2008, Robert Burck filed suit against Mars Corp. for trademark infringement.[15] Mr. Burck is better known as the "Naked Cowboy" of Times Square where, clad only in tight white cotton briefs and cowboy boots and hat, he plays the guitar and sings. The Mars Corp. ran an electronic billboard featuring various New York City locations and M&M's dressed as famous New Yorkers. Burck filed suit alleging that one of the M&M's was dressed in his trademark outfit.

One who had never before heard of the Naked Cowboy might view the offending M&M image and determine that it looked like a baby wearing a diaper. This lack of familiarity with the subject of the suit might lead to the hasty conclusion that Burke's suit was most likely a publicity stunt. In the structure of this rubric, one would have rated the Law with an "A" value (commercial appropriation and trademark infringement); the Liability with a value of "F" (lack of any notoriety to appropriate and no trademark to infringe upon); the Damages likewise with an "F" (no value to the fame traded upon since there was no fame to trade upon). However, upon investigation it may be discovered that the "Naked Cowboy" was an iconic New York figure whose fame and act were well known. An internet search easily reveals Mr. Burck's website which prominently includes his trademark registration information.[16] Hence, an unenlightened view of the case was as an AFF case; while an enlightened view was closer to an AAA case.

C. Overlap

There is a significant amount of overlap in the characteristics that are attempted to be defined by each axis. For instance, it is inherently difficult to evaluate the strength of the Law (legal theory) in a case without considering the facts supporting liability. In the 1990's, Richard Overton sued Anheuser-Busch for false and deceptive advertising.[17] He claimed that the ads depicting a glamorous lifestyle lived by those imbibing the Anheuser-Busch products caused him to actually consume the products in an attempt to achieve the depicted lifestyle. The dissatisfied plaintiff sued for mental injury, emotional distress and financial loss. Certainly the law allows for recovery for damages resulting from false and deceptive advertising. However, in this case, the facts are so weak as to undermine the legal theory. The court dismissed the case essentially stating that any reasonable person would have understood the advertising to be something less than factual representations. Therefore, the facts were insufficient as a matter of law. It is not clear whether the value of this deficiency should be indicated on the x axis, the y axis or both.

Likewise, recently a lawsuit was filed by a former St. Louis Rams football player and three fans against the New England Patriots[18] claiming that the Patriots surreptitiously taped the Rams' walk-through practice the day prior to their meeting in the 2002 Super Bowl. As far as may be gleaned from newspaper reports, the action is based in fraud. While fraud is a bona fide and mature legal theory, the facts here regarding the factual nature of the representations made, if any, leave the theory weakly supported by the facts and probably deficient as a matter of law.

There is crossover, as well, with the analysis of the y and z axes. In Montana, a plaintiff who changed his name from Bob Craft to Jack Ass sued the producers of the movie "Jackass" claiming trademark and copyright infringement and defamation.[19] While Mr. Ass has latched onto bona fide legal theories, the brief recitation of facts seems to fall short of a compelling factual scenario supporting the theory. Likewise, the extent of Mr. Ass's injury or damage is not readily evident. In cases where damage or injury are part of the factual basis to support the legal theory of recovery, then the y and z values are necessarily dependent upon each other (and may influence the x value as well).

VI. OUT OF LIMITATIONS COMES STRENGTH

While many cases may present challenges for determining axes values, a strength of the rubric lies in its requirement that the discussion of the axes values is necessitated in the first instance. "Frivolous lawsuits" are a societal boogeyman; the monster that lurks in the dark waiting to pounce and wreak havoc and ruin. The rubric forces students, reformers and pundits to focus the rhetoric. Engaging in a detailed analysis of whether a particular lawsuit or type of lawsuit should earn an "A" or an "F" value on the x or y axis necessarily forces a detailed discussion and analysis of the elements of the claim, rather than a vague tirade against all things "bad." This type of discussion and analysis may be able to turn empty attack rhetoric into real and focused discussion about the need, or lack of need, to modify identified common law theories. Scattershot reform proposals, if directed to the rubric, will need to be aimed more specifically and explained along the lines of precisely which weakness the reform is designed to address.

VII. THE PUBLIC DEBATE, REPHRASED

The goal of this article has been to suggest a way to get past the rhetoric of "frivolity" to a more precise analysis of perceived deficiencies in the civil justice system. The suggested x, y and z axes analysis may be useful for serious public policy critique and evaluation, but it is unlikely to find its way into the on-going public debate that takes place in newspapers and blogs. Because those arenas are the public face of the tort reform debate, it would be a mistake to close this discussion without proposing a way to sharpen the public or "amateur" rhetoric on the subject. Toward that end I would propose that the "frivolous lawsuit" designation may be sharpened and replaced as follows:

For a case that exhibits weakness on the Law (x axis): "unwarranted."
For a case that exhibits weakness on Liability (y axis); "unsupported."
For a case that exhibits weak Damages (z axis); "insubstantial."

Reframing the lexicon of lawsuit criticism may begin to sharpen the debate. An appropriate response to the next editorial rant about frivolous lawsuits would be to request that the critic be more specific. Is the specific complaint that the lawsuit is unwarranted by the law, unsupported by the facts or insubstantial in its claimed losses? Demanding precision in criticism should help to separate the reforms that are aimed at improvement of the system from those that are aimed at improvement of individual self-interests.

VIII. CONCLUSION

Continued railing against "frivolous lawsuits" creates the atmosphere for dishonestly cloaking self-interested reforms in the language of the public good. Any governmental system can be improved with reforms, but only those reforms that legitimately address the parts of the system that fail to function are in the public's interest. Toward that end, the rhetoric of "frivolous lawsuits" should be vigorously challenged in the marketplace of political discourse with a demand for specificity. This article attempts to establish a framework to support that more focused discourse. Any policymaker who is genuinely interested in enhancing the public good should welcome any device that exposes and distinguishes vague and amorphous complaints from real deficiencies. Perhaps the rubric proposed in this article can contribute to that process.

ENDNOTES

[1] *See e.g.,* Associated Press, *300-pound Inmate Sues County Over Meager Jailhouse Fare.* , April 28, 2008, LexisNexis Academic. In this wire service news article about a 300 lb. Arkansas inmate suing the state for starving him in prison, the reader must wait until the next to last sentence of the article to find that the lawsuit was filed *pro se*.

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[2] *See, e.g.*, CONN. PRACTICE. BOOK, Rule 3.1, *at* http://www.jud.ct.gov/Publications/PracticeBook/PB1.pdf accessed June 18, 2009.

[3] *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

[4] *See, e.g.*, Deborah Ng, *Top Ten Frivolous Lawsuits*, legalzoom.com, *at* http://www.legalzoom.com/legal-articles/top-ten-frivolous-lawsuits.html , accessed June 18, 2009.

[5] *The Actual Facts About the Mcdonald's Coffee Case*, 'LECTRIC LAW LIBRARY, lectlaw.com *at* http://www.lectlaw.com/files/cur78.htm accessed January 25, 2010. Stella Lieback, 79, was a passenger in a car driven by her grandson. They purchased hot coffee at the drive-up window of a McDonald's franchise. The car was moved out of the drive up area and pulled over to a stop. Ms. Lieback held the coffee cup between her knees as she removed the cover in order to put cream and sugar in her coffee. As she did so, the entire contents of the coffee spilled into her lap resulting in third degree burns to her groin, genitals, buttocks and inner thighs. The crucial facts that are rarely publicized include the fact that the coffee served by McDonalds was maintained in the coffee urns at between 180-190 degrees fahrenheit – between 45 and 55 degrees hotter than coffee is brewed in a home coffee pot. At trial, experts testified that liquid at 180 degrees would cause third degree burns within two to seven seconds after contact with human skin. McDonald's own quality assurance manager engineer testified during trial that the coffee that McDonald's served, at the temperature at which it was served, was unfit for human consumption.

[6] *Cummings v. Office of Catholic Education*, No. 05-104, 2005, U.S. Dist., E. PA. (Order-Memorandum, May 10, 2005), *at* http://www.paed.uscourts.gov/documents/opinions/05D0584P.pdf , accessed June 18, 2009.

[7]Joe Milicia, *Viewer Sues NBC over "Fear Factor" Rat-Eating Episode*, Law.com *at* http://www.law.com/jsp/article.jsp?id=1104759364675 accessed June 18, 2009.

[8]DeeDee Correll, *Prisoner's Lawsuit Says it Was Too easy to Escape*, L.A. TIMES, Jan. 13, 2008, *at* http://www.latimes.com/news/nationworld/nation/la-na-jailescape13jan13,1,1452469.story?coll=la-headlines-nation&ctrack=1&cset=true accessed June 18, 2009.

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[9] *Id.*

[10]*Topless Dancer Wins on TV's "Court,"* ASSOCIATED PRESS, July 09, 1998, LexisNexis Academic.

[11] *Id.* at 7.

[12]*The Actual Facts About the Mcdonald's Coffee Case*, 'LECTRIC LAW LIBRARY, lectlaw.com *at* http://www.lectlaw.com/files/cur78.htm accessed June 18, 2009.

[13] *Angry Anna Fans Sue Penthouse for $8.99,* CHICAGO SUN-TIMES, August 28, 2002, at 12, LexisNexis Academic.

[14] *See, e.g.*, Martha Neil, *Suit Seeks Damages in Electrocution Allegedly Resulting from Wired Window,* CHICAGO DAILY LAW BULLETIN, Nov. 26, 1997, LexisNexis Academic., (describing a lawsuit based on a would be burglar's electrocution at the hands of a booby-trapping bar owner).

[15] Larry Neumeister, *Judge Lets Naked Cowboy Suit Go On*, ASSOCIATED PRESS, June 23, 2008, LexisNexis Academic.

[16] Nakedcowboy.com *at* http://www.nakedcowboy.com/index.html accessed June 18, 2009.

[17] Overton v Anheuser-Busch Co, 205 Mich. App. 259, 261; 517 NW2d 308 (1994).

[18] John Branch and Greg Bishop, *Suit Could Shed Light on Actions of Patriots*, NY TIMES, Feb. 16, 2008, at http://www.nytimes.com/2008/02/16/sports/football/16nfl.html?ref=sports accessed June 18, 2009.

[19] *Names and Faces*, WASHINGTON POST, Jan. 2, 2003. LexisNexis Academic.

REBUKING:
A JEWISH ALTERNATIVE TO WHISTLE-BLOWING

by Robert S. Wiener*

I. INTRODUCTION

Whistle-blowing is in the news again.[1] Bernard L. Madoff is behind bars for securities fraud, reported to federal prosecutors by his own sons.[2] The resume of Danny Pang, head of Private Equity Management Group (PEMGroup), was under scrutiny due to allegations by a former president of his firm[3] before Pang committed suicide at 42.[4]

If you want to do the right thing, is whistle-blowing the right thing to do?[5] Business ethicists have written extensively on the theme of blowing the whistle on corporations, but little on alternatives.[6] And there is an alternative that might result in better communication, esprit de corps, and more ethical (and legal) behavior in businesses. Greater profitability through enhanced morale, greater efficiency, reduced legal costs, and a positive perception in the marketplace may follow. It's a Jewish alternative called rebuking.

