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NORTH EAST JOURNAL OF LEGAL STUDIES

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ARTICLES

PEDAGOGY

THE EVOLUTION OF FORSEEABILITY IN THE COMMON LAW OF TORT

By

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INTRODUCTION

"Proof of negligence in the air, so to speak, will not do."[1]

In the long, rich, dense, and circuitous history of the common law, no cause of action is so fraught with legal intrigue and controversy as tort law. Within tort law, no case has generated so much of that legal and intellectual intrigue as *Palsgraf v. Long Island Railroad*.[2] As every first year law student learns, Judge Cardozo, writing for the majority, and Judge Andrews, writing for the dissent, have a classic battle of the titans in arguing whether *foreseeability* is intertwined in the legally-determined duty or whether it is a component of the factually-decided proximate cause. *Palsgraf* creates a number of legal questions which reflect back on, and determine the future of common law torts. Let's begin with the classic overview of *Palsgraf*.

PALSGRAF V. LONG ISLAND RAILROAD[3]

Two employees of the defendant, the Long Island Railroad, were helping a late-arriving passenger onto his train

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when their actions caused the passenger to drop a package containing fireworks. The fireworks exploded and the shock wave caused a scale at the other end of the platform to fall, injuring Mrs. Helen Palsgraf. Palsgraf sued successfully and prevailed on appeal as well. The New York Court of Appeals, comparable to every other state's Supreme Court, reversed by a 4-3 decision, with Judge Cardozo writing for the majority and Judge Andrews writing for the dissent.[4]

The gist of the decision was not whether *foreseeability* was a requirement in determining tort liability, but where that *foreseeability* was placed, so to speak. Cardozo argued that foreseeability is part and parcel of the determination of duty, and as such, is an issue of law. To that end, Cardozo opined that the foreseeability requirement was not met, as a matter of law.[5] Andrews argued that *foreseeability* is part and parcel of causality, specifically proximate cause, and subject to a jury's finding.[6] As such, he argued that the trial jury found for Palsgraf, affirmed on appeal, and thus the judgment should be affirmed by the state's highest court.

These arguments beg the questions of when, how and why did *foreseeability* make an appearance in tort theory.

STRICT LIABILITY OR NEGLIGENCE

The source of the common law of torts comes from the ancient English legal theory of the writ of trespass.[7] It is argued that this writ may have evolved from the appeal of a felony since trespass required an action be alleged to have occurred "with force and arms" (*vi et armis*). The writ also provided for a jury trial and money damages.[8] Rather than an innovative development by the royal courts, it is thought that royal courts, in recognizing this writ, were merely reflecting what local courts had recognized traditionally. By the fourteenth century, the requirement of "with force and arms" had disappeared with the recognition of the write of trespass on the case.[9] It is interesting to note that this writ of trespass on the case would lead to the modern tort of negligence, common law of contract via the writ of assumpsit, property law via the writ of ejectment, and the modern theory of restitution.[10]

Rather than travel through the winding, tortuous (pun-intended) route of tort law's evolution from the fourteenth century until now, let's start with the notion that "[t]he English law of torts—like the law of contract—was quite underdeveloped in the eighteenth century."[11] Common law rules of evidence prohibited both the victim and the tortfeasor, as parties in interest, from testifying. Such testimony was generally crucial to trial success. Likewise, in what we would now call medical malpractice, the plaintiff had to survive in order to pursue an action, a questionable condition in light of the medical crudity of the times.[12]

It seems that prior to the advent of negligence as the driving causation of tort, tort law reflected more of a strict liability approach, which could be schematically reflected as Action=>result=>injury. Thus, the actor is liable for the resulting injury so long as the injury is causally related to the action committed. It seems that the relationship between Action and Result is a strict liability one, i.e. Action-causes-result (regardless of how and why). The causality issue then is viewed as "result=>not-too-remote injury," whatever "not-too-remote" means. "It is the general principle, that every person is liable for the consequences of his own acts; he is thus liable in damages for the proximate results of his own acts, but not for remote damages."[13] So, the "Action" is not required to be a *negligent* action, but *any* action. The strict liability here is in the breach of duty, not the causality of injury. As one commentator notes rather definitively:

> …prior to 1850 remedies for civil wrongs were governed by common law principles of strict liability…Fault was irrelevant in trespass actions and proximate cause as a concept was nonexistent. Defendants were strictly liable for trespass injuries. Indirect injuries, those that occurred as a consequence of the defendant's actions but not because of direct physical contact, could be compensated for by using "trespass on the case."[14]

What caused the relatively rapid shift from strict-liability to negligence in the late nineteenth century? The often-cited Morton J. Horowitz argues that the fault theory of negligence was not established in American tort law until "nineteenth century judges sought 'to create immunities from legal liability and thereby to provide substantial subsidies for those who undertook schemes of economic development.' The modern notion of negligence, then, was incorporated into tort law by economically motivated judges for the benefit of businessmen and business enterprises."[15] Lawrence Friedman supports Horowitz's contention in arguing that negligence-based tort liability "has to be attributed to the industrial revolution—to the age of engines and machines [which] have a marvelous capacity to cripple and maim their servants."[16] "According to Friedman, nineteenth-century judges believed that holding business strictly liable for all of the injuries they caused could have drained them of their economic blood. Consequently, these judges reduced tort liability to a standard of ordinary care 'to limit damages to some modern measure' so that capital could 'be spared for its necessary work.'"[17]

However, Kaczorowski vehemently disagrees with Horowitz's conclusion in his exhaustive review of historical tort law.[18] His rationale, though, is a bit confusing. He argues that the shift to negligence-based tort liability and away from strict liability is a result of changing public policy of "economic interests of society generally, not the interests of particular classes," apparently referring to "business" as a "particular class."[19] Kaczorowaki writes

> As societal conditions changed, the judicial application of these principles and policies changed accordingly to achieve the same public policies. Judicial instrumentalism, understood as judges formulating, modifying, and changing rules to achieve desirable goals of public policy, was characteristic of the common-law system for centuries. It was not new or unique to the nineteenth century as some legal historians, such as Morton Horowitz, have argued.[20]

He further claims that "modern tort law was not the creation of judges in nineteenth century America trying to protect business interests and to promote economic development."[21] Yet, in a paragraph before this conclusion and as referred to above, he notes "[j]udges also sought to promote economic activity as a social good. However, they used tort law to protect and promote the economic interests of society generally, not the interests of particular classes."[22] Kaczorowski does an excellent job in identifying the use of negligence in tort liability prior to the nineteenth century.[23] However, an argument can be that the preponderance of using negligence in tort liability did not fully come into its own until the latter part of the nineteenth century. Maybe the difference here is so nuanced that the differentiation is not clear. But there are two "clear" conclusions to be drawn from this debate:

1) The mid- to –late nineteenth century saw a clear shift in tort theory away from strict liability and towards negligence; and
2) Whether intended or coincidental, the result of this shift clearly aided business and economic development.

It seems that by fast-forwarding fifty to sixty years or so, history can determine that this development foreshadows the legal realism attack on classical formalism in formalistic contract areas, such as estoppel theories. If, as Morton claims, these judges were social engineers, so to speak, then they did indeed lay the foundation for legal realism's practical result-oriented views leading us to believe that the tort liability shift was indeed deliberate and designed for the economic result which actually manifested itself. The timing is simply too coincidental to conclude otherwise. Now, as to whether judges crafted the negligence theory out of new, whole cloth, as Morton may be implying, or whether it was the coming together of centuries of tort evolution at this specific time is a topic for a legal historian, which both of these scholars are, but for our purposes, it is essentially an interesting side note.

THE EMERGENCE OF FORESEEABILITY

It seems that "foreseeability" may have been in the law from very early times in tort evolution, but simply unrecognized as such. Even though Frances Bacon referred to something like "foreseeability" and even more specifically "proximate cause" in his early seventeenth century maxim *in jure non remota causa, sed proxima specatatur,*[24] the maxim was not cited in any legal opinion until the mid-nineteenth century.[25] As the previous section of this paper indicates, tort-like damage theory was rooted in a strict liability foundation.

As Pollock and Maitland identify during the reign of Henry I in the *Leges Henrici* "[d]amages which the modern

English lawyer would assuredly describe as 'too remote' were not too remote for the author of the *Leges Henrici*."[26] However, we begin to see cracks in the wall of strict liability in the late eighteenth century, a full hundred years prior to the clear rise of the articulation of foreseeability in tort theory. These cracks begin to show in the often-cited case of Scott v. Shepherd,[27] known more famously as the "squib case."

The case involves a youth, Shepherd, who tossed a lit squib into a public market area. A squib is a miniature explosive, much like a moderately powerful firecracker. It landed on the table of a gingerbread dealer who immediately tossed it away onto another merchant's table. That merchant quickly tossed it as well when it hit and exploded, injuring one Mr. Scott, who lost an eye as a result of the explosion. Scott sued Shepherd in trespass. The question before the court on Shepherd's appeal raised a number of issues: 1) does the action sound in trespass or trespass on the case?; 2) are the consequences two remote for liability to vest in Shepherd?; 3) does the third party intervener rule provide a defense for Shepherd?

A divided court affirmed the judgment for Scott over the dissent of none other than Judge Blackstone. Blackstone points out that trespass lies for immediate or direct damages while trespass on the case lies for any kind of consequential damages. Thus, Blackstone states that the matter must be dismissed in that it sounds in trespass. However, even more interesting is that Blackstone argues that if the case sounds in trespass on the case because the damages are both too remote and subject to the third party intervener defense with the two merchants who tossed the squib after Shephard's original toss.

However, the majority relies on "strict liability" in rejecting Blackstone's rationale in a two-pronged argument: 1)

Shepherd is liable in a strict-liability argument in that ". . .he who does the first wrong is answerable for all the consequential damages. . ."[28]; 2) since the original act, the throwing of the squib into a public place, is an unlawful act, the miscreant is responsible for all results.[29] This hardly raised the specter of foreseeability. However, it is Blackstone's dissent that creates the "first chink in the wall," so to speak, but it is intermingles with a significant question regarding the form of the action. Does he rely on a concept of foreseeability or third party intervener or some hybrid of the two? In his dissent he cites

> Suppose several persons are playing at foot-ball [sic], which is tossed by many, and at last breaks windows; trespass *vi at armis* will only against the man who struck it against the windows.[30]

Is Blackstone saying here that the injury to the third party is too remote for an action to lie against the original assault? If so, we have the presence of "foreseeability." Or, is he referring more to the form of the action: trespass versus trespass on the case? He seems to rest his ultimate conclusion on the form of the action; however, his dicta clearly states that he believes that an action on the case would fail under a remoteness or third party intervener analysis. Blackstone's opinion does seem to follow contemporary English legal precedent that

"A line of distinction" between trespass and case settled in Reynolds v. Clarke

> [T]hat, where the *immediate act itself* occasions a prejudice, or is an injury…the proper remedy is by action of trespass *vi et armis*; but, where the *act itself* is not an injury, but a *consequence* from that act is prejudicial to the plaintiff's person, etc his remedy is by an action on the case.[31]

Perhaps the question of when *forseeability* arose lies in the distinction between trespass/trespass on the case and the rise of negligence. Strict liability, and conversely the lack of a foreseeability requirement, did not require the proof of foreseeability as a necessary element to prevail on a trespass or on the case action.[32]

POST PALSGRAF

In American tort law, clearly *Palsgraf* was a game changer. Courts rushed to establish formulas and standards to use to insure that there was no longer unlimited liability for any of the potentially accused. Many of the cases that established modern tort law involve the shipping and transportation industries, which were the most lucrative and potentially dangerous in the early twentieth century. Competing legal theories soon emerged as courts continually cited foreseeability as the reasoning for their decisions but lacked any existing theory to justify their decisions.

Noted legal theorist Leon Green wrote *The Rationale of Proximate Cause* in 1927 which established that any tort has six requisite elements: "(1) An interest protected, (2) against the particular hazard encountered, (3) by some rule of law, (4) which the defendant's conduct violated, (5) thereby causing, (6) damages to the plaintiff."[33] Patrick J. Kelley, a professor of law at Southern Illinois University, postulated in 1991 that Green led a group of hard-line legal realists that believed that the courts' reliance on proximate cause limitations for liability in decisions was really a cover for legislative policies of the time that were not as easily citable or understandable.[34]

When looking at modern tort law, it is most important to examine the period just after *Palsgraf*, when strong jurists like Justice Cardozo and Learned Hand appeared to want to establish clear and consistent rules for tort law so that there would be no confusion as to duties of care nor unlimited potential liability for the accused. While public opinion may not have always been on the same page (see *Liebeck* sixty years later), Twentieth Century tort law took great strides in limiting accused's potential liability while also factoring in plaintiff's possible contributory negligence (and to an extent establishing their own care of duty).

EARLY DAYS OF PROXIMATE CAUSE LITIGATION POST-PALSGRAF

In *McFarlane v. City of Niagara Falls*[35], only a year after *Palsgraf*, Justice Cardozo took a swing at the nuisance area of tort law, making sure to factor in contributory negligence into any liability equation. In this case, a woman tripped over cement that had extended onto a driveway after the City of Niagara Falls had ineptly installed a sidewalk three years prior. After catching her heel, the woman sued the City for damages, stating that their negligent cement pouring had created a nuisance in her driveway which had caused her to trip.

However, Justice Cardozo established here that "whenever a nuisance has its origin in negligence," negligence must be proven and a plaintiff "may not avert the consequences of his [or her] own contributory negligence by affixing to the negligence of the wrongdoer the label of a nuisance."[36] Basically, Cardozo found that the woman was partly to blame and could not just cite the city's "nuisance" as a factor in any perceived damages from her tripping.

> "Like many of Cardozo's innovate decisions, *McFarlane* was a decision restricting potential liability. It was also a decision that preserved uniformity and

> predictability in tort law even though it apparently changed some rules … The more often litigants in a tort case could anticipate the set of rules that would be governing their conduct, the more skillfully might they plan their affairs."[37]

In *United States v. Carroll Towing Co.*,[38] written by the great jurist Learned Hand, this case established "the calculus of negligence" or "Hand test." In this case, the United States had been leasing the barge *Anna C*, which was loaded with flour owned by the United States and moored to Pier 52 in New York Harbor. When the towing tug *Carroll* was sent out to move another barge, it accidentally severed the mooring line for all barges connected to Pier 52 and *Anna C*, now free, ended up sinking, causing the United States to sue the Carroll Towing Company in an indemnity action.

The crux of this case is an algebraic formula whereby if $B \geq L \times P$ then the accused may have met the standard of care, with B being the burden on the accused, L the possible cost of injury and P the foreseeable probability. If $B < L \times P$, then the accused will not have met the standard of care required to have them free from liability. Often abbreviated BPL, this test is also referred to as $C > GL$ (where **C**ost is greater than **G**ravity of **L**oss). It is important to note as well that this test first occurred in case law in 1932 in *The T.J. Hooper*[39], another tugboat case. In this case, it was found that the Carroll Towing Company failed the Calculus of Negligence test since the Court ruled that leaving a barge unattended during daylight hours posed such a significant risk that it would be fair to require the towing company to have a crew member to be aboard the ship.

SHIFT TOWARDS PROTECTING DEFENDANTS AND ADDING DUTY OF CARE TO PLAINTIFFS

In *Webster v. Blue Ship Tea Room*[40], much like the McDonald's coffee case[41], this important decision (at least in New England) involved a woman being hurt by a restaurant's offering that many in the public would likely scoff at. While eating her fish chowder (the restaurant was out of the clam chowder she initially tried to order) at a Boston restaurant, Ms. Webster soon found herself unable to swallow after a fishbone became lodged in her throat. Like the plaintiff in the McDonald's coffee case, which on its face seems like a trivial injury, "this misadventure led to two esophagoscopies at the Massachusetts General Hospital, in the second of which, on April 27, 1959, a fish bone was found and removed. The sequence of events produced injury to the plaintiff which was not insubstantial."[42]

Noting that the plaintiff had been born and raised in New England ("a fact of some consequence" according to the court)[43], the Defendant asserted that "here was a native New Englander eating fish chowder in a 'quaint' Boston dining place where she had been before; that '[f]ish chowder, as it is served and enjoyed by New Englanders, is a hearty dish, originally designed to satisfy the appetites of our seamen and fishermen'; that '[t]his court knows well that we are not talking of some insipid broth as is customarily served to convalescents.' We are asked to rule in such fashion that no chef is forced 'to reduce the pieces of fish in the chowder to miniscule size in an effort to ascertain if they contained any pieces of bone.' 'In so ruling,' we are told (in the defendant's brief), 'the court will not only uphold its reputation for legal knowledge and acumen, but will, as loyal sons of Massachusetts, save our world-renowned fish chowder from degenerating into an insipid broth containing the mere essence of its former stature as a culinary masterpiece.'"[44]

While the initial auditor as well as the judge and jury in the Massachusetts Superior Court (the trial level in the Massachusetts court system) originally sided with the plaintiff, ultimately the Massachusetts Supreme Judicial Court sided with the Defendant's arguments, after much discussion into the history of chowder and even a footnote including a recipe. The Court stated that "We are not inclined to tamper with age old recipes by any amendment reflecting the plaintiff's view of the effect of the Uniform Commercial Code upon them … Thus, while we sympathize with the plaintiff who has suffered a peculiarly New England injury, the order must be Exceptions sustained. Judgment for the defendant."[45]

This case, while apparently silly and amusingly written, is helpful to provide a look at the attitude of the era since the Court even goes so far as to cite a similar California case (since, in the Court's opinion, "we know that the United States District Court of Southern California, situated as are we upon a coast, might be expected to share our views"[46]) as well as an Ohio case that was written by the future Chief Justice Taft (which the Court was "most impressed, however, by Allen v. Grafton, 170 Ohio St. 249, 164 N.E.2d 167, where in Ohio, the Midwest …"[47]).

Continuing Justice Cardozo's fight (and eventually the legislatures') against frivolous suits, the Massachusetts Supreme Judicial Court ultimately ruled in favor of the Defendant due to an underlying sense that basically the plaintiff should have known what she was getting herself into. Going further than contributory negligence, the Court in this case decided not to punish a Defendant for a Plaintiff's suffering an injury that could be seen as a natural and foreseeable by-product of eating fish chowder. It is not unreasonable for a fish bone to be found in fish chowder (now had she been able to order the clam chowder as originally desired, this case would have probably had a different outcome). Regardless, the Court here limited Plaintiff's ability not only to recover any damages but to sue in the first place because the plaintiff's ordering of the fish chowder was the proximate cause of her suffering an injury due to a fishbone in her food.

CONSUMER LIABILITY AND PROXIMATE CAUSE

During the latter half of the twentieth century, proximate cause case law shifted from transportation and larger entities to the individual and consumer liability as the individual consumer became the greater focus. There is no greater example of this than the infamous "McDonald's coffee" case, aka *Liebeck v. McDonald's*.

In *Liebeck v. McDonald's Restaurants*,[48] while not an appellate decision that established any grand tort theory, this case is arguably one of the most famous of the last fifty years. Stella Liebeck, a then 79-year-old woman, was the passenger in her grandson's 1989 Ford Probe, which lacked cup holders. After going through the McDonald's drive-through and ordering a 49-cent cup of coffee, her grandson pulled over so that she could add cream and sugar to her coffee. As she placed the cup between her knees and pulled the lid off towards her, the coffee spilled on her cotton sweatpants, causing third-degree burns on her thighs, groin and butt. As a result, the plaintiff had to be hospitalized for eight days and required multiple skin grafts.

Testimony during trial included McDonald's stating that they purposefully kept the coffee hot so that the coffee would remain hot during the commuters' drive. However, McDonald's own research showed that people often drank the coffee right away. By making the coffee as hot as it was served (around 180 degrees Fahrenheit), the plaintiff's attorneys argued that coffee drinkers could suffer third-degree burns in approximately twelve to fifteen seconds. Cooling the coffee another 20 degrees extended that time to twenty seconds.

Applying the principles of comparative negligence, the jury found McDonald's 80% liable and Liebeck 20% liable, awarding her $200,000 in compensatory damages and $2.7 million in punitive damages (totaling two days' worth of coffee sales for McDonald's). While the case never made it to appellate court, settling for less than $600,000 before it was heard, this case became the stereotypical example in the media of a frivolous lawsuit and, much to the delight of huge corporations, helped to pave the way for many states to pass legislation capping potential tort case recovery.

To this day, many Americans, when they hear this case, believe the plaintiff's claims to be without merit and frivolous, with the extent of her injuries suffered often massively underestimated by the general populace. However, once this case is boiled down (no pun intended), it really is simply a proximate cause case, asking the jury to determine just how much McDonald's should have been able to foresee and how much they should have been able to prevent in Liebeck's injuries. While the idea of a customer being able to sue because she spilled coffee on herself may seem ridiculous on its face, this case ultimately made corporations more responsible and more fearful of publicity-damaging litigation, forcing them to reexamine their care of duty and their potential proximate cause liability while lobbying state and federal legislatures to limit any such punitive monetary liability.

While the outcome of this case has ultimately been to coincide with the mid-century shift back towards the establishing of a care of duty towards the plaintiffs, this case was interesting in that it showed that some of the early century trend towards establishing just how much of a care of duty existed for the accused still was prevalent in the public mind. This case also speaks to the difficulty of allowing juries to determine seminal tort law – absent an appellate decision on this case it is almost impossible to discern where courts would have come down on this verdict (though many similar cases were thrown out by trial courts prior to this one and most assuredly since).

PROXIMATE CAUSE IN THE UNITED KINGDOM

Our analysis of the modern tort theory of proximate cause would not be complete without a look at the Court system of the United Kingdom, if for no other purpose than as a comparison to the evolution of the theory in the United States.

Before jumping into the modern field of proximate cause in the courts of the United Kingdom, a cursory look at the historic case law of foreseeability shows a similar development to that of the United States. Beginning, very simply, with the earlier mentioned *Scott v. Shepard*[49] also known as the Squib case, negligence is determined by a simple "but-for" causation analysis. However, as we move into the next century another case enters the British legal system in 1841 that displays aspects of what any American law student would recognize as proximate cause. In *Lynch v. Nurdin*[50] the Court held that a defendant who negligently left a horse cart unattended for a lengthy period of time in an area where children are known to play is liable for harm to the plaintiff (a child) who fell off the cart and was injured when another child started up the horse attached to the cart. This decision introduced the foreseeability argument into the "but-for" causation analysis in the United Kingdom. More than thirty years later another case involving a horse and cart arose in *Clark v. Chambers*[51] (1878) where the Court found that the defendant-landowner, who negligently blocked a carriageway with spiked stakes, is liable for harm caused to the plaintiff when an unknown third-party removed the stakes from the road and put them in the middle of an adjoining footpath causing injury to the plaintiff. Again, foreseeability is used as a means of finding liability *through* a but-for analysis, and erasing the intervening cause defense.

The historical analysis then jumps into the 20th century with a string of three cases that set the stage for modern causation in tort law in the United Kingdom. Starting with *In re Arbitration Between Polemis and Furness, Withy & Co., Ltd.* (1921)[52] which held defendant liable for damage "directly traceable to the negligent act" even if that damage is not "the exact kind of damage one would expect." Thus utilizing the foreseeability analysis laid out in the previous century and adding a limitation to said analysis in terms of causation and liability. Eleven years later, a duty is established in *Donague v. Stevenson* (1932)[53] which expounded the general principle that reasonable foreseeability of physical injury to another generates a duty of care. This principle is then explained more thoroughly thirty years later in the Australian case *Wagon Mound I* (1961)[54] which stated that the injury must be reasonably foreseeable otherwise it is "outside the scope of duty" or "too remote." The proposition being that reasonable foreseeability governs the question of whether the injury comes within the scope of duty.

As this analysis indicates the United Kingdom does have a smattering of case law from the past two hundred years, some of which parallels the proximate cause case law of the United States. However, the United Kingdom never had the seminal *Palsgraf*-type case that we all learn about in our Law

School 1L torts class. There is no assumption of proximate cause, and in fact, that term rarely to never comes up in the literature and cases. Foreseeability is the benchmark and standard by which all negligence cases are determined in the UK. Per the case *Bourhill v. Young's Executor*[55] foreseeability is used four times to determine: 1) whether a duty exists; 2) whether an act or omission is a breach of duty; 3) whether reasonable care has been taken (in the guise of probability); and 4) for what damage the defender is liable.[56] Below are four cases that illustrate and outline the current field of negligence analysis currently in play in the courts of the United Kingdom.

In the facts of *Jolly v. Sutton London Borough Council,*[57] a small boat and trailer that had been abandoned in 1987 on a piece of open land owned by the Sutton Borough of London and adjacent to a block of apartments also owned by the Borough. The open land where the boat was placed was a green space where children from the neighboring apartments often played. In 1988 the Council placed a sticker on the boat stating "Danger do not touch this vehicle unless you are the owner" and also stated that the boat would be removed in seven days if not claimed by the owner. The boat was never removed and in mid-1989 the Plaintiff, Justin Jolly, then 13 years old, and a friend found the boat as they were walking past. The following February the plaintiff and his friend returned to the boat with the intention of fixing it up in order to sail it. During the course of their repairs, which took several months, the plaintiff and his friend turned the boat over and propped it up so it was supported by the trailer and a jack the plaintiff brought from home in order to crawl underneath to render repairs. During one work session in April 1990, Justin was alone under the boat when it started rocking. Before the plaintiff could crawl out from under the boat, it collapsed off the jack and trailer that were holding it up and fell onto the plaintiff causing him to suffer a broken back resulting in paraplegia.