II. BLOWING THE WHISTLE

The English language tells us much about our society's attitude toward whistle-blowing. Synonyms for whistle-blowing are negative: rat, snitch, fink, inform, squeal, and tattletale.[7] Whistle-blowing is often seen as a betrayal of

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confidence, even a breach of one's duty of loyalty.[8] Why then would anyone blow the whistle? Is it even ethical?[9] Is there no other way; perhaps an alternative would avoid the need for whistle-blowing. "Alternative dispute resolution" (ADR) has garnered a great deal of attention as a means of avoiding litigation.[10] If avoiding litigation is a good idea, might not the same be true of avoiding whistle-blowing?

Jewish law discourages reporting another's behavior to third parties. The transparency achieved by truthful whistle-blowing is not seen as a good in itself. In fact, the principle of *lashon hara*,[11] a rule against gossip, is based on a passage from the Torah,[12] "You must not carry false rumors."[13] This proscription extends to the listener as well as to the speaker.[14] What then is a Jew to do when confronted with actions perceived as wrongdoing? Avoid whistle-blowing by doing nothing? No. In fact, under Jewish law, one is obligated to take direct action.

III. *HOKHE'ACH TOHKI'ACH* – REBUKING AS A LEGAL DUTY

The Hebrew Scriptures instruct, "Reprove (*hokhe'ach tokhi'ach*) your neighbor, but incur no guilt because of him."[15] Others translate it as "rebuke your neighbor".[16] Rashi[17] did not comment on the statement "Reprove your neighbor," perhaps because the commandment is clear and needs no interpretation to establish its basic intent. Under Jewish Biblical law, one is obligated to bring it to the attention of others when they miss the mark. This is a positive commandment, a legal duty, a *mitzvah* that occupies a central place in the Torah.[18]

A. What is Rebuking?

"It is a mitzvah for a person who sees that his fellow Jew has sinned or is following an improper path [to attempt] to correct his behavior…."[19] This corrective action is rebuking.

B. Why Rebuke?

Why rebuke another? The answer comes from understanding the Biblical obligation to rebuke. For a Jew who accepts the Torah as containing the legally binding commandments of God, it is enough, without further explanation, that the text requires one to reprove one's neighbor. And Maimonides[20] makes it clear that this is a commandment -- "It is a mitzvah..."[21]

Is there a justification for this commandment, even if none is theologically needed? According to Maimonides, the purpose of rebuking another is "to inform him [the sinner] that he is causing himself a loss by his evil deeds…."[22] The objective is not to affect the future behavior of the sinner by deterrence or education. The goal is to give the sinner the opportunity to repent,[23] to do *t'shuvah*.[24] This rationale is not the self-interest of the rebuker, but altruism for the rebuked. Rebuking is in the interest of the rebuked party. Repentance is key and can have powerful positive implications.[25] One would be "making these statements for his colleague's own welfare, to allow him to merit the life of the world to come."[26]

On the other hand, J.H. Hertz[27] understands the commandment to rebuke in the context of the following phrase, "[thou shalt] not bear sin because of him" and concludes that the reason for the commandment is self-interest, to keep the rebuking party from future sin. "Unless there is a frank statement from the aggrieved party, the hatred or dislike smouldering in his heart may lead him into sin."[28] Recent commentators have agreed with this psychological explanation. "The context suggests the interpretation that an individual should not allow ill feelings to fester; rather, he should confront his kinsman and admonish him directly, in this way avoiding grudges and vengeance that breed hatred."[29] Jacob Neusner puts it this way, "The important point is not repressing one's viewpoint."[30]

Commentary on this passage focuses on one-on-one rather than on group relationships. However, Maimonides observed that a person "causes real loss to himself and the entire world [by sinning]."[31]

C. Whom Should One Rebuke?

Should one rebuke both Jews and non-Jews? According to Maimonides, one is commanded only to rebuke a fellow Jew.[32] This is probably because, according to Jewish law, a non-Jew is not obligated to obey the commandments of the Torah and, therefore, cannot be said to have sinned.[33]

Should one rebuke superiors? It is not obvious to the rabbis of the Talmud that any Jew who sins should be rebuked. Interpretation of the double verb helps to answer the question. Rava[34] says that the use of the term *hokhe'ach* alone would simply teach that teachers must rebuke students when they sin. The additional *tokhi'ach* is there to teach us that students must also rebuke teachers when they sin. According to Rava, therefore, sinning should be rebuked in all cases.[35] Thus this commandment to rebuke does not distinguish between teacher and student, superior and inferior, although perhaps it does in the manner of rebuke.

Should one rebuke only those who have committed wrongs against other people? Maimonides states that one also has a duty to rebuke one who commits a wrong against God.[36] In other words, we cannot even leave it to God to right all wrongs.

Should one rebuke only friends or strangers too? According to a later codification of Jewish law,[37] one is required only to rebuke a close friend. The reason for not having to rebuke others is that such rebuke is unlikely to be effective.[38] Jewish law seems to have become increasingly practical as the centuries passed.[39] However, perhaps even the rebuking of strangers can be effective.

D. How Often Should One Rebuke?

Should one rebuke just once, or repeatedly? The generally accepted rabbinic answer is that one should rebuke multiple times if necessary. This response is based again on the use of the double verb *hokhe'ach tokhi'ach*. There are several different interpretations as to the significance of the repetition.

One unnamed Talmudic rabbi argued that the doubling of the verb means that one should rebuke not once, but twice.[40] Rava responded that the doubling of this verb was not necessary to teach one to rebuke as often as necessary – that a single statement of the verb *hokhe'ach* would suffice.[41] On the other hand, Sifra[42] says,

A. And how do we know that if one has rebuked him four or five times, he should still go out and rebuke him again?

B. Scripture says, "reasoning, you shall reason with your neighbor."[43]

Thus, the general rule is that one should rebuke repeatedly when necessary.[44] The proof text is again the repetition of the term for rebuke in the verse.[45]

Maimonides states the principle in the most persistent manner. "If one sees one's fellowman sinning, one must rebuke him. If he [the sinner] accepts the rebuke, it is well. If not, he must be rebuked again, even a hundred times, until the sinner strikes the rebuker and says, "I do not wish to hear another word."[46]

Elsewhere in the Gemara,[47] Ramban[48] and Ran[49] question whether the obligation is to rebuke multiple times for a single sin or for multiple sins. They reason that the single verb *hokhe'ach* establishes the principle that one must rebuke repeatedly those who sin repeatedly. But the second verb, *tokhi'ach*, establishes that one must rebuke repeatedly for a single sin for which there has not yet been repentance.[50]

E. How Should One Rebuke?

In Jewish law it matters how one rebukes. To rebuke in the wrong way may be a sin itself. Rashi interpreted "but incur no guilt because of him" at the end of the *hokhe'ach tokhiach* verse as meaning "i.e. though rebuking him thou shalt not expose him to shame (lit., make his face grow pale) in public, in which case you will bear sin on account of him."[51] Sifra says,

A. Might one suppose that that is the case even if one rebukes him and his countenance blanches?

B. Scripture says, 'lest you bear sin.'[52]

Jacob Neusner understands this as a limitation on rebuking. One's rebuke should not cause the recipient embarrassment.[53]

A rebuke should be discrete. According to Maimonides "A person who rebukes a colleague – whether because of a [wrong committed] against him or because of a matter between his colleague and God – should rebuke him privately." Maimonides is also concerned with the content of rebuking. He believes that the primary objective of rebuking is to convince the sinning party to change their behavior and that the most effective method of achieving success is to show that repentance is in the sinner's best interest.[54] Maimonides writes, "He should speak to him patiently and gently, informing him that he is only making these statements for his colleague's own welfare, to allow him to merit the life of the world to come."[55] Jacob Neusner comes to a similar conclusion based on the Torah text itself. He translates the Biblical Hebrew of the passage, "but reasoning, you shall reason with your neighbor…."[56]

Although one has an obligation to rebuke even one's own teacher, the manner of the rebuke should be respectful. According to Maimonides, a student would accomplish this by "phrasing his rebuke in such a way that it sounds like an ordinary question."[57] "[A student who] saw his teacher transgress the words of the Torah should tell him: "Master, you have taught us such and such…."[58] The advice is to rebuke by asking a question of the teacher designed to elicit a response of repentance. This approach is identical to that used by God with Cain. "Why does He who knows everything ask of the fratricide [Cain], "Where is Abel your brother?" He wishes that man himself shall confess of his own free will…."[59]

J.H. Hertz comments,[60] "A precept extremely difficult of fulfilment; it is as difficult to administer reproof with delicacy and tact, as it is to receive reproof. Reproof must, of course, be offered in all kindness, otherwise it fails of its purpose; and if it entails putting a man to shame in public, it is mortal sin. No matter how much learning and good works the man who commits such a sin may possess, he has no share in the world to come – says a great Mishnah teacher."[61]

This is an essential difference between Biblical rebuking and whistle-blowing. Whereas whistle-blowing is public, bringing matters out in the open, rebuking is private, focused on achieving proper actions without shaming the wrongdoer.

F. When Should One Rebuke?

In the Jewish community at Qumran,[62] rebuking was a prerequisite to litigation. In fact, reproving must occur before witnesses. "Moreover, let a man not bring against his fellow a matter before the "Many" [a quasi-judicial body] which had no reproach before witnesses."[63] Another text states the matter even more explicitly. "Any man from the members of the covenant [of the Qumran sect] who brings against his fellow a charge which has had no reproach before witness, but brings it out of anger, or tells it to his elders in order to shame him, he is guilty of taking revenge and holding a grudge…. His sin is upon him insofar as he did not carry out the commandment of God who said to him, 'You shall surely reproach your fellow and bear no sin because of him'"[64]

Perhaps witnesses were intended to preserve evidence of an attempted negotiation.[65] Or they may have served as conciliators or mediators. By the time of Maimonides, any practice of rebuking in front of witnesses had disappeared and it was took place in private. But in Qumran, rebuking appears to have been a form of alternative dispute resolution where it may have been practical and possible to preserve a relationship between in a small community with limited judicial resources.[66]

G. What If One Doesn't Rebuke?

Although Jewish law requires one to rebuke a fellow Jew who sins, no punishment is stated for not doing so. However, to ignore a Biblical commandment, according to Maimonides, makes one responsible for the sin committed. "Whoever has the possibility of rebuking [sinners] and fails to do so is considered responsible for that sin, for he had the opportunity to rebuke the [sinners]."[67] This may be a sin punished by God, not man.

IV. REBUKING IN THE WORKPLACE

The business world, an arena in which doing the right thing is often equated with making a profit, has more than its share of unethical behavior.[71] In business codes of conduct, internal reporting is often the recommended first step.[74] A confidential ethics/fraud hotline or ethics officer might stave off whistle-blowing, but it does not have the advantages that come from creating a community of shared ethical values and trust.[75]

Although the principle of rebuking derives from Jewish and then Christian law it is not an essentially religious concept. Even if profitability is not the objective of observing the precept of *hokhe'ach tokhi'ach*, encouraging employees to encourage each other to do the right thing could be in the best interest of business organizations. In a communitarian corporate culture, possible wrongdoing can be confronted effectively before great harm is caused. Starbucks expresses its concern for its corporate image in case problems are made public.[79] Those of us whose workplace is the academy can attempt to create such communities and serve as a role model for other industries.[80]

Is it reasonable to expect effective rebuking in the workplace? Perhaps. Direct appeal to a colleague may achieve positive results, especially when peer pressure is collective.[72] In fact, a university ethics handbook proposes rebuking a superior as the initial method of resolution of ethical issues.

> Discuss your concerns with your immediate supervisor, even if your supervisor is the one presenting the ethical problem. Sometimes when presented with a subordinate who questions the ethical nature of a situation, the supervisor will rethink the situation and step back from the unethical action. If, however, this does not provide a satisfactory solution, you will need to find an alternative course of action. Don't think it is okay to just do what you are told to do!"[73]

Is this proposal naïve? The rebuker's option of subsequent whistle-blowing may deter retaliation, but their work environment may be made so uncomfortable as to amount to implied discharge. A common perception is that ethical behavior is not rewarded and "No good deed goes unpunished."[76] Defensive and threatened superiors may retaliate when they think their own actions are challenged.

The greatest practical obstacle to rebuking may be that if it does not achieve the desired result a rebuker might be ostracized without even the legal protections against retaliation afforded whistle-blowers. They may have no alternative to resignation, if they are not fired first. For rebuking to succeed in practice, a rebuking-friendly workplace is necessary.

Change to a rebuking community will not happen by itself. Such a workplace would have to be created by management. If a business is committed to this approach, it must get all of its members to buy into the process. Deeds matter far more than words, but these words from a corporate ethics document at Texas Instruments may be a start in that direction:

·We encourage open, honest and candid communications….

·We respect all TIers without regard to their position or level within the organization.[78]

Superiors must be prepared to educate others and to lead by example. Workers would have to be assured that they would not be punished, if not in fact rewarded, if they rebuke fellow employees, and even superiors. As Texas Instruments claims, "We respect the right and obligation of every TIer to resolve concerns relating to ethics questions without retribution and retaliation."[77]

V. CONCLUSION

Over the development of Jewish law there has been a variety of perspectives on what to do when confronted with wrongdoing. The prevailing position is that Jews are their "brothers' keepers,"[68] responsible to urge other Jews to do the right thing, preferably through rebuking under the principle of *hokhe'ach tokhi'ach* and not whistle-blowing.[69] Jewish biblical and rabbinic law arose in self-policing Jewish communities; therefore there is no discussion of reporting fellow Jews to non-Jewish authorities or whether a Jew should report a non-Jew for wrongdoing. Based on Jewish sources a persuasive case could be made that now we are all responsible to each other to make the world a better place through *tikkun olam*, repairing the world,[70] and that we should all encourage others to act ethically, to do the right thing.

This ancient Jewish principle of rebuking can provide an effective and practical alternative to whistle-blowing in the modern workplace, achieving its benefit of avoiding wrongdoing without it costs. Whether institutionalizing *hokhe'ach tokhi'ach* succeeds would depend, as so much does in business organizations, on the leadership of those on the top.

But what is one to do if rebuking has no positive effect, if this quiet diplomacy fails? In the most difficult cases, such as those of Madoff and Pang, the wrongdoing is by a business organization's leadership itself. Rebuking by insiders, for example by Madoff's sons or by Pang's president, might be effective – but they might have been in on it too. Even if Jewish law commands rebuking in the face of sinful behavior, would the end of ethical behavior justify other means? What does Jewish law say about whistle-blowing if rebuking fails? That is a topic for another paper.

ENDNOTES

[1] The term “blow the whistle” is slang – “To expose a wrongdoing in the hope of bringing it to a halt: *an attorney who blew the whistle on governmental corruption*.” “Whistle blower … *Slang.* One who reveals wrongdoing within an organization to the public or to those in positions of authority: “*The Pentagon’s most famous whistleblower is … hoping to get another chance to search for government waste”* (Washington Post).” AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (3d ed. 1992).
[2] Alex Berenson & Diana B. Henriques, *Inquiry Finds No Signs Family Aided Madoff,* N.Y. TIMES, December 15, 2008.
[3] Mark Maremont, *Highflying Financier Faces Questions Over Fund Empire*, THE WALL STREET JOURNAL, April 15, 2008.
[4] *Danny Pang, Financier Under Investigation, Is Dead at 42*, THE ASSOCIATED PRESS, September 12, 2009. Danny Pang’s death has been ruled a suicide. *Death of Accused Financier Ruled a Suicide*, N.Y. TIMES, January 12, 2010.
[5] Baltimore has seen both anti and pro snitching campaigns. Rick Hampson, *Anti-snitch campaign riles police, prosecutors,* USA TODAY, March 28, 2006.
[6] Sissela Bok, *Whistleblowing and Professional Responsibility*, N.Y.U. EDUC. Q., 11, 2-7 (1980); NORMAN BOWIE, BUSINESS ETHICS (1982); Ronald Duska, *Whistleblowing and Employee Loyalty*, in CONTEMPORARY ISSUES IN BUSINESS ETHICS 142-46 (Joseph R. Des Jardins & John J. McCall eds., 2d ed. 1990).
[7] The same is true in other cultures; for example, the Spanish term *chota* is used to label one who has committed a betrayal. Urban Dictionary, http://www.urbandictionary.com.
[8] “[W]histleblowing … violate(s) a *prima facie* duty of loyalty to one’s employer.” Duska, *supra* note 6.
[9] Several articles have addressed the moral issues concerning whistle-blowing, e.g., Gene G. James, *Whistle-blowing: Its*

Moral Justification, *in* ESSENTIALS OF BUSINESS ETHICS (Peter Madsen & Jay Sfaritz, eds., 1990).

[10] A Wikipedia entry, http://en.wikipedia.org/wiki/Alternative_dispute_resolution and 2,550,000 Google hits for "alternative dispute resolution," http://www.google.com/search?client=safari&rls=en&q=alternative+dispute+resolution&ie=UTF-8&oe=UTF-8

[11] NACHUM AMSEL, THE JEWISH ENCYCLOPEDIA OF MORAL AND ETHICAL ISSUES, 64 Speech 279-80 (1994).

[12] Torah. Name applied to the five books of Moses, Genesis, Exodus, Leviticus, Numbers, and Deuteronomy, http://www.jewishencyclopedia.com/view.jsp?artid=265&letter=T&search=torah#ixzz0S5wwMjGE

[13] Exodus 23:1. ETZ HAIM: TORAH AND COMMENTARY 470 (2001).

[14] 1. You must not carry. A *midrash* interprets this to prohibit receiving as well as spreading false and damaging rumors. Even to listen to such a rumor is to participate in its circulation and thereby participate in hurting another human being. *Id.*

[15] The entire verse reads, "[You shall not hate your kinsman in your heart.] Reprove (*hokhe'ach tokhi'ach*) your neighbor, but (exact force of we- uncertain) incur no guilt because of him." Leviticus 19:17. THE TORAH: THE FIVE BOOKS OF MOSES 217 (1962).

[16] "[T]hou shalt surely rebuke thy neighbour, and not bear sin because of him." THE PENTATEUCH AND HAFTORAHS 501 (J.H. Hertz ed., 2d ed. 1961).

[17] Rashi (Solomon bar Isaac) French commentator on Bible and Talmud; born at Troyes in 1040; died there July 13, 1105, http://www.jewishencyclopedia.com/view.jsp?artid=121&letter=R&search=rashi#ixzz0S5g9ozxP

[18] "Chapter 19 may be characterized as a brief *torah* (instruction). It states the duties incumbent on the Israelites as a people and includes a wide range of laws and commandments that are representative of the basic teachings of the

Torah." BARUCH A. LEVINE, THE JPS TORAH COMMENTARY: LEVITICUS 124 (1989). The rabbis of the Talmud consider this commandment in the tractate *Bava Metzia*. The Talmud is "The collection of ancient Rabbinic writings consisting of the Mishnah and Gemara, constituting the basis of religious authority in Orthodox Judaism." AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 1832 (3d ed. 1992). It also constitutes the basis of religious authority in Conservative Judaism. See JOEL ROTH, THE HALAKHIC PROCESS: A SYSTEMIC ANALYSIS (1986). ADIN STEINSALTZ, THE TALMUD, VOL.II, TRACTATE BAVA METZIA, PART II, 31A 167. Bava Mezia "(Aram. "middle gate"), tractate of Mishnah, with *gemara* in Jerusalem and Babylonian Talmuds; second of three sections of original large tractate *Nezikin*. Deals with laws of chattels, lost and found property, the four types of caretakers, embezzlement, fraud, interest, rights of hired labor and partnership." ENCYCLOPEDIC DICTIONARY OF JUDAICA 67 (GEOFFREY WIGODER ed. 1974). The problem of the rabbis of the Talmud with this passage is that a verb is repeated, with a slight variation, in *hokhe'ach tokhi'ach*. They argue over how to interpret the many double verbs in the Torah. Torah is used here in a limited manner, "3. The first five books of the Hebrew Scriptures." AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 1890 (3d ed. 1992). Some rabbis expect God to follow William Strunk's principle of omitting needless words. "Elementary Principles of Composition 17. Omit needless words." WILLIAM STRUNK & E.B. WHITE, ELEMENTS OF STYLE (4th ed. 2000). Any repetition of words requires rabbinic commentary. "[T]he Sages analyzed every word and letter of the Torah, and derived important laws from the slightest case of seeming superfluity…." STEINSALTZ, *supra* note 18, AT PART II, 31A 163. The assumption is that every word must have significance. These rabbis do not see repetition as intended merely for emphasis or dramatic effect. Therefore, the second use of a word must have a meaning that adds to the meaning of the first use of the word. Other rabbis see the use of double verbs as simply stylistic without legal importance. "[T]here is an opinion that the use of a double verb is no more than a stylistic matter with no specific Halakhic significance." STEINSALTZ, *supra* note 18, AT PART II, 31A 163. These rabbis understand that even if God would not waste words, the objective is to communicate to human beings. Therefore, "The Torah speaks in the ordinary language of human beings," at least when double verbs, and occasionally double pronouns, are used. STEINSALTZ, *supra* note 18, at 31B 173. The duplication of the verb in this passage, *hokhe'ach tokhi'ach*, is one of several double verbs that many rabbis of the Talmud interpret as having importance. And their interpretations of the phrase have important implications as to the meaning of the commandment, for example, as to how often and whom one should rebuke.

[19] "[A]s [Leviticus 19:17 states: "You shall surely admonish your colleague." MAIMONIDES, MISHNEH TORAH, HILCHOT DE'OT, THE LAWS OF PERSONALITY DEVELOPMENT 126-27 (Za'ev Abrahmson & Eliyahu Touger trans., 1989).

[20] Moses ben Maimon, Talmudist, philosopher, astronomer, and physician; born at Cordova March 30, 1135; died at Cairo Dec. 13, 1204, http://www.jewishencyclopedia.com/view.jsp?artid=905&letter=M&search=maimonides#ixzz0S60FArJw

[21] "Mitzvah (Heb.), 'precept' or religious duty…. Traditionally there are 613 precepts – 248 positive and 365 prohibitive." This commandment is categorized under Mandatory Commandments as #205 (not ordered by verse) as a Social commandment. WIGODER, *supra* note 18, at 133.

[22] "[A]s [Leviticus 19:17 states: "You shall surely admonish your colleague." MAIMONIDES, *supra* note 19.

[23] Repentance. The noun occurs only in post-Biblical literature, but it is derived from the vocabulary of the Bible. Maimonides'

dictum, "All the prophets preach repentance" ("Yad," Teshubah, vii. 5), echoes the opinion of Talmudic authority (Berakhot 34b) http://www.jewishencyclopedia.com/view.jsp?artid=216&letter=R&search=repentance#ixzz0S614b5Sl

[24] MAIMONIDES, *supra* note 19, at 126-29.

[25] In fact, the Jewish concept of repentance (*t'shuva*), includes a commitment to change one's behavior in the future.