The issue that arose before the House of Lords was whether the boat was a reasonably foreseeable trap or allurement to children such that it would cause them injury, and whether or not the defendants should have taken measures to protect the plaintiff from danger. [58]

At trial the court held that the accident and sustained injury to the plaintiff were reasonably foreseeable, therefore the defendants breached their duty to plaintiff as occupiers.[59] The Appeals Court reversed and held that the immediate cause of the injury was the plaintiff's decision to jack up the boat and work underneath it, essentially claiming his "work" was an intervening cause. The Secondary Court then when on to determine that it was not reasonably foreseeable that the injury would occur in this way.[60] The House of Lords ultimately agreed with the trial court and held that even though this particular injury may not have been foreseeable, it was foreseeable that the boat would cause injury, thus the defendant is liable.[61]

The Trial Court reasoned that it was foreseeable that children would play in the area where the dilapidated boat was abandoned and thus could be attracted to the boat and thus harmed by it if they were to play on it. This particular harm was foreseeable because children imitating adults, in this case working on the boat, is a form of play.[62] The Court of Appeal however, held that working on the boat was not playing and therefore was not a foreseeable action.[63] Upon appeal to the House of Lords it was determined that the trial court was the finder of fact and at trial it was determined that play can mimic adult behavior, thus what the plaintiff and is his friend were doing was play. "The Court of Appeal was not entitled to disturb the judge's findings of fact."[64]

This case hinges on the basic legal and factual concept of foreseeability. Although it was foreseeable that the abandoned and derelict boat could cause harm to children playing on or in it, the exact play that was used in this case was perhaps not foreseeable. Nonetheless, the trial court determined that the plaintiff's actions were play and that therefore the damage was foreseeable. The House of Lords goes on to determine that the Court of Appeals was wrong to overrule the trial court's finding of fact, and by viewing the injury as unforeseeable meaning the defendant as not liable. The House of Lords ruled that prevailing case law determined that a foreseeable hazard even if an unforeseeable consequence results in liability.[65] Lord Hoffman, concurring with the majority, states that the Council admits a duty in regards to the damages of the boat as evidenced by the "Danger" sign. Therefore, to eliminate this risk would have been the same amount of effort as to eliminate the risk to the plaintiff.[66] "[T]he judge's broad description of the risk as being that children would 'meddle with the boat at the risk of some physical injury' was the correct one to adopt on the facts of the case. The actual injury fell within that description and I would therefore allow the appeal."[67] Because some injury was foreseeable to the child-residents a duty was owed to the plaintiff. Defendant is liable because it breached this duty even though the exact injury which occurred was not entirely foreseeable.

In the 2004 Scottish case of *Simmons v. British Steel Plc.,*[68]the plaintiff, Christopher Simmons, was employed by the defendant, British Steel, doing a job which involved holding a burning torch to strip off scrap metal. The torch was fed with gas and oxygen through flexible tubes. On the date in question

Simmons had climbed onto a table to complete his work, approximately 1.5 feet off the ground. As he went to step down off the table he became entangled in the tubes attached to the torch and as a result fell off the table, hitting his head and splitting the visor on his headgear. The plaintiff sustained an injury to his right ear and complained of a sore head and a headache. A few weeks after the accident the plaintiff's pre-existing skin condition became exacerbated and the plaintiff developed signs of depression. This was accompanied by the plaintiff's inability to return to work and an ever increasing anger at the situation.

> "Some time after the accident the pursuer's anger exacerbated his pre-existing psoriasis and, as a result, the defenders' works medical officer refused to allow him to return to work. This, too, angered the pursuer. His prolonged absence from work caused him to become preoccupied with the accident and more angry at the defenders, inter alia because the defenders' personnel department failed to visit him or to take any interest in him. All of this resulted in a deterioration in the pursuer's mental state, leading to his depressive illness."[69]

The issue on appeal was whether the trial court was correct in finding that the defendant is liable for not only the immediate physical injuries of the accident (which it did not contend) but also that the defendant is liable for the emotional distress, depression, and exacerbated skin condition.

The Trial Court found that the emotional damages and skin condition were not part of the defendant's liability.[70] The Second Division (appeal) found for the plaintiff and awarded him a sum of £498,221.77.[71]

The basic rule states that if physical injury to the defendant was foreseeable, then there is a duty of care established, and therefore the actual injury doesn't matter.[72] "[A]ll that matters is that the defenders were in breach of their duty of care not to expose the pursuer to the risk of personal injury and that, as a result of the breach, the pursuer suffered both physical and psychiatric injuries."[73] The duty was clearly established through the employer-employee relationship, but is further established by the fact that other stations, similar to the one at which plaintiff worked, had altered torches with retractable tubes to prevent accidents such as the one in question in this case.[74]

The House of Lords found that "Regret, fear for future, frustration at the slow pace of recovery and anger are all emotions that are likely to arise, unbidden, in the minds of those who suffer injuries in an accident such as befell the pursuer. If, alone or in combination with other factors, any of these emotions results in stress so intense that the victim develops a recognized mental illness, there is no reason in principle why he should not recover damages for that illness."[75] Thus stating the rule that defendants are liable for both physical and psychological damage incurred as a result of the negligence, even if this extent of injuries were not foreseeable.[76] This general rule and other rules from case law are then laid out, being often quoted and applied in subsequent cases.

> "[O]nce liability is established, any question of remoteness of damage is to be approached along the following lines which may, of course, be open to refinement and development. (1) The starting point is that a defender is not liable for a consequence of a kind which is not reasonably foreseeable. . .(2)While a defender is not liable for damage that was not

> reasonably foreseeable, it does not follow that he is liable for all damage that was reasonably foreseeable: depending on the circumstances, the defender may not be liable for damage caused by a novus actus interveniens or unreasonable conduct on the part of the pursuer, even if it was reasonably foreseeable. . . (3) Subject to the qualification in (2), if the pursuer's injury is of a kind that was foreseeable, the defender is liable, even if the damage is greater in extent than was foreseeable or it was caused in a way that could not have been foreseen. . .(4) The defender must take his victim as he finds him. . .(5) Subject again to the qualification in (2), where personal injury to the pursuer was reasonably foreseeable, the defender is liable for any personal injury, whether physical or psychiatric, which the pursuer suffers as a result of his wrongdoing."[77]

In the case of *Corr (Administratix of the Estate of Thomas Corr (Deceased)) v. Ibc Vehicles Limited,*[78] Thomas Corr, now deceased, was employed by the defendant has a maintenance engineer. On the day in question, Mr. Corr was working on a line producing prototype vehicles when a machine fitted with a high intensity sucker picked up a metal panel and moved it quickly and without warning at Mr. Corr. Mr. Corr ducked, otherwise he would have been decapitated, however the metal did hit the right side of his head and severed most of his right ear. As a result of this accident Mr. Corr had to endure reconstructive surgery, he was disfigured, and he suffered from unsteadiness, tinnitus, severe headaches, and had trouble sleeping. Mr. Corr also suffered from post-traumatic stress disorder as a result of the accident. Due to the accident and lingering physical and emotional effects it left on him, Mr. Corr developed depression and became suicidal over the next six years until 2002 when he took his own life by jumping off a parking garage.

The issue before the House of Lords was whether the plaintiff, the estate of Mr. Corr, can recover damages from the defendant for the financial loss attributable to Mr. Corr's suicide? Was Mr. Corr's death caused by a wrongful act, namely the employer's breach of duty? Or is the suicide too remote from the accident to make the defendant liable?[79]

The general rule states that "it is now accepted that there can be no recovery for damage which was not reasonably foreseeable"[80] The foreseeability issue is tackled by determining that the depression was a reasonably foreseeable consequence of the breach of duty (the accident) and the suicide was a direct result of the depression.[81] "Here, the inescapable fact is that depression, possibly severe, possibly very severe, was a foreseeable consequence of this breach."[82]

Causation is established by using a purely but-for chain of analysis. "[B]ut for the employer's negligence the accident at work would not have happened, that but for the accident at work and the physical damage he suffered Mr. Corr would not have become clinically depressed and that but for that psychiatric feature he would not have entertained suicidal thoughts or have attempted suicide."[83] When physical injuries are foreseeable and have been caused by the defendant, the defendant cannot then limit liability because the extent of those physical injuries were not foreseeable.[84] This rule was then extended by a later case to include psychiatric injury.[85]

The court in this case applies the five principles, or rules, laid out in *Simmons*[86] and finds that although suicide may not have been a foreseeable consequence in terms of the extent of the injury (death), injury was foreseeable and there was a duty which was breached. Therefore, because some injury was foreseeable, and because that injury was a result of the accident the defendant is liable for the suicide.[87]

The events of *Robert Eric Spencer v. Wincanton holdings, Ltd.*[88] started when plaintiff was in a collision with a stationary tractor unit while serving as a serviceman in the Royal Air Force (RAF). The collision injured his right knee, which remained so painful that he eventually had to terminate his employment and underwent an above-knee amputation. Plaintiff adapted to his new physical situation, obtained a new job and bought a car which was in the process of being outfitted for use with a prosthetic leg. Before the car could be altered for use with the prosthetic, however, plaintiff was out in the car when he pulled into the local gas station and without the assistance of his prosthetic leg or any sort of crutches filled his tank up by steadying himself against his car. As the plaintiff returned to the driver's side he tripped over a raised manhole cover and fell, causing him to rupture his left quadriceps tendon and confining him to a wheelchair.

The issue before the House of Lords was whether or not the consequences of the second accident were caused by the negligence of the defendant, the party originally liable for the initial accident while plaintiff was in the RAF? To answer this question the House of Lords uses the five rules set out in *Simmons*.[89]

> "English law uses the concept of causation to attribute responsibility for things that happen. . .In this context the English law of tort has developed what might be called 'exclusionary rules.' These are intended to assist judges in deciding the circumstances in which a defendant, whose liability to a claimant for a particular occurrence has been established, will not be responsible

> for certain consequences of an act of negligence and the damages that are claimed to flow from those consequences. Such consequences and the damages resulting are said to be 'too remote' in law to be recoverable."[90]

The court then goes on to discuss, what American law would call proximate cause by stating that "[f]airness, baldly stated, might be thought to take things little further than reasonableness. But what it does is acknowledge that a succession of consequences which in fact and in logic is infinite will be halted by the law when it becomes unfair to let it continue. In relation to tortious liability for personal injury, this point is reached when (though not only when) the claimant suffers a further injury which, while it would not have happened without the initial injury, has been in substance brought about by the claimant and not the tortfeaser."[91]

Despite the discussion and recognition of the theory of proximate causation and the limitations it places on negligent causation the House of Lords ultimately holds that "[l]ike the amputation, the fall was, on the judge's findings, an unexpected but real consequence of the original accident, albeit one to which Mr. Spencer's own misjudgment contributed."[92] Utilizing the tried-and-true "but for" causation analysis the court holds that the gas station accident was a natural consequence of the original incident and would not have happened but for the original negligence.

As this succession of these cases from the past 15 years shows, the courts of the United Kingdom are holding very closely to the but-for causation analysis. Rather than limiting liability assigned to the defendant by cutting the chain of events, the courts in the UK are in fact expanding liability through factually based foreseeability analysis. What is also clear through the broader analysis and discussion within the case law, is that there is the idea of a limitation on defendant liability, similar to that of the role of proximate cause in the United States, there just has not yet been the widespread application of such a limitation.

CONCLUSION

In law school classrooms all across the country, first year students are struggling with the concept of proximate cause. They aren't alone. "Attorneys and the courts fail to understand the task involved in deciding the question and are often confused by terms such as proximate cause and foreseeability."[93] The courts of our nation, as well as the courts of our fellow common law country the United Kingdom, continue to struggle with this nebulous legal concept. Where does foreseeability attach? Is it part of duty or causation? What if the plaintiff contributed to the action? These questions are indicative of the struggle that lawyers, judges, legal scholars, and our society as a whole must grapple with when confronted with a system of common law, the evolution of legal concept. What is clear from case law and analysis over the past century is that liability has shifted away from the defendant with the devaluing of the but-for analysis, and towards a more thoughtful, and limiting, analysis based in proximate cause. While the evolution has been relatively quick to progress in the United States, perhaps due in part to the ever growing interests of big business, in the United Kingdom they are still working to figure out if a limitation on liability via a proximate cause analysis is appropriate. Moving forward into the jurisprudence of the 21st century, the courts will need to determine more fully how to define and apply proximate cause in negligence tort cases. Common law is only useful if we can rely on it for precedent, even if that precedent is evolving.