[26] MAIMONIDES, *supra* note 19.

[27] "Joseph Herman Hertz (1872-1946), chief rabbi of British Commonwealth 1913-46…." WIGODER, *supra* note 18, at 254.

[28] HERTZ, *supra* note 16.

[29] "Moreover, a proper attitude promotes love for one's neighbor. The opening statement (v.17) contrasts with the conclusion (v.18) as hate contrasts with love." This contextual argument refers to the passage in Leviticus 19:18, "Love your fellow as yourself." BARUCH A. LEVINE, THE JPS TORAH COMMENTARY: LEVITICUS 129 (1989).

[30] JACOB NEUSNER, SIFRA: AN ANALYTICAL TRANSLATION, Parashat Qedoshim Pereq 4 CC:III 2.A, 109 (1988).

[31] Compare this concept to the approach of communitarianism. "It is entirely appropriate, therefore, for my fellow countrymen to ask of me some kind of service to the common cause." T.A. Spragens Jr., *The Limitations of Libertarianism, Part II*; THE ESSENTIAL COMMUNITARIAN READER 33 (Amitai Etzioni ed., 1998).

[32] MAIMONIDES, *supra* note 19.

[33] According to Jewish rabbinic law, only seven laws are applicable to all people. They are the Noachide Laws, given to Noah and do not include the commandment of *hokhe'ach tokhi'ach*. WIGODER, *supra* note 18, at 455.

[34] "Rava (Abba bar Joseph bar Hama; d.352), Babylonian *amora*; colleague of Abbaye." WIGODER, *supra* note 18, at 500. Amora… [U]sed for Jewish scholars who taught in Erez Israel and especially Babylonia 3rd-6th c. in period after

conclusion of Mishnah, their work being comprised in the *Gemara*." *Id.* at 26.

[35] STEINSALTZ, *supra* note 18, AT PART II, 31A 165.

[36] MAIMONIDES, *supra* note 19.

[37] SHULCHAN ARUCH HARAV 156:7, according to MAIMONIDES, *supra* note 19, at Commentary, Halachah 7. Shulchan Arukh "name given by Joseph Caro to code of Jewish law compiled by him." WIGODER, *supra* note 18, at 552. Joseph ben Ephraim (1488-1575) codifier, mystic, author of Shulchan Arukh. *Id.* at 116.

[38] MAIMONIDES, *supra* note 19, at Commentary, Halachah 7.

[39] Compare to the philosophy of the king in The Little Prince. "If I ordered a general," he would say, by way of example, "if I ordered a general to change himself into a sea bird, and if the general did not obey me, that would not be the fault of the general. It would be my fault." … "One must require from each one the duty which each one can perform…." ANTOINE DE SAINT-EXUPERY, THE LITTLE PRINCE 42-45 (K.Woods, trans. 1943).

[40] STEINSALTZ, *supra* note 19, at 165.

[41] *Id.*

[42] Sifra is Aramaic for book. "[T]annaitic halakhic Midrash to Leviticus. Probably compiled in Erez Israel in late 4th c. CE." WIGODER, *supra* note 18, at 500.

[43] Leviticus 19:17.

[44] NEUSNER, *supra* note 30, at 4 CC:III 2.B.

[45] Translated here as "reasoning, you shall reason." *Id.*

[46] MAIMONIDES, MISHNEH TORAH, HILKHOT TALMUD TORAH 5:9, STEINSALTZ, trans., *supra* note 19, AT PART II, 31A 165.

[47] TALMUD, TRACTATE ARAKHIN 16B.

[48] Nahmanides (Moses b. Nahman; Ramban; 1194-1270), Spanish rabbi, talmudist, philosopher, kabbalist, exegete, poet, communal leader…." WIGODER, *supra* note 18, at 440.

[49] "Nissim ben Reuben Gerondi (Ran; ?1310--?1375), Spanish talmudist, authoritative *posek*, yeshivah head in Barc Menachem Elona." WIGODER, *supra* note 18, at 455.
[50] STEINSALTZ, *supra* note 19, at PART II, 31A 165.
[51] "Notes: According to Rashi, [*v'lo taseh alav]* is not an independent statement, it merely expresses a condition: Rebuke thy fellow man but in such a manner that you do not thereby bring upon yourself sin. The sin would be to rebuke him in public." PENTATEUCH WITH RASHI'S COMMENTARY, M. Rosenbaum & A.M. Silbermann, trans., Vol. 3, 87b (1929).
[52] NEUSNER, *supra* note 30.
[53] "No. 2 then sets limits to this process of rebuke or reasoning with the other. *Id*.
[54] Although "The Torah, the most important Jewish text, has no clear reference to afterlife at all," by the time of Maimonides, belief in an afterlife was generally accepted in Judaism. JOSEPH TELUSHKIN, JEWISH LITERACY (1991). http://www.jewishvirtuallibrary.org/jsource/Judaism/afterlife.html
[55] MAIMONIDES, *supra* note 19, at 126-29.
[56] NEUSNER, *supra* note 30.
[57] MAIMONIDES, MISHNEH TORAH, HILKHOT TALMUD TORAH 5:9, STEINSALTZ, trans. *supra* note 19, at PART II, 31A 166.
[58] MAIMONIDES, *supra* note 57, at 242-43.
[59] JAMES L. KUGEL, THE BIBLE AS IT WAS 93 (1997).
[60] On the passage "rebuke thy neighbour." HERTZ, *supra* note 16.
[61] *Id.*
[62] Home to a Jewish community near the Dead Sea that existed around the start of the Common Era.
[63] (1QS) *Community Rule* 6:1, KUGEL, *supra* note 59 at 454. "*Community Rule*: a translation of the Hebrew name *Serekh ha-Yahad*; also called the *Manual of Discipline*." This document is one of the Dead Sea Scrolls at Qumran. James L. Kugel, *On Hidden Hatred and Open Reproach: Early Exegesis*

of Leviticus 19:17," 80 Harvard Theological Review 52-55 (1987).

[64] *Damascus Document* 9:3-8, KUGEL, *supra* note 59 at 454.

[65] This seems to be the gist of this Gospel passage, "If your brother sins against you, go and tell him his fault, between you and him alone. If he listens to you, you have gained a brother. But if he does not listen, take one or two others along with you, so that every word may be confirmed by the evidence of two or three witnesses." Matt. 18:15-16, KUGEL, *supra* note 59 at 454-55; Dennis C. Duling, "*Matthew 18:15-17: Conflict, Confrontation, and Conflict Resolution in a "Fictive Kin" Association*," Biblical Theology Bulletin, Vol. 29, No. 1, 4-22 (1999).

[66] Christian law observed this positive result of reproving. "For when such people are corrected and reproached, you will not have many lawsuits." *Didascalia Apostolorum* ch.11, KUGEL, *supra* note 59 at 455.

[67] MAIMONIDES, *supra* note 19, at 128.

[68] "Am I my brother's keeper?" Genesis 4:9, ETZ HAIM: TORAH AND COMMENTARY 26 (2001).

[69] "*Kol Yisrael arevim ze bazeh*," all Jews are responsible one for the other. TALMUD, SHAVUOT 39a.

[70] NATHAN J. DIAMENT, TIKKUN OLAM: SOCIAL RESPONSIBILITY IN JEWISH THOUGHT AND LAW (1997).

[71] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y.TIMES, Sept. 13, 1970, at 122.

[72] Peer pressure can change behavior. One example is New York City mayor Ed Koch's "Where's your pooper scooper" campaign. "Both Mr. Schneider and Mr. Bornstein cited former Mayor Edward I. Koch's promotion of the pooper-scooper law. 'He created an awareness, and it's worked," Mr. Bornstein said." Jake Mooney, *Neighborhood Report: Upper East Side; Fed Up With Cars That Travel on Giant Cat Feet*, N.Y. TIMES, May 8, 2005.

[73] C. Whistle-blowing

You have identified the ethical dilemma and evaluated the situation using the decision-making tool. However, your supervisor has asked you to take an action that makes you uncomfortable. You have examined the situation, identified the stakeholders, determined and tested the options. You are firmly convinced that if you take the action your superior has asked, the act would be unethical. What do you do now? You need this job to pay your bills and simply walking away from your job is not a course of action you want to take. Going against what a superior has asked or ordered is never easy, but you need to decide what to do.
Following the directions or orders of the boss is not an ethical or legal defense for wrongdoing. You must be prepared to think and act in a way that is beneficial to you and that of the organization for which you work. Are there alternatives for you to follow short of quitting? Fortunately, in most organizations the answer is "yes." Here are some possible courses of action if you find yourself in this type of ethical dilemma: 1….
HANDBOOK: BUILDING ETHICAL LEADERS (Northern Illinois University College of Business) 22-23 (2006), Association to Advance Collegiate Schools of Business Ethics Education Resource Center.
http://www.aacsb.edu/resource_centers/EthicsEdu/EthicsHandbook.pdf

[74] Such as directives to "report," "notify," or "contact" various offices. BellSouth's Code of Conduct (2005)
http://www.ethics.bellsouth.com/OVIA_K00801W.02.pdf

[75] *Supra* note 73, at 23.
"…Guardsmark maintains an ethics committee and a dedicated ethics officer who can be reached through a toll-free number. We take every ethics concern or issue seriously and provide assistance about applying principles to any given situation." Guardsmark, Ethics.
http://www.guardsmark.com/approach/approach_sec.asp?nav=1&subnav=3&content_id=8; "Providing a means to report

exceptions (i.e., possible misconduct). We maintain an Ethics Line (1-800-455-1996) to receive reports from anyone who is aware of a violation of our Code of Conduct or Policies and Procedures. This line is answered at all times." HCA Healthcare Company
http://ec.hcahealthcare.com/CustomPage.asp?guidCustomContentID={0C97D70A-C35D-4E02-B1A8-CB335070158B};
"The TI Ethics Office has three primary functions: …
3. To provide multiple channels for feedback through which people can ask questions, voice concerns and seek resolution to ethical issues." Texas Instruments, Ethics
http://www.ti.com/corp/docs/csr/corpgov/ethics/index.shtml

[76] Attributed to Clare Booth Luce.
http://www.answers.com/topic/luce-clare-boothe

[77] Texas Instruments, Values and ethics of TI: Integrity
http://www.ti.com/corp/docs/csr/corpgov/ethics/integrity.shtml

[78] *Id.*

[79] Ethical Decision-Making Framework 4. Determine the best approach (what should you do?)…. • Would your approach embarrass you or Starbucks? • How would your approach look published in the newspaper?...Starbucks Business Ethics and Compliance: Standards of Business Conduct.
http://www.starbucks.com/aboutus/SoBC_FY09_eng.pdf

[80] Perhaps that process can begin in the business school classroom. "So business school students, when your ethics professors greet you with careworn faces and an exasperation unbecoming of anyone with a guarantee of lifetime employment, be patient with them. They don't have the weight of the world on their shoulders, just the fate of your chosen profession. Listen to them. They can't solve this moral crisis in capitalism, but they can convince you to give it a try." John Paul Rollert, "*Bernard Madoff, Adam Smith, and captalism's moral crisis*," CHRISTIAN SCIENCE MONITOR, September 21, 2009.