[1] Pollock on Torts, p.455
[2] 162 N.E. 99 (N.Y. 1928)
[3] *Id*.
[4] *Id*.
[5] *Id*. at 341.
[6] *Id*. at 356.
[7] Langbein, John H. *et al*., *History of the Common Law* (Wolters Kluwer:2009) p. 103 citing to fn. 50 *Select Cases of Trespass from the King's Court: 1307-1399* (Morris Arnold ed. 1985) (Selden Soc., vol 100)
[8] *Id*. p. 103
[9] *Id*.
[10] *Id*. at 104.
[11] Ibbetson, David, *A Historical Introduction to the Law of Obligations* (1999) pp. 97-98.
[12] Langbein, op. cit. p.1068
[13] Ryan v. N.Y. Central R.R., 35 N.Y.210 (1866) p. 210.
[14] Ballam, Deborah, *The Evolution of the Government-Business Relationship in the United States: Colonial Times to Present*, 31 Am. Bus. L.J. 4 (1994), p 583 citing to Lawrence Friedman, A History of American Law (2d ed. 1985) and Kermit Hall, The Magic Mirror: Law in American History (1989)
[15] Kaczorowski, Robert, The Common-Law Backgound of Nineteenth-Century Tort Law, 51 Ohio St. L.J. 1127 (1990) citing to Morton Horowitz, The Transformation of American Law 1780-1860 (1977)
[16] Op.cit. Friedman p. 300 as cited in Kaczorowski 1128.
[17] Op. cit. Kaczorowski 1128 siting to both Morton and Friedman cf. fn 16, 17
[18] *Id*. 1199
[19] *Id*.
[20] *Id*.
[21] *Id*.
[22] *Id*.
[23] *Id*. fn, 111 citing to M'Clures v.Hammond, 1 BAY 99, 100 (S.C. 1790)
[24] Patrick J. Kelley, Proximate Cause in Negligence Law: History, Theory, and the Present Darkness, 69 Wash. U.L.R. 54 (1991) citing to F. Bacon, A Collection of Some Principal Rules and Maximes of the Common Laws of England, in The Elements of the Common Laws of Engli\and (1630 and

photo reprint 1978), Regula 1, at 1. (Translated as "In law not the remote, but the proximate cause is looked at".)
[25] Id. 55
[26] Pollock, Frederick and Maitland, Frederic, The History of English law, Vol II (1959) 470-471
[27] 96 Eng. Rep. 525 (K.B. 1773)
[28] *Id*.
[29] *Id*.
[30] *Id*.
[31] Kaczorowrski, op.cit 1184 citing to Taylor v. Rainow, 12 Vs. (2 Hen. & M) 443 (1808) at 445 (citing with approval Raynolds v. Clarkem 2 Ld. Raym. 1399, 1402, 92 Eng. Rep 410, 413 (K.B. 1725); for an excellent historical review see Dix, Elizabeth Jean, *Origins of the Action of Trespass on the Case*, 46 *Yale L.J*. 1141 (1936-37).
[32] Winfield, Percy and Goodhart, Arthur, Trespass and Negligence, 49 L. Q. Rev. 359 (1933) at 372 citing "…as late as 1875, in *Holmes v. Mather*, [L.B. 10 Ex. 261, 266] Herschell, Q.C., as counsel for the plaintiff, could argue:'it is immaterial in all these cases there was negligence in the drivers; for, in considering whether trespass will lie, negligence is not regarded.'"
[33] See L. Green at 3-4; for an excellent discussion of "duty" and Professor Leon Green's reformulation of "duty" which was contemporaneous with the *Palsgraf* case, see Vandall, F.J., "Duty: The Continuing Vitality of Dean Green's Theory," 15 Quinnipiac L.R. 343 (1995)
[34] Patrick J. Kelley, *Proximate Cause in Negligence Law: History, Theory, and the Present Darkness*, 69 Wash. U. L. Rev. 49, 105.
[35] 247 N.Y. 340,160 N.E. 391 (1928)
[36] White, G. Edward, Tort Law in America: An Intellectual History, Oxford University Press, 2003, citing *Id*. at 344-5.
[37] White 129.
[38] 159 F.2d 169 (2d. Cir. 1947)
[39] 60 F.2d 737 (2d Cir.), cert. Denied, 287 U.S. 662 (1932)
[40] 347 Mass. 421, 198 N.E.2d 309 (Mass., 1964)
[41] Cf. fn 51 infra and discussion associated therewith
[42] *Webster v. Blue Ship Team Room*, 198 N.E.2d at 310.
[43] *Id*. at 309.
[44] *Id*. at 310-11.
[45] *Id*. at 312.
[46] *Id*.
[47] *Id*.
[48] 1994 Extra LEXIS 23 (Bernalillo County, N.M. Dist. Ct. 1994), 1995 WL 360309 (Bernalillo County, N.M. Dist. Ct. 1994)

[49] 2 Wm. BL 892, 96 Eng. Rep. 525 (1773)
[50] 1 Q.B. 29 (1841)
[51] L.R. 3 Q. B.D. 327
[52] 3 KB 560
[53] AC 562
[54] [1961] UKPC 1
[55] [1943 SLT 105] at p. 107.
[56] *Id*. at para. 17.
[57] [2000] UKHL 31.
[58] *Jolly v. Sutton London Borough Council* [2000] UKHL 31 Id. 3.
[59] *Id.* at 4.
[60] *Id.* at 5.
[61] *Id*. at 8.
[62] *Id*. at 3.
[63] *Id*. at 5.
[64] *Id*. at 6.
[65] *Hughes v. Lord Advocate* [1963] A.C. 837; Id. 7.
[66] *Id*. at 10.
[67] *Id*. at 10.
[68] Scotland [2004] UKHL 20
[69] *Id.* at 52
[70] *Id*. at 4.
[71] *Id*. at 2.
[72] *Id*. at 54.
[73] *Id*. at 56.
[74] *Id*. at 31.
[75] *Id*. at 55.
[76] *Id*. at 56.
[77] *Id*. at 67.
[78] [2008] UKHL 13
[79] *Id.* at 8.
[80] *Id*. at 11.
[81] *Id*. at 12.
[82] *Id*. at 13.
[83] *Id*. at 27.
[84] *Id*. at 29.
[85] *Id*. at 29.
[86] *Id*. at 8.
[87] *Id*. at 13.
[88] [2009] EWCA Civ. 1404

[89] *Id.* at 12.
[90] *Id*. at 29.
[91] *Id*. at 15.
[92] *Id*. at 23.
[93] Vandall, *op. cit*. p 343

***BARNES v. COMMISSIONER:* USE OF THE STEP TRANSACTION DOCTRINE TO TAX A TRANSNATIONAL REINVESTMENT PLAN**

by

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INTRODUCTION

The Barnes Group Inc. (Barnes) is a Bristol, Connecticut transnational corporation which manufactures industrial and aerospace components, including springs for airframes, machinery and turbine engines, providing repair and logistics support for the aerospace industry. Founded in 1857, this engineering group by 1999 operated three separate business enterprises through its domestic and foreign subsidiary corporations which oversaw significant operations in the United States, Europe, Latin America and Asia. In 2000 and 2001, Barnes and its subsidiaries executed an agreement and plan of reinvestment which sought to reallocate assets from Asia to the United States without incurring tax consequences.

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At the end of 2000, due to aggressive acquisitions of related businesses in the United States and abroad, Barnes had some $230 million of outstanding long term debt and about $50 million due on its revolving credit line for its domestic business. The acquisitions had increased Barnes' cost of borrowing and debt-to-equity ratio, a highly unusual situation for any company within the industrial equipment and component industry[1]. Barnes planned to address its domestic problems through discussions with its Asian subsidiary, Associated Spring-Asia PTE Ltd. (ASA), a highly successful and cash-rich Singapore corporation which was a second tier Barnes subsidiary. This subsidiary conducted operations for Barnes' Associated Spring division, manufacturing and marketing precision, mechanical and nitrogen gas springs in Southeast Asia. As of September 1, 2000, ASA had approximately $12.9 million of existing cash reserves held in short-term accounts and another $26.1 million in cash receivables due from foreign affiliates. ASA possessed more than enough cash for its immediate operating needs. The discussions between the parent and the second tier subsidiary corporations resulted in a reinvestment plan geared to assist the domestic parent without incurring U.S. tax liability. This article will examine the reinvestment plan and its failure to fulfill its desired objective. The United States Tax Court and the Court of Appeals for the Second Circuit[2] indicated that Barnes improperly relied upon its tax advisers. The courts applied the step transaction doctrine procedure used by courts in any number of situations similar to the Barnes plan. The article will conclude with observations for the tax planner, counseling that valid business plans clearly appear in documents and be executed in accord with those documents.

THE SEARCH FOR A PLAN: SECTION 351 AND ITS REVENUE RULINGS; EXPERT ADVICE

Section 351

The United States Internal Revenue Code Section 351 and its Regulations describe the non-recognition of gain or loss for tax purposes if the corporation transferor exchanges its property solely for the stock of another corporation, if immediately after the exchange of stock for property, the transferor is also in control of the transferee corporation, owning at least 80% of its shares.

The section states:

§ 351 Transfer to Corporation controlled by transferor
(a) General Rule
No gain or loss shall be recognized if property is transferred to a stock corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation
(b) Receipt of Property If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then—
(1) gain (if any) to such recipient shall be recognized, but not in excess of—
(A) the amount of money received, plus
(B) the fair market value of such other property received; and
(2) no loss to such recipient shall be recognized[3].

Revenue Ruling 74-503 commented upon the Section 351 statements by indicating that if one corporation transfers treasury stock to another corporation and now owns 80% of newly issued stock in the transferee corporation, no gain or loss will occur. In 2006 Revenue Ruling 2006-2 indicated that the 1974 ruling was incorrect; the ruling was revoked because the Internal Revenue Service had recognized that gains or losses could occur even in the mere transfer for stock between corporations. The Service indicated, however, that any decisions made in reasonable reliance upon Revenue Ruling 74-503 before its revocation would be honored and not questioned.[4]

Expert Advice: Barnes' Officers and Accounting Consultants

The Barnes reinvestment plan resulted from a series of events concerning the company's strategy to expand the company through acquisitions. Between 1998 and 2000 Barnes hired an entirely new management team. Its Vice-President for Tax, with the other members of the management team, noted the precarious financial position of Barnes which had resulted from the acquisitions. As already mentioned, Barnes owed more than 230 million dollars to its creditors and 50 million dollars was due to its revolving credit line by the end of 2000. In May 2000, the team noted that the Singapore second tier subsidiary Associated Spring-Asia PTE Ltd. (ASA) had the 12.9 million dollars of existing cash reserves and 26.1 million dollars of cash receivables available. The team discovered that Barnes was earning approximately 3% interest on its investment holdings worldwide but that its domestic debt interest rates range from 7.13% - 9.47%. The Barnes management team sought a solution to this problem by discussing a reinvestment plan which would move ASA's cash reserves to the parent company Barnes Group Inc. The team clearly understood that either a dividend or a loan from ASA to Barnes would incur federal tax liability.[5]

The recently hired vice-president for tax had over 20 years of international tax experience with Pfizer Corp, Johnson & Johnson, ITT Sheraton Corp. Millipore Corp. and Loctite Corp. He approached Ernst & Young (EY) and Deloitte & Touche (Deloitte) for assistance in attempting to solve the interest rate differential problem without incurring federal income tax liability while retaining funds for overseas investment opportunities. After examining the solutions posited by these firms the vice-president rejected them and approached PricewaterhouseCoopers (PwC) with whom he had worked extensively for other international accounting and tax problems. Barnes had been a client of PwC for over 7 years and after receiving the vice president's request for assistance they reviewed their internal Ideasource database for tax solutions submitted by their own professionals to a central network. Ideasource 1365 suggested a structure similar to what would become the reinvestment plan.

PwC issued and executed an engagement letter with Barnes. Its scope included:

> Designing an appropriate…[reinvestment plan]; working closely with personnel of …[Barnes] and its subsidiaries to implement the … [reinvestment plan]; and providing tax opinions in the countries with subsidiaries affected by the …[reinvestment plan] (anticipated to be Singapore, Canada, United States and one other tax jurisdiction)….
>
> Services provided in Singapore will include all tax and legal services needed to implement the … [reinvestment plan]. These services will include preparation of legal documents, share registration documents and a tax and legal

> opinion on the Singapore tax implications of the… [reinvestment plan].[6]

The Barnes management team and PwC spent 3 to 4 months over the summer of 2000 to develop the transaction scheme for the reinvestment plan. PwC professionals from the United States, Singapore, Canada, France and the United Kingdom assisted Barnes, including the tax vice-president and several Barnes' officers and employees to describe a plan in which 1) Barnes would create a domestic financing entity; 2) ASA would create a foreign financing entity; 3) ASA would exchange cash for the foreign entity's stock; 4) the foreign entity would transfer its stock and cash to the domestic entity in exchange for the domestic entity's stock; 5) the plan would then be unwound when the foreign entity purchased the domestic entity stock from Barnes and liquidated the domestic entity. The business purpose of the plan described an international plan for cash management for a multinational manufacturing and distribution company.[7] PwC and the Barnes tax planning team then identified the foreign and domestic entities, their incorporating jurisdictions, prepared representation and opinion letters for execution, and drafted a board of directors' resolution. The Barnes board of directors ratified the plan on October 12, 2000.

REINVESTMENT PLAN SUMMARY

Plan Structure

The Barnes group and three of its subsidiaries, two of which were formed for the execution of the plan, were included: the Singapore ASA second tier subsidiary mentioned above; the newly formed Barnes Group Finance Co. Delaware (Delaware); and the newly formed Barnes Group Finance Co. Bermuda Ltd. (Bermuda). In order to assist in the initial financing of the plan three other Barnes' subsidiaries participated, although they were not mentioned. Barnes Canada, Bowman UK, and Bowman France: the Canadian subsidiary would loan money to the French and UK subsidiaries, which would then pay their receivables due to ASA.[8]

Plan Execution

The reinvestment plan occurred in two parts, both of which had a similar structure. In a Section 351 transaction, ASA and Barnes would exchange foreign currency with Bermuda in exchange for Bermuda common stock; in a second Section 351 transaction, Bermuda and Barnes would transfer foreign currency and Bermuda common stock to Delaware in exchange for Delaware stock. Barnes would receive its common stock and Bermuda would receive its preferred stock. In a final transaction, Delaware would convert its foreign currencies to US dollars and lend the funds to Barnes. The interlocking boards of directors of ASA, Bermuda and Delaware formally approved the plan. The plan itself occurred in two phases:

Phase 1:

(a) 12/7/2000: Bermuda transferred 222,000 shares of common stock to Barnes in exchange for 384,171 Singapore dollars ($222,000);

(b) 12/7/2000: Delaware issued 3,184 common stock shares to Barnes in exchange for Barnes' transfer of 234,000 Bermuda common shares (100%) and 5,137,425 Singapore dollars (2,951,000) to Delaware.

Phase 2:

(a) 12/12/2000: Bermuda issued 39,000,000 Bermuda common shares to ASA in exchange for 67,720,713 Singapore dollars ($39,000,000) to Bermuda;

(b) 12/22/2000: Bermuda transferred 68,204,884 Singapore dollars ($39,222,000) and 2,950,000 Bermuda common shares to Delaware in exchange for Delaware's issuance of 42,172 Delaware preferred shares to Bermuda.

(c) 12/26/2000: Delaware transferred 42,105,000 to Barnes in exchange for Barnes' promise to repay the loan.

Barnes then used the funds to pay off its own outstanding debts, thereby reducing its interest payments.

The Plan and Section 351

In order to justify its conclusion that the reinvestment plan would occur on a tax-free basis, the Barnes management team, after considering the PwC analysis, decided to emphasize the exchanges between Bermuda and Delaware. The team concluded that there are no material factual differences between these exchanges and the exceptional rule promulgated by Revenue Ruling 74-503. Section 351, as already noted, indicated that no gain or loss occurs if property is transferred to a stock corporation by one or more persons in exchange for the corporation's stock, so long as after the exchange, the transferor is in control of 80% of the corporation's stock. The ruling had indicated that, as an example, stock in one corporation could be exchanged for stock in another corporation without realizing any gain or loss for tax purposes in this situation. This rule was later revoked but the Internal Revenue Service had indicated, as already noted, that it would not question and would honor any transaction which occurred before 2005. Since the series of transactions of the plan occurred in 2000 and continued through 2001, the Barnes management team envisioned that no tax would result from the transactions which resulted in the execution of the reinvestment plan.

Section 351 (b) however, indicates that gain would occur if the transferor received money in addition to the stock. The Tax Court noted that Revenue Ruling 74-503, therefore, would not apply to the facts of the case. As noted in *Briarcliff Candy Corp v. Commissioner*[9]and *Anschutz Co. v. Commissioner*[10] both a Tax Court Memo and a Court of Appeals for the 10th Circuit held that Revenue Rulings may only be used to decide tax questions in the limited facts to which the ruling speaks. The 10th Circuit *Anschutz Co.* decision concerned the attempted use by taxpayers to use Revenue Ruling 2003-7 to exempt them from taxation. The ruling, however, envisioned a pledge of stock as security for a loan, whereas the taxpayers used the pledge device to sell the shares to a third party rather than using those shares as security for a loan. The Anschutz Corporation, a Kansas corporation with its principal place of business in Denver, Colorado, was a qualified subchapter S subsidiary of the Anschutz Company. The company initially engaged in the exploration of oil and the development of natural resources. It subsequently expanded its business activities to include railroads, real-estate and entertainment companies. Late in the 1990’s and early in the 2000’s the company sought to leverage its stock holdings through variable pre-paid forward contracts which anticipated the actual delivery of the stock on a specified future date and merely pledged the stock as security for a loan. The contracts, however, permitted the third party lender to use the pledged shares to pay for the third party’s outstanding debts. The Tax Court and the Circuit Court agreed with the Commissioner that ownership rights in the pledged shares had in fact been transferred to the third party in a taxable event. They concluded that Revenue Ruling 2003-7 could not be used to exempt the taxpayers from liability[11].

Revenue Ruling 74-503, then, can only provide guidance where treasury stock is exchanged for newly issued stock of another corporation. The ruling cannot otherwise be used.

The Tax Court noted:

> Specifically, the ruling addresses a situation where treasury stock is purchased by a corporation (corporation X) from its shareholders for less than fair market value and subsequently exchanged for 80% of the newly issued stock of another corporation (corporation Y), in a transaction in which no gain or loss was recognized by either corporation under sections 351 (a) and 1032(a).[12]

The Status of Bermuda and Delaware in the Execution of the Plan

The Tax Court and the Court of Appeals both noted that not only did 351 and Revenue Ruling 74-503 not exempt the reinvestment plan from tax liability. They also noted that the actual execution of the plan only minimally involved participation from Bermuda and Delaware.

In particular, the Tax Court noted that Bermuda declared no income or deductions for 2000 and only $12,000 in revenue and $13,410 in deductions. Bermuda had no paid employees in 2000 and 2001 and noted that the wholly owned Barnes subsidiary listed cash reserves of $12,000 in 2000 and $10,590 in 2001. Bermuda's Board of Directors was interlocked with that of its Barnes parent, including the parents' assistant treasurer, senior vice president for finance.

Delaware declared in a number of 1042 income tax forms for various years from 2002 to 2009 that it paid some $7,471,566 to Bermuda, but it was unclear as to whether Delaware actually paid these preferred dividends to Bermuda.

In addition, the loan from Delaware to Barnes evidenced by various agreements and corresponding notes, which required Barnes to make annual interest payments on the unpaid interest balance on a fixed rate of 7.5% commencing on 12-1-2002 totaled $67,605,000. Once again, it was unclear to the Tax Court whether Barnes ever paid any interest payments on the Delaware loans[13].

The Court finally noted that Barnes did include documents regarding the reinvestment plan with its 2000 and 2001 Federal income tax returns including the series of purported section 351 transactions among Barnes, Delaware, Bermuda and ASA. Barnes did not report any income attributable to the reinvestment plan. Both the Tax Court and the Court of Appeals concluded that the reinvestment plan had no valid business purpose, but merely operated as a conduit, a series of steps, for the transfer of funds from its second tier foreign subsidiary, ASA, to its domestic parent, Barnes.

SUBSTANCE OVER FORM: THE STEP TRANSACTION DOCTRINE

Development of the Doctrine

Smith v. Commissioner[14]described the step transaction doctrine in the following words:

> The step transaction doctrine generally applies in cases where a tax payer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary steps is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken

by the tax payer and the intervening stops may be disregarded or rearranged.

The *Smith* Tax Court and 4th Circuit decisions emphasized the importance of substance over form in determining tax liability. The step transaction doctrine treats the steps in a series of separate transactions as amounting to a single transaction if all the steps are substantially linked. The *Smith* decisions described an agreement between Georgetown University and Harry Smith and a number of other individuals. The University and these individuals entered into a limited partnership agreement concerning ownership of an off-campus housing project. The University had purchased the project from Chase Manhattan Bank, but was operating it at a loss in order to maintain rental parity between on-campus and off-campus housing. The limited partnership agreement transferred a "beneficial ownership" of the project to the partnership in which Georgetown retained a 20% general partnership interest. In return for the other limited partners contribution of $300,000.00, Georgetown promised, among other matters, to make non-recourse loans to the partnership if it needed money for operating expenses. The proceeds of any sale of the project were to be distributed in accordance with the partners' interest, but the agreement was never filed because of Georgetown's concern that the filing would cloud its title to the project. Both courts concluded that substance must prevail over form, and that the step transaction doctrine would apply. Despite its statement of a 20% interest, the University retained all the attributes of ownership. It made all decisions concerning operations management, including the right to sell or re-finance the property. All licenses, insurance leases and property tax returns remained in the University's name without disclosure of the partnership. The required landlord legislation form filed with the District of Columbia bore only Georgetown's name. In addition, the other limited partners did not acquire any equity interest in the project. Georgetown held the sole responsibility to stay the project's $4 million outstanding mortgage and the agreement allowed taxpayers to abandon any debt obligation to the University, other than their $300,000 investment in the partnership. The court concluded, therefore, that Georgetown had not transferred any ownership rights or duties to the other partners, and that the limited partner taxpayers could not claim income tax reductions equaling 80% of the losses accumulating from the operation of the off-campus housing facility. The courts noted that taxpayers are certainly entitled to deduct interest on a debt if the debt is genuine and of economic value, but there was no genuine debt nor economic value, but rather an economic incentive to abandon the collateral and merely forfeit the $300,000.00 investment after having taken substantial write-offs against income unrelated to any ownership in the property itself. The substance of the whole transaction required the collapse of the entire series of transactions so that its individual steps will be disregarded. The step transaction doctrine then must be applied.

Both the Tax Court and Court of Appeals decisions applied the step transaction doctrine to the Barnes reinvestment plan scenario. The court noted that the objective of the plan included a number of steps for no other purpose than to avoid tax liability[15].

One of three alternative tests may be used in deciding whether the step transaction doctrine should apply: 1. The Binding Commitment Test, 2. The End Result Test and 3. The Interdependence Test. Only one of these tests need apply to permit the use of the step transaction doctrine in the reinvestment plan situation[16].

The Binding Commitment Test: This test considers whether, at the time of taking the first step, the parties had made a binding commitment to undertake the subsequent tests. But this test is usually used in situations where a substantial period of time has passed between the steps. In the Barnes reinvestment plan situation, the plan was executed in a matter of days; this test is not appropriate to apply the step transaction doctrine[17].

The End Result Test: The End Result Test may be used if a series of separate transactions are viewed as prearranged parts of a single transaction, set to achieve an ultimate result[18]. The Barnes reinvestment plan would certainly be amenable to the use of this test.

The Interdependence Test: The courts eventually decided to apply the Interdependence test to the Barnes reinvestment plan execution. This test examines whether or not the intervening steps in a transaction are so interdependent that they each depend upon the other for the completion of the later steps[19]. No valid and independent economic or business purpose was served by the inclusion of Bermuda and Delaware in the reinvestment plan: Bermuda could have been established in Singapore under local law and was created merely to add an extra step in the plan. Delaware was created but its form was never respected in the execution of the plan.

In the light of all of the circumstances of the case, the evidence was insufficient to support a finding that either Bermuda or Delaware had any valid business purpose. The various intermediate steps, therefore, are properly collapsed into a single transaction in accord with the Interdependence Test. The reinvestment plan was a device by which ASA transferred a substantial amount of cash to Barnes, which Barnes was able to use to pay its debts. The courts decided that the plan was in substance a taxable dividend payment from ASA to Barnes in 2000 and 2001.

CONCLUSION: THE NEED TO PLAN AND TO EXECUTE WITH A BUSINESS PURPOSE

The introduction to this article indicated that corporate management teams and tax planners should use extreme caution in formulating and executing valid and tax-free reinvestment plans between parents and subsidiaries of transnational corporations. Because of its failure in business planning which envisioned a bonafide profit potential for all interested parties, Barnes was liable not only for a $1,304,352 tax deficiency in 2000 and a $1,807,478 tax deficiency in 2001; the company also had to pay accuracy related penalties under Section 6662(a) of $1,733,084 in 2000 and $307,735 in 2001. The Second Circuit Court of Appeals unpublished opinion firmly indicated that Barnes did not and could not rely upon its tax advisor PwC. This advisor, in fact, clearly stated in its opinion letter that it was not advising as to the tax consequences of the entire series of transactions in the investment plan. The opinion letter examined the stock transfer relationship between Bermuda and Delaware and did not examine any transfer of cash which was planned to occur.

In any plan examining the tax consequences of dealings between transnational parents and subsidiaries, the Internal Revenue Code, revenue rulings and court decisions should be carefully examined and caution should be used in formulating business plans and executing them strictly in accord with the form of the plan. Both the plan and its execution are vitally important. Profit must be planned for all participants and procedures must actually occur which encourage profitability.

In a Checkpoint tax practitioner commentary upon the *Barnes* decision[20], the comment criticizes the decisions of the courts for relying upon the fact that interest was not paid on the notes included in the plan. The courts, it argued, ignored the fact that the interest was accrued, rather than presently and actually paid. But it appears that the courts thoroughly examined the documents for any evidence of intent to treat the interest as accrued; their examinations of the plan and of its execution found a disregard of all form and practice. This disregard amounted to common law fraud. In addition, the commentary criticized the application of penalties for the taxpayer's lack of substantial good faith and reasonable reliance upon substantial authority. The courts, however, and the accountant's tax opinion indicated that reliance would have been misplaced. Prior court decisions implied that Revenue Ruling 74-503, because it did not describe the exact procedures as stated in the plan, could not be the reasonable basis for the taxpayer's decision. In addition, PwC explicitly stated in its opinion letter that it made no decision about the tax consequences of the plan.

The *Barnes* decision and the practice commentary, then, plainly indicate certain essential elements needed in any reinvestment plan or other plan, whether national or transnational, which involves a parent and a subsidiary. Such plans, as already mentioned, must express an explicit business purpose and must be executed in accord with that purpose. In addition, caution is needed: revenue rulings must be strictly construed and expert advisors' opinion letters must be carefully read and used to prevent the penalty levies which resulted in this case.

ENDNOTES

[1] According to Tax Court records, Barnes' debt-to-equity ratio increased from .30 to 1.15. *Barnes v. Commissioner* 2013 Tax Ct. Memo LEXIS 113.