TREATMENT OF TREAS. REG. §1.752-6 PROVIDES INSIGHT INTO THE APPLICATION OF REVISED I.R.C. §7805(b)

By:

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In *Maguire Partners-Master Investments, LLC v. United States*,[1] a District court in California joined the Seventh Circuit in *Cemco Investors, LLC v. Unites States*,[2] in upholding the validity of Treas. Reg. §1.752-6 and the retroactive application of that same regulation. This same regulation was declared invalid by the Court of Federal Claims in *Stobie Creek Investments, LLC v. United States*[3] and the District court for Colorado in *Sala v. United States*.[4] In addition, in *Klamath Strategic Investment Fund, LLC v. United States*[5] a District court in Texas called into question the retroactive effect of the regulation.

These opinions are important because they are the first cases to address the restrictive provisions regarding retroactivity of regulations applicable to statutes enacted after July 30, 1996. Prior to its amendment, section 7805(b) provided that regulations were effective retroactively unless the

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Secretary of the Treasury (hereafter "Secretary") provided otherwise.[6] Section 7805(b)[7] now provides that regulations are to have prospective effect unless they fit within certain specifically delineated exceptions.

I. CLASSIFICATION OF TREASURY REGULATIONS AND DEFERENCE ACCORDED TO EACH CLASS

Treasury regulations fit within three broad classifications – legislative, interpretative or procedural.[8] Legislative regulations are those issued by the Secretary where Congress "has explicitly left a gap for the agency to fill."[9] In these instances, Congress can be viewed as having vested in the Secretary the right to "make the law" in a specific area.[10] Interpretative regulations are those promulgated by the Secretary under the general grant of authority contained in section 7805(a). Their scope is more circumscribed as the authority conferred upon the Secretary by section 7805 is to interpret a particular statutory provision.

In *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc*, the Supreme Court stated that "legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."[11] The deference accorded properly adopted legislative regulations is, therefore, virtually absolute. In evaluating a legislative regulation the threshold issue is whether, "Congress has directly spoken to the precise question at issue … [if it has], that is the end of the matter."[12] If "Congress has not directly addressed the precise question at issue, the court does not impose its own construction on the statute … [r]ather if the statute is silent or ambiguous … the question for the court is whether the agency's answer is based upon a permissible construction of the statute."[13]

The deference accorded an interpretative regulation is not as clear. The threshold question is again whether Congress has directly addressed the issue the regulation seeks to address in a clear and unambiguous manner. If that is the case, there is no room for administrative interpretation.[14] Where Congress has not addressed an issue, or has done so in an ambiguous fashion, the reasonable interpretation of the administrator of an agency (*e.g.*, the Secretary) should be adhered to even if the reviewing court would have not adopted the same approach.[15] Stated another way, a court must defer to the administrator's judgment so long as the administrator's interpretation is one of a number of possible reasonable interpretations.

In *United States v. Mead*, [16] the Supreme Court considered whether a tariff classification ruling issued by the United States Customs Service was entitled to the deference accorded regulations under *Chevron*. The ruling at issue in *Mead* was analogous to an Internal Revenue Service (hereafter "Service) letter ruling.[17] The Supreme Court refused to accord the classification ruling in *Mead* the same deference accorded regulations under *Chevron*.[18] *Mead's* significance lies in the fact that it affirmed the standard of judicial review applicable to interpretative regulations set forth in *Chevron*.[19]

Chevron did not specifically address interpretive regulations promulgated by the Secretary under section 7805(a). Two earlier Supreme Court cases that did so were *National Muffler Dealers Association, Inc. v. United States*[20] and *Vogel Fertilizer Company v. United States*.[21] Neither of these cases was the subject of analysis in *Chevron*, thus leaving open the question of whether they or *Chevron* set forth the appropriate level of deference to be accorded interpretative regulations issued pursuant to the general grant of authority conferred upon the Secretary under section 7805(a).

In holding the regulations at issue in *National Muffler* valid, the Supreme Court stated that "[i]n determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose."[22] Applying that same standard in *Vogel Fertilizer*, the Supreme Court struck down Treas. Reg. §1.1563-1(a)(3) as incompatible with the statute.[23] The court held in the context of interpretative regulations that the "general principle of deference, while fundamental, only sets 'the framework for judicial analysis; it does not displace it.'"[24] The majority held that Congress had directly addressed the question that was the subject of Treas. Reg. §1.1563-1(a)(3) in a clear and unambiguous manner, after analyzing the language and the legislative history of the statute. Thus, the regulation was found to be invalid. This conclusion left no room for the Secretary to interpret the statute and is fully consistent with rule articulated in *Chevron*.[25]

The Tax Court has continued to apply *National Muffler* in testing the validity of interpretative regulations. In its view, *Chevron* merely represents a restatement of the standard articulated in *National Muffler*.[26] In *Swallows Holding, Ltd. v. Commissioner*,[27] the Third Circuit rejected this view. It held instead that *Chevron* effectively preempted *National Muffler*.[28] In many cases the same result would obtain regardless of which test is applied. The *Chevron* standard is, however, a more liberal one which affords a greater degree of deference to interpretative regulations promulgated under section 7805.

II. THE RETROACTIVITY OF TREASURY REGULATIONS UNDER SECTION 7805

The retroactive exceptions fall within two categories, those which are temporal and those which are substantive. Under Section 7805(b)(1), a regulation cannot be applied retroactively to any period prior to the filing of final, temporary or proposed regulation with the Federal Register or alternatively the date on which any notice substantially describing their contents is published.[29] The principal substantive exceptions are found in section 7805(b)(3) relating to the prevention of abuse and section 7805(b)(6) relating to a legislative grant allowing for an effective date earlier than that prescribed in section 7805(b)(1).

The threshold question in evaluating the Secretary's authority to invoke the substantive exceptions permitting retroactivity under section 7805(b)(3) is the extent to which prior case law under Old Section 7805 should be imported into the analysis.[30]

Under Old Section 7805(b), the Secretary's decision not to apply a regulation prospectively, was subject to review under an abuse of discretion standard.[31] Judicial review was generally predicated on the need to prevent fundamental unfairness in situations where the Secretary sought to alter settled tax policy upon which a taxpayer justifiably had a right to rely.[32]

In *Anderson, Clayton & Company v. United States*,[33] the Fifth Circuit set forth some of the relevant factors for determining whether to accord a regulation retroactive effect. These included:

> (1) whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters that law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent Code provisions; (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether according retroactive effect would produce an inordinately harsh result.[34]

In *Snap-Drape, Inc. v. Commissioner*,[35] the Fifth Circuit reaffirmed that "this list of relevant considerations is neither exhaustive nor exclusive" and that it "merely reflects a distillation of prior case law."[36] The court held that the factors listed in *Anderson, Clayton* were intended only to serve as a guide and that the presence of all four "factors" was not required in order for a court to conclude that the retroactive application of a regulation does or does not constitute an abuse of discretion.[37] The court in *Snap-Drape* held the regulations before it valid despite finding that "the retroactive application of this regulation has already produced inordinately harsh results."[38] It did so because it found that the Secretary satisfied the requirement that the regulation served a rational legislative purpose.[39]

Under Old Section 7805(b), where there are existing regulations, or a clearly established administrative practice, the Secretary is generally precluded from issuing new regulations having retroactive effect.[40] That limitation, however, is not absolute as the Secretary has the authority to correct erroneous regulations or administrative practices. For example, in *Dixon v United States*,[41] the Supreme Court stated that the Secretary "could make retroactive a new regulation increasing tax liability beyond that provided for by the prior regulation where the superseding regulation corrected an erroneous interpretation of the statute." Moreover, taxpayers relying on non-authoritative administrative pronouncements generally do so at their peril.[42]

Where there is no outstanding regulation construing or interpreting a statute when the Secretary chose to issue regulations, those regulations could apply with retroactive effect since the taxpayer's liability was governed by the underlying statute.[43] This rule is applicable even if the regulation is promulgated after litigation has commenced,[44] although the regulation would remain subject to review under the abuse of discretion standard.[45]

It is arguable that by eliminating the blanket authority granted the Secretary to allow regulations to have retroactive effect under Old Section 7805(b), Congress obviated the need for a court to apply the traditional standards for determining whether the Secretary abused his discretion. For statutory provisions enacted after July 30, 1996, the sole inquiry in determining retroactivity of regulations should be compliance with the literal language of either section 7805(b)(3) or 7805(b)(6).

Thus, where the Secretary relies on section 7805(b)(3) (relating to the prevention of abuse), the inquiry should be into the potential existence of the type of abuse the retroactive application of a particular regulation is intended to combat. Upon a finding that the potential for such abuse exists, the sole inquiry should be whether the regulation represents a rational or reasonable attempt to prevent that abuse. Similarly, where the reliance is on section 7805(b)(6) (relating to a Congressional grant of authority), the inquiry should be limited to whether Congress has indicated a willingness to permit retroactivity, and whether the retroactive application of a particular regulation serves a rational legislative purpose.

III. TREAS. REG. §1.752-6

(A) *Its Origins and Purpose*

Section 358(h)(1) was added to the Internal Revenue Code by section 309(a) of the Community Renewal Tax Relief Act of 2000 (hereafter "CRTRA").[46] It generally requires that a shareholder, who receives stock in an exchange, or series of exchanges, must reduce the basis of that stock to its fair market value by subtracting any liability the corporation assumes.

Section 358(h)(2) provides exceptions to this rule where (1) a trade or business is contributed to the corporation or (2) "substantially all of the assets to which the liability is associated" are transferred to the corporation. The Secretary is, however, permitted to set forth circumstances under which the aforementioned exceptions do not apply.

Section 358(h)(3) provides that "the term 'liability' shall include any fixed or contingent obligation to make payment."

CRTRA §309(c) provides, in pertinent part, that:

> The Secretary … shall prescribe rules … under subchapter K … to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) … in transactions involving partnerships ….[47]

The Secretary relied on this language in promulgating Treas. Reg. §1.752-6. The Service's position is this provision provided it with the authority to prescribe regulations that requires a partner to reduce the basis of his partnership interest by the amount of any liabilities described in section 358(h)(3) that the partnership assumed (or, alternatively took property subject to) in exchange for an interest in the partnership. Those critical of the regulations have ascribed a narrower meaning to the statutory language. They argue that the authority granted to the Secretary was limited to prescribing regulations which give effect to section 358(h) only in cases where a partner or partnership is the transferor shareholder in an exchange involving a corporation.[48]

(B) Is Treas. Reg. §1.752-6 Legislative or Interpretive in Nature?

The threshold question regarding Treas. Reg. §1.752-6 is whether it is a legislative regulation or an interpretive one. There can be no question the statute explicitly grants the Secretary the authority to issue regulations which give effect to the provisions of section 309(c) of the CRTRA. As such it is a legislative regulation entitled to *Chevron* deference.[49] Thus, the key question is whether Congress in the statute has directly spoken with respect to the issue in a clear and unambiguous fashion, or whether the statute is silent or ambiguous. If it is the latter, the validity of the regulation can not reasonably be questioned. Stated another way, Treas. Reg. §1.752-6 is invalid only if Congress has unambiguously and directly addressed the issue the regulation purports to address, or the regulation is "arbitrary, capricious, or manifestly contrary to the statute."[50] Finally, if Treas. Reg. §1.752-6 is valid, its retroactive application is guaranteed by reason of section 7805(b)(6).

Those courts which have declared Treas. Reg. §1.752-6 not to be legislative in nature have relied on a number of overlapping arguments.[51] These are: (1) that section 309(c) of the CRTRA makes no mention of section 752 (*Klamath*, *Stobie Creek*), (2) that since section 309 was first proposed on October 19, 1999, before the issuance of Notice 2000-44,[52] Congress could not have been aware of the partnership transactions covered by that Notice (*Klamath*), (3) that the regulation is not a "comparable" rule because it does not address the acceleration or duplication of losses (*Sala*, *Stobie Creek*), (4) that Treas. Reg. §1.358-7 represents the only valid exercise of the authority granted to the Secretary (*Klamath*), and (5) that the regulation does not purport to address liabilities described in section 358(h)(3) (*Sala*).

With respect to the absence of any specific reference to section 752 in the statutory language or legislative history of CRTRA §309(c), *Klamath* and *Stobie Creek* either ignore or give no weight to the fact that the statute specifically refers to Subchapter K, of which section 752 is part. Moreover, the determination of a partner's basis is not governed by section 752, but rather by section 705, although partnership liabilities play an important role in determining a partner's basis under that section.

As to the second point, that because of its timing Congress could not have been aware of the type of transactions covered by Notice 2000-44, this is essentially a statement that in the absence of a direct reference to section 752, Congressional knowledge of "overstated basis" transactions cannot be inferred. This argument has superficial appeal, however, it should be noted that Notice 2000-44 had already been issued when the CRTRA was passed by the House and Senate on December 15, 2000.[53]

While both *Sala* and *Stobie Creek* addressed the issue of "comparable" rules and the "duplication or acceleration of losses," they did so in a different manner. *Sala* addressed each of these points separately, while in *Stobie Creek* the court viewed them as part of the same argument.

The court in *Sala* acknowledged that the obligation under the contributed short option position would constitute a contingent liability within the meaning of section 358(h)(3). It held, however, that Treas. Reg. §1.752-6 did not provide rules "comparable" to those contained in section 358(h), because it failed to adopt the exception set forth in section 358(h)(2)(B).[54] Assuming that section 358(h)(2) is relevant in determining "comparability," *Sala* simply ignores the "[e]xcept as provided by the Secretary" language of that section which allows the Secretary to determine when the section 358(h)(2) exceptions shall not apply.[55] Thus, the Secretary appears to have been well within his rights to provide the "exception to the exception" that the *Sala* court found objectionable.[56] It would appear that the court in *Sala* erred by requiring that Treas. Reg. §1.752-6 achieve a result identical to that which it believes would have resulted from the application of section 358(h) to a transaction within the purview of section 351.

The more cogent argument, advanced by both the court in *Sala* and *Stobie Creek*, is that Treas. Reg. §1.752-6 does not address the "acceleration or duplication of losses." *Sala* held that Notice 2000-44, and consequently Treas. Reg. §1.752-6, instead addressed transactions that "result in a single loss that occurs at a specific time: liquidation of the inflated-basis assets."[57] The court in *Stobie Creek* articulated this same argument stating that "[t]he mandate of Congress … in Section 309(c) … was not to combat inflation of basis … [but] to preclude the acceleration and/or duplication of losses."[58]

According to the court in *Stobie Creek* Treas. Reg. §1.752-6 cannot be a "comparable" regulation "when it does not speak to transactions involving the possible acceleration and/or duplication of losses." (Emphasis Added).[59] What appears to have been lost on both courts is the fact that the inflated basis that section 358(h) addresses does not result in a prohibited acceleration or duplication of a loss;[60] rather, it is the disposition of the stock received in a section 351 transfer that caused a loss to be accelerated and/or duplicated. Similarly, something more needed to occur in order for a loss to be accelerated in the transactions before the court in *Sala* and *Stobie Creek*. Consequently, section 358(h) and Treas. Reg. §1.752-6 both similarly focus on the "possible" acceleration of a loss because of the existence of an inflated basis.[61] The question is – Whether the recognition of a "real" loss resulting from the disposition of stock having an inflated basis, should be denied; while the recognition of a "created" loss resulting from the disposition of an asset having an inflated basis by reason of it having been passed through a partnership, should be respected?

In *Klamath*, the court held that Treas. Reg. §1.358-7 was "plainly the type [of regulation] contemplated by [section 309(c) of the CRTRA]," because it addressed "rules applicable to partnerships that were shareholders in corporations that engaged in transactions subject to Section 358(h)." The court thus restricted the ability of the Secretary to issue regulations under the grant of authority contained in CRTRA §309(c) to those situations where partners or partnerships became shareholders of a corporation in a transaction within the scope of section 351. The *Klamath* court did not cite any authority either within section 309 or its legislative history in support of its position.

There can be no question that Treas. Reg. §1.358-7 addresses the situation described by the court in *Klamath*, nor can it reasonably be asserted that this action was not within the grant of authority conveyed to the Secretary by Congress. However, the possibility of an acceleration or duplication of a loss where a partnership or partner was a transferor in a section 351 transaction is limited in scope.[62] Arguably, the Secretary could have crafted regulations to address these limited circumstances under his authority to issue interpretive regulations pursuant to section 7805(a).[63] The fact that the Secretary was able to issue Treas. Reg. §1.358-7 under the specific grant of authority contained in CRTRA §309(c), does not mandate a finding that this is the only situation the Secretary was authorized to address. Had section 309(c) been drafted in the conjunctive (*i.e.*, "and") that would certainly have favored a finding that the Secretary's authority was limited to situations in which a partner or partnership participates in a transaction within the scope of section 351. Congress, however, drafted section 309(c) in the disjunctive (*i.e.*, "or").

The court in *Sala* held Treas. Reg. §1.752-6 to be overly broad, because it sought to extend section 358(h)(3) outside of the corporate realm. In reaching this conclusion, the court analyzed the language of section 358, but it failed to analyze the language of CRTRA §309(c). The court could have more carefully examined the meaning and interaction of two specific phrases, the first being the "liabilities described in section 358(h)(3)" and the second being "in transactions involving partnerships."[64]

Focusing on its limiting language, "[f]or purposes of this subsection," the court concluded that the section 358(h)(3) definition of "liability" was limited in scope to corporate exchanges, such as those described in section 351. Having reached this conclusion it then went onto to hold that since section 358(h)(3) applies only to corporate exchanges, the phrase “in transactions involving partnerships” was a reference to corporate exchanges to which partnership was a party (*i.e.*, the type of transaction covered by Treas. Reg. §1.358-7). This construction is not unreasonable, but it is not the only possible interpretation of the language of section 309(c).

Section 358(h)(3) is definitional in nature,[65] thus, CRTRA §309(c) can be read as follows, “The Secretary … shall prescribe rules … under Subchapter K … to prevent the acceleration or duplication of losses through the assumption … of [any fixed or contingent obligation to make payment] in transactions involving partnerships.” When construed in this manner, the phrase “in transactions involving partnerships” does not carry with it a requirement that the participating partnership be a party to a corporate exchange. This construction is consistent with the rules embodied in Treas. Reg. §1.752-6.

Like the court in *Klamath*, the *Sala* court bottomed its holding on the fact that Congress did not specifically amend section 752 to incorporate the contingent liability language of section 358(h)(3), nor did it specifically reference section 752 in CRTRA §309(c). However, neither did Congress clearly indicate an intention to limit the scope of section 309(c) to only those situations described in Treas. Reg. §1.358-7. Under *Chevron* had Congress done either, that would have ended the matter.

Chevron mandates that when Congress does not unambiguously and directly address the precise question at issue, the Secretary may issue regulations filling the gap. Once the Secretary has done so, a court may not construe the statute to its own liking, to the exclusion of another permissible construction. Rather, the Secretary's interpretation will control unless it is "arbitrary, capricious, or manifestly contrary to the statute."

In *Stobie Creek*, *Sala* and *Klamath*, each court determined that the intent of Congress was clear and unambiguous that the grant of authority to issue regulations pursuant to CRTRA §309(c) extended only to those transactions that involved the acceleration or duplication of losses where a partnership or partner was a party to a corporate exchange, such as, the transferor of property to a controlled corporation pursuant to section 351. Having so held, the decision not to treat Treas. Reg. §1.752-6 as a valid exercise of the Secretary's authority is consistent with *Chevron*.

As noted above, it is an open question as to whether CRTRA §309(c) provides direct unambiguous direction on this issue. In that case all three courts would have erred, because in effect they would have preferred their construction of the statute over that of the Secretary, an approach specifically rejected in *Chevron*.

(C) *If Treas. Reg. §1.752-6 Is Interpretive In Nature, Does It Represent a Valid Exercise of the Secretary's Authority Under Section 7805?*

There can be no doubt that the Secretary had the authority to make a prospective change in the regulations under section 752 to force a reduction of basis for contingent liabilities.[66] The only requirement is that the regulation represents a reasonable interpretation of the underlying statute. If the interpretation is a reasonable one, a court may not substitute its judgment for that of the Secretary.[67] The focus, therefore, is on the Secretary's efforts to make the regulation retroactive.

Section 7805(b)(3) can only apply if the regulation was issued to "prevent abuse." There can be no question that Treas. Reg. §1.752-6 satisfies this requirement. The type of transactions at issue in the cases that have addressed the validity of these regulations are clearly abusive in nature.[68] In order for a regulation to have retroactive effect under section 7805(b)(3) the regulation must interpret or construe a post July 30, 1996 statute.

The problem is not one of timing, but rather what part of the CRTRA would the regulations purport to interpret. If the regulation was issued pursuant to the lawful exercise of the authority granted the Secretary under section 309(c) of the CRTRA, then it would be a legislative regulation and by virtue of section 309(d) would be retroactive to October 18, 1999.[69]

If, however, as determined by the courts in *Klamath*, *Sala* and *Stobie Creek*, the regulation was not legislative in nature then the Service could not rely on section 309(c) as the predicate statute. Under *Chevron*, the opinions of those courts can only stand if section 309(c) represented a clear and unequivocal expression of Congressional intent that only transactions of a type described in Treas. Reg. §1.358-7 were intended to be within its scope. If that is the case, it is difficult to envision how Treas. Reg. §1.752-6 could be found to "harmonize with the plain language of the statute, its origin, and its purpose."[70] It would also be unlikely that the regulation could satisfy even the more liberal standard of *Chevron* – that it simply be a reasonable interpretation of the statute.

Thus, if Treas. Reg. §1.752-6 is interpretative in nature, the only way it can have retroactive effect is to satisfy the requirements of Old Section 7805(b). Under that provision, all regulations are retroactive unless the Secretary provides otherwise. The Secretary could have, for example, allowed the regulation to be valid back to the date of the enactment of section 752, or he could have, as he did, picked a later point in time.[71] Had Congress not enacted CRTRA §309(c), it is likely that the Secretary would have made the regulations retroactive to the date of the release of Notice 2000-44. Regardless of the earlier date chosen, the Internal Revenue Service would need to establish that the decision not to apply the regulation prospectively did not constitute an abuse of discretion.

As noted in *Anderson, Clayton*, there are a number of "factors" that shape the consideration of this issue. In *Klamath*, the court examined each of the "factors" articulated by the Fifth Circuit in a structured fashion. The other courts that have passed on Treas. Reg. §1.752-6 did so by applying a more flexible approach. Regardless of the mechanics applied to the analysis, it is clear that the principal concerns were – (a) whether prior law was settled, (b) the extent that the regulation altered prior law, (c) the taxpayers' justifiable reliance on that prior law, and (d) whether giving the regulation retroactive effect would produce an inordinately harsh result.