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[2] *Barnes v. Commissioner* 2014 U.S. App. LEXIS 21239., which is an unpublished opinion.
[3] See https://www.law.cornell.edu/uscode/text/26/351
[4] The Internal Revenue bulletin 2006-2 dated January 9, 2006 stated "Section 351 The conclusion in Rev. Rul. 74-503 that a transferor's basis in transferee stock received in exchange for transferor stock…is incorrect….Rev. Rul. 74-503 revoked….Under the authority of section 7805(b), the Service will not challenge a position taken prior to December 20, 2005, with respect to a transaction occurring prior to that date, by a taxpayer that reasonably relied on the conclusions in Rev. Rul. 74-503."
[5] *Barnes v. Commissioner* 2013 Tax Ct. Memo LEXIS 113 at 115.
[6] 2013 Tax Ct. Memo LEXIS 113 at 117.
[7] 2013 Tax Ct. Memo LEXIS 113 at 118.
[8] Due to debt equity considerations however, Barnes itself lent funds to Bowman UK and Bowman France; ASA collected these receivables and thereafter Barnes Canada made the investments in UK and France which were repaid to Barnes. 2013 Tax Ct. Memo LEXIS 113 at 120.
[9] *Briarcliff Candy Corp v. Commissioner*, T.C. Memo 1987-487
[10] *Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Circuit, 2011) Affirming 135 T.C. 78 (2010).
[11] 664 F. 3d 313 at 329.
[12] 2013 Tax Ct. Memo LEXIS 113 at 121.
[13] 2013 Tax Ct. Memo LEXIS 113 at 118-119.
[14] *Smith v. Commissioner* 78 T.C. 350 at 389 (1982), affirmed without published opinion, 820 F.2d 1220 (4th Circuit, 1987).
[15] See *Long-Term Capital Holdings v. United States*, 150 Federal Appendix, 40 (2nd Circuit, 2005).
[16] See *Superior Trading, LLC v. Commissioner*, 137 T.C. 70 (2011).
[17] See *Commissioner v. Gordon*, 391 U.S. 83 (1968).
[18] See *Greene v. United States*, 13 F.3d. 577 (2nd Circuit, 1994).
[19] See *American Bantam Car Co. v. Commissioner* 11 T.C. 397 (1948), 177 F. 2nd 513 (3rd Circuit, 1949).
[20] See commentary entitled "The Tax Court in *Barnes Group* Misapplies the Step Transaction Doctrine, Imposes Penalties" https://checkpoint.riag.com at p.267

HOSTING IN THE NEW PEER-TO-PEER MARKETPLACE: BETTER BARTER DISRUPTS REGULATORY REGIMES

by

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INTRODUCTION

Everyone loves a bargain and wants to cut out the middleman. The new lingo of “collaborative consumption,” the “sharing economy, and “disintermediation” all come down to connecting buyers and sellers directly through social media sites that facilitate commercial transactions. New sites promise faster, better, and more accessible services, all available on phones equipped with the latest app. But what are the downsides? This paper will focus on one of the major “disrupters” in the hotel industry, Airbnb, and review the regulatory risks for hosts operating under this new business model.

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BACKGROUND ON THE SHARING ECONOMY

Collaborative consumption is not new. Before industrialization, commerce thrived on a robust barter system that relied on direct personal exchanges. Today, food cooperatives and community supported agriculture programs offer the benefits of locally grown produce to participating members, typically at a reduced fee and/or in return for work contributed to the enterprise. Such traditional barter systems rely on face-to-face transactions. The availability and widespread use of the Internet now provides a vehicle that magnifies the possibilities of commercial exchanges on a global scale. Collaborative consumption has gone viral.

During the late 1990s, Napster facilitated peer-to-peer (P2P) file sharing of music. Despite years of legal battles that eventually shut down Napster, the technology revolutionized the music industry and dramatically brought down consumer prices.[1] It is not surprising that the $6 trillion travel business is now under similar assault.[2] The creation of hyper-efficient global digital markets allows one to obtain every type of product or service without moving through a physical supply chain and without paying a middleman.[3] In P2P, individuals transact exchanges directly through an Internet platform maintained by a third party, essentially a matchmaker. P2P property rental websites provide marketing and advertising, screen renters and owners, have access to the owners' inventories, manage rental bookings, collect payments, and provide some form of insurance coverage for damages caused by the renters.

AIRBnB MOVES IN, AND RAPIDLY GOES MAINSTREAM

No-cost room sharing was pioneered by the nonprofit site

CouchSurfing.com. In contrast, Airbnb (originally called Airbedandbreakfast) was founded in 2008 with a clear for-profit focus. In the last few years, it has grown by leaps and bounds. Currently its listings exceed 600,000 properties spread around the world in over 190 countries and 34,000 cities. Its couches, beds and rooms are used by more than 15 million people.[4]

Annual sales are reported to be in the range of $100-$250 million and it employs 700 people. Airbnb’s main source of revenue is through the 12 percent fees (3% paid by the host and 9% paid by the guest) it collects for every completed transaction. Its operating expenses include:

- Hosting of the Internet platform
- Screening and identity verifications of both hosts and guests
- Collection of fees
- Maintenance of a secure payment process
- Insurance premiums for its $1 million host guarantee policy
- Litigation and related legal costs for compliance with local, state, and national regulatory laws[5]

Airbnb is the major innovator in the new sharing economy, with a valuation of anywhere from $2.5 to $10 billion. (It is difficult to be more specific as the company is privately owned and financial information is not readily available.) Many experts expect its IPO to be one of the largest, putting it squarely with other tech leaders like Facebook and LinkedIn. Its growth derives not only from internal expansion (it opened a new headquarters in Singapore to exploit the Asian market), but also through strategic acquisitions. Airbnb bought German competitor Accoleo and London-based Crashpadder. In addition, it has started experimenting with offering optional experiences to guests in which the hosts may choose to participate. These include guided tours, nature hikes, bike excursions, and food and drink tastings. The company's popularity also has been enhanced through mobile apps that allow for instant bookings and an interactive website which answers user questions in real time. Airbnb is beginning to enlist owners of unique properties for exchanges, mainly with the idea of attracting non-budget, upscale travelers.[6]

In fact, CEO Brian Chesky envisions Airbnb as a "full-blown hospitality brand" with consistent services that can generate lots of additional revenue. For starters, Airbnb is testing a full-service cleaning package that will include towels, bed sheets, mints and a welcome gift. The cost will be about $60 per rental, and it is anticipated that hosts will pass that fee on to guests. Also under consideration are airport-transportation services and a new "business-ready" designation to woo corporate travelers.[7] Airbnb seems to be gaining corporate recognition. Billionaire investor Warren Buffett has recommended that shareholders in his Berkshire Hathaway Company use it when attending the company's annual shareholders meeting in Omaha, Nebraska, since the city has a relatively small number of hotel rooms. And in another nod to respectability, American Express added Airbnb to its membership rewards program in December, 2014.[8]

There are several other external factors that have contributed to Airbnb's success. The Great Recession of 2008 left many home and condo owners holding upside down mortgages with the possibility of foreclosure. Job losses and lower incomes saddled many renters with unaffordable monthly payments. These two factors have increased both the supply of units made available by people looking for additional income and the demand for such units by people exploring ways to cut costs when traveling. Positive experiences with sites such as Taskrabbit (outsourcing routine and skilled jobs), as well as Uber and Lyft (ride-sharing) have led to general acceptance of the Internet-based sharing paradigm. Many guests, particularly those seeking a bargain, are willing to rent rooms through non-hotel avenues.

For the parties directly transacting business through Airbnb, the benefits and costs are obvious. Tenants and owners with rooms to rent earn financial rewards and simultaneously enjoy the pleasure of meeting new people. Guests save money, meet new people and stay in neighborhoods where hotels may be rare or very expensive. Nonetheless, potential costs to a tenant may be high:

- Theft of and damage to their own and neighbors' properties
- Consequences of crime for hosts and their neighbors
- Possibility of eviction due to severe infraction of the rules by guests and/or the Airbnb rental being deemed in violation of the lease

Guests may encounter poor quality rooms and furniture, unfriendly hosts, and rentals that are not in compliance with safety, health and fire regulations.

Renting out one's own private home is quite different than turning one's residential tenant lease into a commercial source of personal income. Unless they receive compensation, landlords will not want to incur the added liability of their tenants serving as paid hosts to unknown guests. Possible responses may include increases in rent to grab a share of the income generated by the tenants. Alternatively, leases may completely ban any form of re-rental without prior permission of the landlord. Some landlords may take a few rental units off the market to reserve for their own use of Airbnb type services, particularly if the unit is likely to attract high rental fees from travelers. If a significant number of landlords follow suit, the supply of long-term rentals could go down, making housing less affordable and disrupting many communities. This strategy may favor tourists over the locals.

The definite losers in this sharing economy are hotels and local, state and federal governments. Hotels are at a significant competitive disadvantage. Hotels have to build and maintain their facilities, assure compliance with the Americans with Disabilities Act, meet fire, food, safety, and health codes related to their operations, and pay sales, occupancy, real estate, franchise and income taxes. Airbnb's low overhead is based on essentially contracting out all of its operational and managerial expenses to its hosts—it can lay claim to being the world's largest hotel chain without owning a single hotel.[9]

Arguably, competition may help drive hotel prices down to more reasonable rates. It has been estimated that in 2013, in New York City alone, over one million hotel room nights were not filled due to P2P sharing arrangements.[10] Airbnb now has 16,000 accommodations available in the city, representing 11 percent of the city's inventory.[11] Spending on Airbnb by Big Apple tourists in 2014 is estimated at $282 million. The service has become especially popular in trendy, up-and-coming areas, and value hotels (those in the $150-$250 per night range) are feeling the pinch. Average revenue per available room in New York has fallen about 5% from its peak, to $225 per night, and Credit Suisse lodging analysts note that competition will continue to exert downward pressure as New York is also experiencing a surge of hotel construction. Although major lodging companies may withstand pressure from oversupply because they derive 60% of their New York business from corporate travel, another worry is that the strong dollar may put a significant dent in summer tourism.[12] Fewer room nights translate to a significant loss of tax revenue, and workers employed in the hospitality industry may experience lower income and possible job losses due to lack of business for traditional hotels.

As a counterpoint, Airbnb contends that it makes contributions to local economies by bringing in travelers who otherwise might not visit expensive cities. The company released a study in 2013 claiming that its services generated $632 million for New York City that year by attracting visitors who couldn't otherwise afford hotel rooms. Airbnb enabled them to stay longer and to spend more money on food and shopping, rather than blowing their budgets on hotel rooms.[13] These assertions are hard to verify because it is impossible to separate such incremental visits from the business siphoned off from standard lodging.

LEGAL AND ECONOMIC CONSIDERATIONS

Not surprisingly, many cities oppose the presence of Airbnb and the impact it has on revenue raised by visitors. Rental properties in New York City are a good example of the competing economic interests at play. Renters there have the second highest average rent in the country.[14] Tenants have found that renting out their apartments is an easy way to offset their high rents. Given the fact that New York has a seemingly never ending supply of tourists seeking housing, and a relatively equal supply of tenants willing to give up their apartments, it is no surprise that Airbnb has been so successful.

The city, on the other hand, oversees a rental system with layers of arduous regulations including rent control, as well as a hotel industry vying for the very same visitors as Airbnb. Apartment building owners and the state have reacted with an aggressive, legalistic approach to rein in Airbnb. Two examples are illustrative.

First, in one of the only reported cases involving Airbnb, *Brookford, LLC v. Penraat* [15] a property owner in New York City challenged one of its tenants' rights to rent via Airbnb. This particular tenant had a rent-controlled apartment on Central Park West, with multiple bedrooms at her disposal to lease. Other tenants in the building became suspicious at the constant stream of strangers entering their building. The defendant left keys with the doorman and instructed him to allow the visitors into her apartment. Perhaps this is how the owner of the building became aware of her Airbnb activity.

The building owner set forth four different arguments to the court. First, the plaintiff argued that the defendant utilized her apartment for business purposes, thus commercializing and profiteering from an illegal hotel and/or bed and breakfast. Second, the presence of transient guests was disturbing to the tenants of the building as both a safety issue (the tenants complained about the noise and disruption caused by the visitors and were frightened by the number of strangers in the building). Third, renting rooms to customers violated the fire safety protections required of hotels in New York, constituting a health, safety and welfare argument; and finally, New York City's rent control law prohibited the renting of an apartment to visitors for stays of fewer than 30 days.[16] The court agreed that the defendant's actions were an "incurable violation of the Rent Control Law as well as a violation of New York's MDL § 4.8, a 2010 city ordinance "intended to prohibit building owners of Class A multiple dwellings, which are intended for permanent residencies, from renting out dwelling units for less than 30 days or on such a transient basis."[17] As a result of the court's decision, precedent clearly exists for building owners to evict tenants who rent their rooms via Airbnb.

Yet one problem still exists for building owners. Unlike the plaintiff in *Brookford*, most landlords do not know if their tenants are leasing rooms. Enter New York State Attorney General Eric Schneiderman (AG). He filed suit against Airbnb in 2013, alleging that virtually no rooms were rented for more than 30 days and that nearly two-thirds of the close to 20,000 listed hosts planned to rent their entire apartment and would not be present.[18] Airbnb initially resisted the AG's subpoena to supply information about its hosts on privacy grounds, but in May 2014 it agreed to provide anonymous data and to identify the names and contact information of individual users the AG's office chooses to investigate for possible enforcement action.[19] Though the AG stated that the focus of his investigation will be on renters of multiple apartments and not on occasional one room rentals, many observers worry about a chilling effect on hosts who might pull out in fear of a violation of their lease or New York law.[20] No statistics exist for how many potential hosts were alarmed about possible eviction and stopped offering their properties through Airbnb, but one could assume a not insignificant affect. Some hosts also have been rattled by Airbnb's tactics, which have involved aggressive emails to solicit properties and very demanding identity verification processes.