Klamath, *Sala* and *Stobie Creek* held that *Helmer*[72] and its progeny[73] represented a well established body of law which called for contingent liabilities to be excluded from the calculation of basis under section 752. In seeking to establish that the law was not settled, the court in *Maguire Partners* noted that the Secretary relied on Rev. Rul. 88-77,[74] Rev. Rul. 95-26[75] and *Salina Partnership v. Commissioner*[76] in issuing Treas. Reg. §1.752-6.[77]

In *Kornman v. Commissioner*,[78] the Fifth Circuit adopted the reasoning of Rev. Rul 95-26 in concluding that an obligation to replace borrowed securities and to close a short sale gave rise to a liability. In so doing, the court rejected the taxpayer's reliance on *Helmer*. The *Kornman* court also found that "[t]he initial short sale that generates the cash proceeds and the subsequent covering transaction are inextricably intertwined."[79] Citing *Kornman*, the court in Maguire Partners held that applying "the *Helmer* line of cases to this case would … '[f]ly in the face of reality' and result in an 'unwarranted aberration'"[80] While the Secretary did not follow *Helmer* line of cases in promulgating Treas. Reg. §1.752-6, even assuming that these cases constituted settled law it is questionable that there was a major alteration to that prior law given the fundamental factual differences between *Helmer* and cases such as *Klamath*, *Sala* and *Stobie Creek*, *Cemco* and *Maguire Partners*.

The question of alteration really comes down to whether the taxpayers/partnerships at issue in the Treas. Reg. §1.752-6 cases justifiably relied on the *Helmer* line of cases and whether the "change" effectuated by the regulation caused them to suffer an inordinately harsh result. A logical way to pose the first question is – Is a taxpayer justified in relying on a case that excluded from basis consideration an option granted to purchase property owned by a partnership, when the actual transaction they engaged in was the contribution to a partnership of a long option and a short option (the proceeds from which were used to acquire the long position) and the failure to treat the short option as a liability resulted in a multimillion dollar inflation of the basis of the long option position? With respect to the second point, the question is – Does the denial of the claimed tax benefits that flow from such a transaction, constitute an inordinately harsh result? If the answer to both questions is yes, the Secretary was not justified in making the regulation retroactive. If the answer to either is no, the regulation should properly be given retroactive effect.

As the CRTRA is not considered as authority for the issuance of Treas. Reg. §1.752-6, the only remaining question is – How far back can the Secretary go in making the regulation retroactive? Conceivably, there would be no limit on its retroactivity assuming that the law was not "settled." If the law is considered settled, than the question is – At what point would someone engaging in an "inflated basis" transaction be considered as having notice of the "change?" The question could be posed alternatively as – Was the Secretary's selection of October 18, 1999 as the limitation on retroactive effect supportable? An argument could clearly be made that given the nature of the transactions (*i.e.*, the creation of losses by inflating basis) that anyone considering entry into this type of transaction should have had pause for concern in light of the Congressional disapproval of "basis inflation" as embodied in section 358(h) and the directive in CRTRA §309(c) that "comparable" regulations be issued in the Subchapter K arena.[81]

Failing that, the question is, should retroactivity be permitted back to August 14, 2000, the date the Service issued Notice 2000-44. Arguably, Notice 2000-44 does not satisfy the requirements of section 7805(b)(1)(C) which permits retroactive application of a regulation to the date when the Secretary issues "any notice substantially describing the expected contents of any temporary, proposed, or final regulation." Query, whether this section is even applicable since the efficacy of Notice 2000-44 must be measured under the abuse of discretion standard attendant in Old Section 7805(b). There can be little question that Notice 2000-44 was intended to put taxpayers on notice that "inflated basis" transactions would not be respected. Since the question under Old Section 7805(b) was one of justifiable reliance, the issue would be whether a taxpayer would be justified in relying on the *Helmer* line of cases, when the Service has indicated that "questionable transactions" such as those described in Notice 2000-44 would not be respected.

IV. CONCLUSION

It would appear that the Service has the better of the arguments regarding the validity of Treas. Reg. §1.752-6. Under *Chevron*, because of the explicit direction to fill a gap in the statute and because section 309(c) of the CRTRA appears to be ambiguous, the regulation is a "permissible construction" of that provision. By virtue of section 309(d) its retroactivity to October 18, 1999 is justified pursuant to section 7805(b)(6). Alternatively, under either *Chevron* or *National Muffler*, the Service again has the better argument that it is a valid interpretive regulation. Finally, the Service has the better argument under Old Section 7805(b), that the regulation should be retroactive in effect.

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1 2009 U.S. Dist. LEXIS 8361, 103 AFTR 2d 2009-763 (C.D. Ca. 2009)

2 515 F.3d 749 (7th Cir 2008), *cert. denied*, 129 S. Ct. 131 (2008)

3 82 Fed. Cl. 636 (2008). In *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516 (2009), the Court of Federal Claims again held that Treas. Reg. §1.752-6 was invalid.

4 552 F. Supp. 2d 1167 (D. Co. 2008), *appeal docketed* (10th Cir. 9/12/2008)

5 440 F. Supp. 2d 608 (E.D. Tex. 2006), *reh. denied*, 99 AFTR 2d (E.D. Tex. 2007), *aff'd in part and rev'd and rem'd in part*, 568 F.3d 540 (5th Cir. 2009)

6 *See*, IRC §7805(b), prior to amendment by Pub. L. No. 104-168 (hereafter "Old Section 7805(b)")

[7] IRC §7805(b) was made effective July 30, 1996 for regulations pertaining to statutory provisions enacted after that date. Thus, if a statutory provision was added to the Internal Revenue Code in 1995, any regulations relating to its provisions would be subject to the rules of Old Section 7805(b).

[8] Procedural regulations, which address internal IRS operating procedures, are not relevant to this paper and will therefore not be discussed herein.

[9] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984)

[10] The best known of these are the consolidated return regulations issued pursuant to the authority granted the Secretary by section 1502.

[11] 467 U.S. at 844. An example of a conflict with the statute that would lead to a legislative regulation being held to be invalid would be an effort by the Secretary to treat an item of income as taxable when another provision of the Internal Revenue Code would provide that the same item was exempt from tax. *See, e.g., Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242 (1959), *acq.*, 1960-2 C.B. 7

[12] 467 U.S. at 842-43

[13] 467 U.S. at 843

[14] Any regulation inconsistent with the clearly expressed intent of Congress is invalid. 467 U.S. at 842-43

[15] 467 U.S. at 844, wherein the Supreme Court stated, "[s]ometimes the legislative delegation to an agency on a particular question is implicit, rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.

[16] 553 U.S. 218 (2001)

[17] 553 U.S. at 228. Letter rulings are administrative interpretations issued by the Internal Revenue Service without formal review. Pursuant to section 6110(k)(3), they may not be cited as precedent. Furthermore, they can only bind the Service with respect to the taxpayer to whom they are issued. As

such, they are at the opposite end of the spectrum from Treasury regulations.

[18] Instead, it held that the classification ruling before it might be entitled to some deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). The Supreme Court, therefore, vacated the decision of the Federal Circuit Court of Appeals and remanded the case to the lower court for further proceedings consistent with its opinion.

[19] Writing for the majority in *Mead*, Justice Souter stated:

> This Court in *Chevron* recognized that Congress not only engages in express delegation of specific interpretive authority, but that "[s]ometimes the legislative delegation to an agency on a particular question is implicit." Congress, that is, may not have expressly delegated authority or responsibility to implement a particular provision or fill a particular gap. Yet it can still be apparent from the agency's generally conferred authority and other statutory circumstances that Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which "Congress did not actually have an intent" as to a particular result. When circumstances implying such an expectation exist, a reviewing court has no business rejecting an agency's exercise of its generally conferred authority to resolve a particular statutory ambiguity simply because the agency's chosen resolution seems unwise, but is obliged to accept the agency's position if Congress has not previously spoken to the point at issue and the agency's interpretation is reasonable. (Citations omitted). 553 U.S. at 229

See, also, *United States v. Haggar Apparel Co.*, 526 U.S. 380 (1999), wherein the Supreme Court held that Customs regulations are entitled to *Chevron* deference. For a diametrically opposed view see the dissent of Judge Vasquez in *Estate of Gerson v. Commissioner*, 127 T.C. 139, 174-75 (2006), *aff'd*, 507 F.3d 435 (6th Cir. 2007) . Judge Vasquez would hold that *Mead* changed the landscape with respect to the deference accorded interpretative regulations effectively overruling *Chevron*, *National Muffler* and *Vogel Fertilizer* by substituting instead a lesser degree of deference more consistent with that articulated in *Skidmore*.

[20] 440 U.S. 472 (1979). Some of the factors to be considered include whether the regulation is a substantially contemporaneous construction of the statute, the manner in which it evolved, the length of time the regulation has been in effect, the reliance placed on it, and the consistency of the Secretary's interpretation, the degree of Congressional scrutiny the regulation received during any subsequent reenactment of the statute.

[21] 455 U.S. 16 (1982)

[22] 440 U.S. at 477

[23] The court in *Vogel Fertilizer* stated that "[d]eference is ordinarily owing to the agency construction if we can conclude that the regulation 'implement[s] the congressional mandate in some reasonable manner.'" (Citations omitted). 455 U.S. at 24

[24] 455 U.S. at 24

[25] In his dissenting opinion, Justice Blackmun found ambiguity to exist both in the language of section 1563 and its legislative history, stating that while the Secretary's "interpretation is [not] compelled by the legislative materials … it is not 'unreasonable or meaningless.'" Consequently he would have held the regulation valid because "[t]he choice among reasonable interpretations is for the Commissioner, not the courts." (Citations omitted). 455 U.S. at 39

[26] *See, e.g*., *Lewis v. Commissioner*, 128 T.C. 48, 54 (2007)

[27] 515 F.3d 162, 164 (3d Cir. 2008), *rev'g*, 126 T.C. 96 (2006)

[28] *See, also, Bankers Life and Casualty Co. v. United States*, 142 F.3d 973 (7th Cir. 1998) ("the structure of *Chevron* encourages a court to defer rather than to interpret. We, therefore, prefer it."); *Peoples Federal Savings & Loan Association of Sidney v. Commissioner*, 948 F.2d 289, 304–05 (6th Cir. 1991) (abandoning *National Muffler* and adopting *Chevron*). *Compare*, *McNamee v. Department of the Treasury*, 488 F.3d 100 (2nd Cir 2007) (applying *Chevron* while also citing *National Muffler* in discussing the

deference accorded regulations promulgated under section 7805); *Snowa v. Commissioner*, 123 F.3d 190 (4th Cir. 1997) (applying both *Chevron* and *National Muffler* without distinction); *Norwest Corp. v. Commissioner*., 69 F3d 1404 (8th Cir. 1995) (applying both *Chevron* and *National Muffler* without distinction); *Nalle, III v. Commissioner*., 997 F.2d 1134 (5th Cir. 1993) (applying *National Muffler* and limiting *Chevron* deference to legislative regulations).

[29] Section 7805(b)(2) provides an exception to this rule for regulations filed or issued within 18 months of the date the statutory provision to which the regulation relates is enacted.

[30] The legislative history is of little help in answering this question as Congress simply repeated the exceptions to retroactivity set forth in the statute. H. Rept. No. 104-506

[31] *See*, *e.g*., *Chock Full O' Nuts Corp. v United States*, 453 F.2d 300, 302-03 (2d Cir. 1971)

[32] *See*, *e.g*., *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957). *See, also*, *CWT Farms, Inc. v. Commissioner*, 755 F.2d 790, 802 (11th Cir. 1985), *cert denied*, 477 U.S. 903 (1986) ("abuse of discretion may be found where the retroactive regulation alters settled prior law or policy upon which the taxpayer justifiably relied and if the change causes the taxpayer to suffer inordinate harm."); *c.f.*, *International Business Machines Corporations v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert denied*, 382 U.S. 1028 (1966) (which, in the context of rulings issued under the authority granted by section 7805(b) emphasized the importance of treating similarly situated taxpayers equally).

[33] 562 F.2d 972 (5th Cir. 1977)

[34] 562 F.2d at 981

[35] 98 F.3d 194 (5th Cir. 1996), *cert. denied*, 522 U.S. 821 (1997)

[36] 98 F.3d at 202

[37] 98 F.3d at 202-03

[38] 98 F.3d at 203

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[39] 98 F.3d at 203 ("the test for the validity of retroactive effect of statutes and regulations affecting economic policy embodies a search for arbitrariness or irrationality, which turns on the presence or absence of a rational legislative purpose").

[40] *See, e.g., Helvering v. R. J. Reynolds Tobacco Co*., 306 U.S. 110 (1939)

[41] 381 U.S. 68, 74 (1965). *See*, *also*., *Automobile Club of Michigan v. Commissioner,* 353 U.S. 180 (1957); *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627 (1979) (correction of regulation through retroactive application of a new example to replace earlier erroneous one).

[42] *But compare, CWT Farms, Inc. v. Commissioner*, 755 F.2d 790 (11th Cir. 1985), *cert denied*, 477 U.S. 903 (1986) (reliance on promise found in Internal Revenue Manual not justified); with *Gehl Co. v. Commissioner*, 795 F.2d 1324 (7th Cir. 1986); *LeCroy Research Systems Corp. V. Commissioner*, 751 F.2d 123 (2nd Cir. 1984); *Addison International Inc. v. Commissioner*, 90 T.C. 1207, *aff'd*, 887 F.2d 660 (6th Cir. 1989) (reliance on same provision in the Internal Revenue Manuel held to be justified).

[43] *Helvering v. Reynolds*, 313 U.S. 428, 433 (1941) ("The fact that the regulation was not promulgated until after the transactions in question had been consummated is immaterial.").

[44] Wilson v. United States, 588 F.2d 1168 (6th Cir. 1978)

[45] In *Anderson, Clayton*, the Fifth Circuit observed that "the Commissioner may not take advantage of his power to promulgate retroactive regulations during the course of litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations." The court went on to note however, that "[n]o case has held that the Secretary abused his discretion to promulgate retroactive regulations merely because the regulation at issue affected a legal matter pending before a court at the time the regulation was adopted" 562 F.2d at 980. *Cf.*, C*hock Full O' Nuts* wherein the Second Circuit noted that regulations issued to "bootstrap" the Services litigation position may not represent "a valid exercise of the Commissioner's power to promulgate retroactive regulations." 453 F.2d at 303

[46] Pub. L. No. 106-554

[47] The conference report discussing section 309(c), H.R. Conf. Rept. No. 106-1033), adds little to the statutory language as it simply states:

> The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships.

[48] See, e.g., T.D. 9207 (May 24, 2005) (Summary of comments on Treas. Reg. 1-752.6T).

[49] As such, the *Sala* court erred by testing the regulation under *National Muffler* instead of *Chevron*. The *National Muffler* standard ("whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose"), to the extent not entirely preempted by *Chevron*, is only applicable in the case of interpretative regulations.

[50] 467 U.S. at 844

[51] In *Klamath*, the district court held the regulation to be interpretive in nature. The *Klamath* court determined that as an interpretive regulation Treas. Reg. §1.752-6 could not be applied retroactively to transactions entered into prior to August 11, 2000 the date Notice 2000-44 was issued. The court, however, declined to rule on the validity of the regulation with respect to transactions entered into after August 14, 2000 as no such transaction was before it. 440 F. Supp. 2d at 625, n.13. The district court in *Sala* also determined that Treas. Reg. §1.752-6 was not a legislative regulation, but rather, once again, was an interpretative one. The *Sala*, court held that the regulation was "unlawful [and] set it aside" because it found the regulation to be "contrary to the underlying statutes." 552 F. Supp. 2d at 1203. The Court of Federal Claims in *Stobie Creek* similarly denied legislative regulation status to Treas. Reg. §1.752-6, holding it invalid because the general abuse provision of section 7805(b)(3) was inapplicable and the issuance of Notice 2000-44 was not sufficient to advise taxpayers of the change in position from established legal principles.

[52] 2000-2 C.B. 255

[53] The CRTRA was introduced in the House on December 14, 2000 as H.R. 5662, which was then incorporated by reference into H.R. 4577. H.R. 4577 passed the House and the Senate on December 15, 2000. The conference report on H.R. 4577 (H.R. Conf. Rept. No. 106-1033) was filed in the House on that same day.

[54] The *Sala* court declared the regulation not to be "comparable" because it failed to take into account the fact that the related long option position was also contributed to the partnership. 552 F.3d at 1199-1200

[55] The relevance of section 358(h)(2) is questionable in determining whether the regulations ostensibly issued under CRTRA §309(c) are "comparable."

[56] The court's importation of the section 358(h)(2) exceptions without giving effect to this limiting language denied the Secretary a right specifically granted to him by Congress.

[57] 552 F. Supp. 2d at 1200

[58] 82 Fed. Cl. at 670

[59] 82 Fed. Cl. at 670

[60] The legislative history of CRTRA §309 is clear that section 358(h) "does not change the tax treatment with respect to the transferee corporation." Thus, a corporation continues to utilize its shareholder's basis in the asset, without reduction for any liability, fixed or contingent.

[61] The loss "duplication" that section 358(h) addresses is the result of the "double-tax" regimen of Subchapter C. Anytime a transfer takes place pursuant to section 351, gain, income or loss is potentially duplicated because of the separate taxable entity status of a corporation. Subchapter K, on the other hand, is concerned with flow-through entities (i.e., those that are not taxpaying entities). The possibility of loss duplication does exist in the context of a partner or partnership that acquires stock in a transaction within the scope of section 351, albeit on a smaller scale. *See*, Section III(B)(4), *infra*.

[62] Prior to the enactment of CRTRA §309(a), the transfer by a partnership of its assets and liabilities was governed by section 351, and the transferor

partnership's basis in the stock received was determined under section 358. This was unchanged by section 309(a). Section 358(h) would cause the basis of the stock a transferor partnership received to be reduced to its fair market value, in the same manner as it would an individual transferor's stock basis. Thus, a sale by the transferor partnership of the stock would not result in the acceleration or duplication of any loss. Similarly, if the partnership were to distribute the stock to a partner in a non-liquidating distribution, there would be little, if any, potential for the acceleration or duplication of any loss as the distributee partner would take as his basis in the stock the lesser of his basis in the partnership or the partnership's basis in the stock. *See*, Section 732(a). The only situation that presents a meaningful possibility for either the acceleration or duplication of a loss is where the partnership itself is liquidated (or the interest of a specific partner is liquidated) and the stock received by the partnership is distributed to the partners or a partner. In that case, the distributee partner will take as his basis in the stock, his basis in his partnership interest. *See*, Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 1). Prior to the issuance of Treas. Reg. §1.358-7(b), the partner's basis in his interest would not have been reduced by a contingent liability. Thus, a partner would have effectively "stepped-up" his basis in the stock received by the partnership and distributed to him in liquidation of his interest in the partnership. This "step-up" would have created the possibility of an acceleration or duplication of a loss by inflating the basis of the stock he received.

[63] For example, the Secretary could have addressed this potential for abuse through the exercise of his general authority under section 7805(a) and made any regulation retroactive pursuant to his authority under section 7805(b)(3).

[64] The court had earlier addressed the meaning of the phrase "acceleration or duplication of losses." *See*, Section III(B)(3), *supra*. In addition, it also had earlier addressed the absence of a specific reference to section 752. *See*, Section III(B)(1), *supra*.

[65] See, H.R. Conf. Rept. No. 106-1033 which refers to "the assumption of liabilities (<u>as defined in the provision</u>) in transactions involving partnerships." (Emphasis added)

[66] This action is generally consistent with the Congressional action in attempting to curb efforts to create non-economic losses which would then be deducted for tax purposes by inflating basis. As noted, by the court in

Cemco, the regulation "instantiate[s] the pre-existing norm that transactions with no economic substance don't reduce people's taxes." 515 F.3d at 752

[67] 467 U.S. at 844

[68] We are aware that the court in *Sala* respected the underlying transactions and sanctioned the created loss in that case. We believe that the *Sala* court made numerous errors in reaching the result that it did and that *Sala* will be reversed on appeal. A discussion of the District court's opinion is beyond the scope of this article.

[69] *See*, Section 7805(b)(6)

[70] 440 U.S. at 477

[71] The Secretary's decision to make the regulation retroactive to October 18, 1999 makes sense given his overall reliance on CRTRA §309(c).

[72] T.C. Memo 1975-160. The transaction at issue in *Helmer* was the status of option payments held to have been received by the partnership and then distributed to the partners. The option payments were not refundable by the partnership and the partnership's only obligation was to apply them against the sales price of property owned by the partnership which was the subject of the option. The Internal Revenue Service argued that any liability under the option was "contingent" and could not be used to increase the partner's basis. As a result the partners were required to report a gain under section 731. The property in *Helmer* was already owned by the partnership when the option was granted. Thus, the option and the property were not contributed to the partnership in the same transaction.

[73] *Long v. Commissioner*, 71 T.C. 1 (1978), *aff'd and remanded*, 660 F.2d 416 (10th Cir. 1981); *LaRue v. Commissioner*, 90 T.C. 465 (1988); *see, also, Gibson Products Co. v. United States,* 637 F.2d 1041 (5th Cir. 1981).

[74] 1988-2, C.B. 128

[75] 1995-1 C.B. 131

[76] T.C. Memo 2000-352

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[77] The Seventh Circuit in *Cemco* made short shrift of the plaintiff's efforts to rely on *Helmer*, stating "Cemco says that in treating $50,000 of euros as having a $3.6 million basis which turned into a loss … it was just relying on *Helmer* …. That may or may not be the right way to understand *Helmer*; we need not decide, for it is not controlling in this court – or anywhere else." 515 F.3d at 751

[78] 527 F.3d 443 (5th Cir. 2008). *Kornman* involved similar option spread transactions. While the court acknowledged the Service's reliance on Treas. Reg. §1.752-6, it declined to address its validity noting that it had found that the short sale created a liability based upon its reading of section 752 and Treas. Reg. § 1.752-1(a)(4)(i). 527 F.3d at 462

[79] 527 F.3d at 460-61. *See*, *also*, *Maguire Partners*, 103 AFTR 2d at 773-775 (applying the step-transaction doctrine to establish that the long option, short option and the AIG note were interlocking obligations that created the "bet" the taxpayer claimed he was attempting to take advantage of); *Jade Trading v. United States*, 80 Fed. Cl. 11 (2007), *reh. denied*, 81 Fed. Cl. 173 (2007), *appeal docket* (Fed Cir. 2/26/2008)

[80] 103 AFTR 2d at 776

[81] *Cf.*, *CWT Farms*, quoting, *Wendland v. Commissioner*, 739 F.2d 580 (11th Cir. 1972) and citing *Helvering v. Reynolds* and *Chock Full O' Nuts* (proposed regulations should have put taxpayer on notice where he engaged in "questionable transactions") 755 F.2d at 804