New York is not the only city to try to limit Airbnb via legal means. Landlords in British Columbia are keeping an eye out for rentals and threatening eviction of errant tenants. In spite of its efforts to stem the rentals, however, one of British Columbia's politicians acknowledged that, "This is likely something that is going to grow, and we don't pretend that we're going to be able to stop it." [21]

In Lousiville, Kentucky, owners renting properties were told by the city to cease and desist or face considerable fines. The city claimed that owners were acting like hotels without the necessity of complying with laws about fire or health inspections. Mayor Greg Fischer believes there is an un-level playing field because those staying in lodging through sharing sites like Airbnb are not paying the same lodging tax paid by those who stay in hotels. Those revenues are used to help fund the Louisville Convention Center and Visitors Bureau.[22]

What New York, British Columbia, and Louisville all have in common is an effort to stem the tide of a popular and lucrative business whose offenders are nearly impossible to catch and whose admirers are countless. Perhaps to avoid more intrusive regulation and to support its assertion that it adds value to city economies, Airbnb now wants its hosts to tax users. Despite Airbnb's estimated projection of raising $21 million per year in state and city taxes, the Hotel Association of New York City adamantly rejects any approach that taxes hosts or users because it would provide legitimacy for Airbnb's business model.[23]

Airbnb appears to be winning this latest battle in many prime locations. In late October 2014, San Francisco Mayor Ed Lee signed a law that legalized Airbnb-style home-sharing in the city.[24] The 14 percent tax is expected to yield as much as $11 million annually.[25] In San Jose, a vote in December 2014 to levy the hotel tax on Airbnb guests also legalized the platform. Chicago and Washington, D.C. have yet to adopt measures that would officially legalize short-term Airbnb rentals, but Airbnb entered into arrangements with both cities "to assist in the collection of a 'transient accommodations' tax equal to 14.5 percent of the listing price plus cleaning fees (D.C.), while in Chicago it is 4.5 percent of the same."[26]

Portland, Oregon, one of Airbnb's largest host cities, is trying to regulate hosts by making them apply for permits, pay lodging taxes and endure housing (safety) inspections.[27] Though the city estimates 1,600 short-term rental hosts list their properties on sites such as Airbnb, HomeAway and

FlipKey, only 166 permit applications have been received since August 30, 2014, when the city's transient lodging tax (11.5%) went into effect requiring hotels and other properties to collect this tax.[28] In January 2015, another ordinance expanded the permit requirement from hotels to "multi-dwellings" hosts, but only an additional 34 applications were received by the end of February 2015.[29] Airbnb began collecting hotel taxes on behalf of its users in July 2014. Nonetheless, Portland's goal to achieve accountability for occasional hosts through its new licensing system may prove elusive.

Interestingly, some cities have declined to regulate or tax rooms rented out, citing other more pressing priorities. The Palo Alto City Council views the few complaints it has received about Airbnb as either invalid or of minimal concern.[30]

Perhaps not surprisingly, Airbnb has created a face-saving escape for its most ardent opposition. It has proposed an ingenious system by which it agrees to collect hotel taxes from its own renters and remit that money to the very cities that oppose Airbnb's existence. Gone then is the argument that Airbnb deprives municipalities of revenue, leaving traditional hotels and licensed bed and breakfast operators to dispute the unfair disparities in the application of fire, health and safety codes. Local government support for increased regulation is less likely once the respective cities have been, in a sense, "paid off." In short, Airbnb may have out-smarted its opposition. By directly addressing the major arguments against its existence, it may have guaranteed its future.

Yet Airbnb's biggest market, New York City, remains unmoved. In a contentious, eight-hour City Council meeting in late January 2015, lawmakers refused to change the city's short-term rental laws and urged stricter enforcement, particularly against commercial operators. In 2014, the Mayor's Office of Criminal Justice fielded 1,150 complaints—up from 713 in 2013—and exercised 900 inspections. City Council wants the unit to be more proactive and to seek operators out through Airbnb's website. More lawsuits have been filed, and the strength of the New York City anti-Airbnb crowd appears to be growing.[31]

CONCLUSIONS AND RECOMMENDATIONS

Airbnb’s routine violations of existing housing laws finally have come under legal challenge. Regardless of the outcome of the pending court cases, the concept of collaborative consumption, where the focus is on access and not necessarily ownership, will lead to significant changes in the laws and regulations. We are accustomed to having one set of laws that businesses need to follow and another set of laws people need to abide by. In the new sharing economy, people and their interactions are the business. One key point that has yet to be addressed is whether individuals participating in these transactions are subject to anti-discrimination laws. P2P platforms ostensibly facilitate connections between private individuals, yet hosts offer accommodations to the general public and then review guest profiles to select a match. Here the blurred lines between places of public and private accommodation may contravene established public policy.

Millennials place great faith in P2P platforms, but that trust is grounded in a relatively high set of standards established by previous generations as the basis of any bargain they strike. Those expectations are the consequence of a long history of hard won consumer protection health and safety regulations. Airbnb already has acknowledged its obligations to police baseline standards such as clean linens and smoke detectors, and it appears to be moving into the higher end market by offering typical concierge services. If taxes are assessed and collected, the price gap between Airbnb rooms and traditional hotels may begin to close, and amateur hosts may find the venture less appealing. As Airbnb settles into its own distinctive brand and niche, new trendsetters will move in. It is clear that P2P transactions will command a growing segment of the hospitality industry. The latest disrupters are social networks such as EatWith, Feastly, and Cookapp that connect chefs with diners, bypassing the licensing and food inspections required of restaurants.[32]

While hoteliers and restaurateurs decry the modern technology that circumvents existing laws and call for a level playing field, to date they have failed to identify the core regulations to which such new business models should adhere. Rather than trying to outlaw the creative energy generated by P2P sharing, regulators and industry leaders must develop a new framework in which these many independent contractors can operate and flourish. A more fluid regulatory regime may engage far more consumers in travel and hospitality pursuits. Old-style businesses must reposition themselves to capitalize on that gain.

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METROPOLITAN LIFE AND THE SHADOW BANKING CONTROVERSY: NON-BANK INVESTMENT ALTERNATIVES TO TRADITIONAL BANKING

by

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INTRODUCTION

"Shadow banking" has a great variety of definitions. The term was originally coined in 2007 by Paul A. McCulley, who attended the Kansas City Federal Reserve Bank annual symposium in Jackson Hole, Wyoming. The meeting discussed the financial crisis then occurring nationally and globally. It focused on systemic risk and, in particular, what the author

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dubbed the “shadow banking system” which he noted was “the whole alphabet soup of levered-up non-bank investment conduits, vehicles, and structures.”[1]

In a series of Staff Reports issued by the Federal Reserve Bank of New York, the authors defined “shadow banks” as “financial intermediaries that provide maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public service credit guarantees.”[2] Two of these staff authors in a later report defined the term as “a web of specialized financial institutions that channel funding from savers to investors through a range of securitization and secured funding techniques.”[3] A comparable variety of definitions: “The system of non-deposit taking financial intermediaries including investment banks, hedge funds, monoline insurance firms and other securities operators”;[4] “all financial activities, except traditional banking, which require a private or public backstop to operate.”[5] “The financial intermediaries involved in facilitating the creation of credit across the global financial system, but whose members are not subject to regulatory oversight. The shadow banking system also refers to unregulated activities by regulated institutions.”[6]

This article will examine the present controversy between the Financial Stability Oversight Council (FSOC) and the Metropolitan Life Insurance Company (MetLife) concerning the council’s final determination concerning the need for the council to oversee MetLife’s shadow banking activities and the company’s continuing efforts to contest the rights of the Council to regulate the company’s activities. The article will conclude that regulation is indeed necessary in light of comparable international regulation and the financial ramifications of the company's activities.

THE METROPOLITAN LIFE CONTROVERSY

The Dodd-Frank Act Empowerment of the Council

The FSOC was established pursuant to §111 of the Dodd-Frank Act. The Council's Board of Governors, among other matters, identifies risks to U.S. financial stability, promotes market discipline, and responds to threats to the stability of the U.S. financial system.[7] With respect to nonbank financial institutions, the Act requires supervision "for nonbank companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure"….[8] The Board of Governors may make recommendations for the establishment of heightened prudential standards for risk-based capital and other financial instruments.

Factors that the Council considers in making a determination of whether a U.S. company is to be supervised by the Board of Governors of the Council include (a) the extent of the leverage of the company; (b) the extent and nature of the off-balance-sheet exposures of the company; (c) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (d) the importance of the company as a source of credit for households, businesses, and

State and local governments and as a source of liquidity for the United States financial system; (e) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (f) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse; (g) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (h) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies; (i) the amount and nature of the financial assets of the company; (j) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (k) any other risk-related factors that the Council deems appropriate.[9]

FSOC's MetLife Inc. Final Determination

On December 18, 2014, the Council designated MetLife as a nonbank systemically important financial institution. MetLife is the fourth nonbank to receive the designation as systemically important. The other nonbanks to receive the designation are Prudential Financial, Inc. (September 19, 2013); General Electric Capital Corporation, Inc. (July 8, 2013); and American International Group, Inc. (July 8, 2013).[10] The Council sought to regulate MetLife as it had regulated other corporations in order to encourage financial stability.[11]

Under §102(a) (6) of the Dodd-Frank Act, a company is predominantly engaged in financial activities if (a) the annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature…and, if applicable, from the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated annual gross revenues of the company; or (b) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature … and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated assets of the company.

With respect to MetLife, the Council issued a lengthy analysis which included over 21,000 pages of the company's submissions. The Council determined that material financial distress at MetLife could pose a threat to the financial stability of the United States. The company, therefore, should be subject to the enhanced prudential standards of FSOC.[12] The Council observed that the Metropolitan Life Insurance Company (MetLife) is a global entity that provides insurance and many other insurance-related and financial products to some 100 million customers to over 50 countries. As of 2014, in fact, it possessed some $902 billion in total assets and that its assets and activities met the 85 percent threshold of Dodd-Frank.

MetLife responded quickly to the determination. In its January 13, 2015 complaint filed in the United States District Court for the District of Columbia, the company sought review of the determination in accord with provisions of the Dodd Frank Wall Street Reform and Consumer Protection Act, the Administrative Procedure Act and the United States

Constitution. The company designated the determination as arbitrary and capricious and not in accord with MetLife's status as an insurance company rather than as a company predominantly engaged in financial activities as defined by the Dodd Frank Act itself and the Bank Holding Company Act. The company noted, furthermore, that the action by FSOC follows the recommendations of the Financial Stability Board (FSB), a mostly European body of bank regulators and central banks in which the U.S. Department of the Treasury and the Federal Reserve are members. The FSB had published an initial list of nine global systematically important insurance companies that are systematically important financial institutions. Its recommendations had no force of law and MetLife had no opportunity to challenge the FSB recommendations.[13]

The seventy-nine page ten-count complaint contended that FSOC's final determination to designate MetLife as a nonbank systemically important financial institution was arbitrary and capricious because, among other matters, (a) the only independent voting member of the Board of Governors with insurance expertise as well as the only nonvoting insurance commissioner on the Council both dissented from the finding; (b) MetLife was denied due process by the rules and obligations under Dodd-Frank, the APA and the due process clause of the Constitution; (c) FSOC made numerous errors that fatally led to FSOC's reasoning in its findings; (d)FSOC failed to give meaningful weight to the existing comprehensive state insurance regulatory regime; (e) MetLife is not predominantly engaged in financial activities as required by statute which of the failure to meet the 85% rule; (f) the FSOC failed to undertake activities-based review for insurance companies; (g) FSOC failed to assess MetLife's vulnerability to material financial distress; (h) FSOC's findings relied upon unsubstantiated speculation and irrational economic predictions[14]; and (i) FSOC failed to examine consequences of its designation decision.

HISTORICAL SETTING OF TRADITIONAL BANKING AS OPPOSED TO SHADOW BANKING

Traditional Banking

Traditional banking has had a checkered history. National banking began at the inception of the New Republic. The First Bank of the United States (1791-1811) operated under the leadership of Alexander Hamilton, who was also the first Secretary of the Treasury under President George Washington. The issuances of bank notes occurred through state banks due to the lack of a national currency. In the seminal case of *McCulloch v. Maryland,*[15] the United States Supreme Court decided that Congress had the right to create a bank under its power to make "all laws which shall be necessary and proper, for carrying into execution" its delegated powers under Article I of the Constitution. In the midst of the Civil War of 1861-1865, Congress enacted the National Banking Act[16] which established standards for banks including minimum capital requirements and the issuance of loans as well as the imposition of a 10 % tax on state banknotes that effectively removed them from circulation.[17]

The Federal Reserve Act of 1913[18] creates the national system of banks that has existed to the present day. It requires all national banks to be members of the Federal Reserve System and to maintain levels of reserve with one of the 12 Federal Reserve banks. State banks are also eligible to become members of the Federal Reserve System with all of the attendant benefits including federal protection of deposit. The "Fed" conducts monetary policy, supervises and regulates banks, protects consumer rights, and provides financial services to the government, financial institutions, and makes loans to commercial banks. The Great Depression that commenced in 1929 and ended with the entry of the U.S. into World War II led to Congressional inquiry concerning the causes of that Depression. The inquiry noted that there were bank panics almost every 20 years. It discovered that among the major causes were the heavy investments in securities by bank affiliates in the 1920s, serious conflicts of interest between banks and their affiliates, speculative investments by banks, and high-risk ventures. Accordingly, the Banking Act of 1933,[19] better known as the Glass-Steagall Act, became the law of the land.

Bank Separation into Classes

Glass-Steagall separated banks into commercial banks and investments banks. Section 20 of the Act forbade a member bank from engaging in the issuance, flotation, underwriting, public sale, distribution, or participation of stocks, bonds, debentures, notes, or other securities. Section 21 forbade firms that engaged in the said forbidden activity from receiving deposits, certificates of deposits, or other evidences of debt. The payment of interest on accounts was restricted by the Act to prevent ruinous competition. As a result bank panics that occurred virtually every other decade did not occur from 1933 until many decades later apparently as a result of the removal of the same separation of banks. The passage of the Riegel-Neal Banking and Branching Efficiency Act of 1994[20] repealed the prohibition of interstate banking by permitting banks to purchase banks in other states or to establish branches therein. The Federal Deposit Insurance Corporation (FDIC) was given jurisdiction over state nonmember banks, the Office of the Comptroller of Currency received jurisdiction over state nonmember banks, and the Federal Reserve Board over state member banks. Applicants for expansion were judged by their compliance with the Community Reinvestment Bank of 1977,[21] which mandated reinvestment by out-of-state banks in the local communities where they were located.

Repeal of Glass-Steagall

In the 1990s U.S. banks complained that they could not compete with foreign, especially Japanese multi-service banks that offered both commercial and investment banking services. The share of total private financial assets held by these banks declined from 60 % to 35 % for the period of 1970-1995. As a result and after four decades of the Glass-Steagall separation without any major run on banks, the Financial Services Modernization Act popularly known as the Gramm-Leach-Bliley Act of 1999 was enacted.[22] The first section of the Act repealed the Glass-Steagall separation of commercial and investment bank. It permitted the creation of a new "financial holding company" whereby the entity may engage in any activity that the Federal Reserve Board determines to be financial in nature or incidental to such activity. It did provide, however, that the activity not pose a substantial risk to the safety or soundness of depositary institutions or to the financial system generally. Banks could now offer services that included insurance and securities underwriting and merchant banking. Before the Glass-Steagall repeal, banks had avoided panics for twice the usual time period; the banking crisis of 2007-2009 raised issues of the soundness of the Glass-Steagall repeal and "too-big-to-fail" bank holdings.

Dodd-Frank and Other Reforms

Whenever a financial crisis looms, it is almost inevitable that governmental regulation is promulgated to solve or prevent re-occurrence. The thousand-page Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[23] was signed into law which contained numerous sub-titles that sought to alleviate many of the ills affecting the financial system. Title VI, known as "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010," explicitly dealt with bank holding companies created under Gramm-Leach-Bliley. Rather than restore the Glass-Steagall separation of commercial banks from investment banks, the major emphasis of Title VI is that a bank holding company is to be "well-capitalized and well-managed."[24] Section 38(b) of the Federal Deposit Insurance Act[25] defines "well-capitalized" as follows: "An insured depository institution is "well-capitalized" if it exceeds the required minimum level for each relevant capital measure." Dodd-Frank raised the standard of well-capitalized to be where its total risk-based capital ratio is 10 % or greater, a Tier I risk-based capital ratio of 6 % or greater, and a leveraged capital ratio of 5 % or greater.

The Volcker Rule

The already mentioned financial crisis of 2007-2009 led to the closures of hundreds of banks, somewhat reminiscent of the closures of the Great Depression. Government had to come to the rescue of certain banks so that the global financial system would not collapse. Some believed that the crisis was precipitated by the repeal of Glass-Steagall; they pointed to the $6 billion loss by JP Morgan Chase in 2012 with respect to speculative trading in the U.K. The "Volcker Rule", named after the former chairman of the Federal Reserve, Paul Volcker, was promulgated pursuant to Title VI, §619 of Dodd-Frank which added a new §13 to the Bank Holding Company Act. It prohibited an insured depository institution and holding company controlling an insured depository institution from engaging in proprietary trading and further prohibited the sponsoring and investing in hedge funds and private equity funds. The term "proprietary trading" was given a broad definition to include acting as a principal or custodian for an affiliated third party; for a trading account used by the entity to acquire or be financially involved in short-term resale; the prohibition of purchasing, selling, or otherwise acquiring or disposing of stocks, bonds, and other financial instruments for the bank's own account. The Rule became effective on July 21, 2012 but allowed banks two years to comply.[26]

Additional Prohibitions

Section 939(a) of Dodd-Frank amended the Federal Deposit Insurance Act to prohibit a savings and loan association from acquiring or retaining a corporate debt security that does not meet the standards of the FDIC. There were detailed considerations set forth in the Act in making the said determination. With respect to "too-big-to-fail," it was noted that in 2011 five banks possessed some $8.5 trillion in assets (56 % of the U.S. economy).[27] §622 of Dodd-Frank, "Concentration Limits on Large Financial Institutions," amended the Bank Holding Act of 1956 to forbid the merger, consolidation, or acquisition of substantially all assets or otherwise acquire control by financial institutions if the total consolidated liabilities of the acquiring financial company exceeded 10 % of the aggregated consolidated liabilities of all financial companies at the end of the prior calendar year. Exceptions which led to even greater enlargement of banks included acquisition of banks in danger of default.

Section 623 of Dodd-Frank amended the Federal Deposit Insurance Act to require the responsible agency to disapprove an application for an interstate merger transaction if the result of the merger is to permit the insured depository institution to control more than 10 % of the total amount of deposits of the insured depository institutions. Among the practices that caused a threat to the U.S. banking sector were loans on derivative transactions and other high risk loans. The total non-secured loans and extensions of credit made by national banks are restricted by statute not to exceed 15% of their unimpaired capital and unimpaired surplus. The total loans and extensions of credit by a national bank fully secured by readily marketable collateral having a market value, at least at least equal to the amount of the funds outstanding, are not to exceed 10% of the unimpaired capital and unimpaired surplus of the association. Dodd-Frank includes in the definition of "loans and extensions of credit" credit exposure on derivative transactions; repurchase agreements; reverse repurchase agreements; and securities lending and borrowing transactions. State banks are also made subject to the credit exposure limits with respect to derivative transactions. The Act also places limitations on lending to insiders as well as to purchases of assets from them unless the transaction is on market terms, represents more than 10% of the capital stock and surplus of the covered bank, and has been approved by a majority of the board of directors of the institution.

International Initiatives

Additional international regulatory requirements also appeared. The Basel Committee on Banking Supervision, composed of 27 countries and Hong Kong SAR, is a forum that calls for cooperation among member countries on banking supervisory matters.[28] Under the 2004 Basel II Accord, a three-pillar framework was established that included (1) risk-based capital requirements for credit-risk, market risk, and operational risk; (2) supervisory review of capital adequacy; and (3) market discipline through enhanced public disclosures. Basel III entitled “A Global Regulatory Framework for More Resilient Banks and Banking Systems, added technical changes concerning assignment of risk or certain securitization positions.[29] Some of the recommendations of the said Basel Accords concerning the market risk framework were adopted as a Final Rule by Federal Reserve Board together with the Office of the Comptroller of the Currency and the FDIC that required banking organizations with significant trading activities to adjust their capital requirements to better account for the market risks of their activities.[30] The Rule modified the existing market risk capital rule by adjusting the minimum risk-based capital calculation by the use of new measures of creditworthiness. It also: (1) modified the definition of covered positions to include assets that are in the trading book and held with the intent to trade; (2) introduced new requirements for the identification of trading positions and the management of covered positions; and (3) requires banks to have clearly defined policies and procedures for actively managed covered positions, for the prudent evaluation of covered positions, and for specific internal model validation standards.[31]

In summary, bank institutions are now also subject to the many statutory and regulatory provisions promulgated after the financial crisis of 2007-2009. As a result of these restrictions, there was a decided effort by many financial and investment institutions to avoid or bypass these onerous provisions.

Shadow Banking

Shadow banking in essence operates by intermediation, the matching of lenders with savings to borrowers who need money by an agent or third party. The agent or third party had always been a bank, but now non-bank financial institutions practice this intermediation outside of the traditional banking system. This type of intermediation lacks both the protections afforded to traditional or regular banks but also avoids onerous statutory and regulatory obligations. In traditional banking intermediation, banks received deposits from depositors which then are used to fund loans to borrowers. The FDIC, the Federal Reserve's discount window, and other governmental guarantees offer relative financial safety to these deposits. In shadow banking financial intermediation, however, and in particular in credit intermediation, these guarantees are wanting. It was believed that this intermediation was safe because of credit lines and tail-risk insurance in the form of wraps and guarantees that included commercial banks and insurance companies. The forms of funding included securitizations such as mortgages, loans, and receivables that were combined into securities and tranches; and secured lending backed by mortgages and other assets.[32]

Although having a serious downturn during the financial crisis of 2007-2009, it is conservatively estimated that non-bank financial intermediation ("other financial intermediaries" [OFI]) grew to $75 trillion in 2014 having advanced by some $5 trillion from the prior year. OFI assets constituted 24 % of the total global financial assets, half of banking system assets, and 117% of GDP.[33] At the end of 2012, the national jurisdictions hold assets of non-bank financial intermediaries were mainly the U.S. (37%); the Euro area (31%); the U.K. (12%); and China (3%).[34] The Financial Stability Board (FSB)[35] divided the OFI into sub-sectors as follows (a)other investment vehicles composed of "equity funds" ($9 trillion); "fixed-income/bond funds" ($7 trillion); "other funds, i.e., neither equity nor bond funds ($3 trillion); and representing a total of $21 trillion and 35% of OFI assets (b)broker-dealers- $7 trillion or 12& of OFI, mainly concentrated in the United Kingdom (UK), U.S., Japan, Canada, and South Korea; (c) structured finance vehicles - $5 trillion held mainly in the U.S. and the U.K.; (d) finance companies ($4.5 trillion [8%]) and money market funds ($3.8 trillion (6%) mainly in the U.S. and the euro area); (e) hedge funds ($0.1 trillion [0.02%]) but the figure appears to be underestimated due to omission of off-shore holdings; (f) jurisdiction-specific entities including Dutch special financing institutions, U.S. financial holding and funding companies.[36]

RISKS AND REGULATION OF SHADOW BANKING

A central purpose of the Dodd-Frank Act is to prevent systemic risk to the entire financial system by entities that are "to-big-to-fail." The designation clearly aimed at the several banks which controlled a vast percentage of deposits, any of which could bring about the financial collapse of the global financial system without governmental intervention. The question arose whether and to what extent shadow banking poses systemic risks to the financial community both within the U.S. and abroad. The collapse of Lehman Brothers caused the tightening of credit standards and banks became much more risk averse. Risks were then simply transferred from traditional banks to shadow banks which found it profitable to assume the risks that traditional banks were no longer able or desired to pursue. Regulators had paid little attention to shadow banks and, as a result, payday loans, "crowdfunding," securitized products, money-market funds, and repurchase agreements became the province of shadow banking. Firms like Blackstone, Ceberus, and Avenue Capital stepped in to provide the capital for smaller companies.

The problem is that while some commentators such as Bill Winters, formerly of JP Morgan Chase and head of Renshaw Bay, a shadow banking company, believe that the rise of shadow banking is healthy to the economy, others such as Professor Steven Schwarcz of Duke University bemoaned the fact that Dodd-Frank focused on traditional banks and essentially ignored shadow banking. Schwarcz would remove the protection of limited liability of managers of shadow banking firms which creates moral hazard. Manages not having "skin in the game" are more likely to take risks that expose their firms to market failure. Most shadow banking firms are owned and operated by investor-managers who may profit extraordinarily form high risk exposure but have little to lose because of limited liability consequence.[37] Similarly, Professor Richard Carnell of Fordham University believes that any confidence in shadow banking would be misplaced.[38]

The FSB suggested that systemic risk can arise from the interconnectedness between the banking sector and the shadow banking entities, both directly and indirectly. Shadow banking entities may be directly owned or benefit directly or indirectly by banks as part of the bank's intermediation chain. There may be funding interdependence as, e.g., the holding of the assets such as debt securities of each other's assets. There may be indirect interdependence and risk exposure as a result of investments in similar assets or exposure to common counterparties.[39]

Scholars at the American Enterprise Institute (AEI) dispute whether the Federal Reserve or the FSOC have the authority to regulate shadow banks. According to Peter J. Wallison of AEI and former counsel to President Ronald Reagan, the Dodd-Frank Act does not give either entity explicit power to regulate shadow banking. Congress was concerned with large financial institutions that could pose prudential risk to the financial system and not with control of transactions with each other. They are carrying out the recommendations of the FSB particularly as they relate to money market mutual funds, which are the major source of short-term funding in the capital markets. FSOC designated the same three U.S. insurance firms (AIG, Prudential, and MetLife) that the FSB designated as systematically important financial firms (SIFIs). The FSB source of authority is contrary to statutory authority. Moreover, Title I of Dodd-Frank limits FSOC's authority to firms it finds that their material distress or activities could cause instability to the U.S. financial system. Moreover, Title VIII of Dodd-Frank gives FSOC the authority to designate firms as systematically important. Such power may introduce moral hazards into the relationship between clearing houses and firms using their services. Title VIII does not set forth standards to be applied in making this designation.[40]

CONCLUSION

The shadow banking system is a major component of our national and international financial system. The shadow banking system arose to meet credit demands. At this time the system arguably is financially greater and more important than the traditional banking system. The Dodd-Frank Act and other financial regulations seek to prevent credit lending excesses that pose substantial risk to the overall financial system of the U.S. The relatively unregulated shadow banking system potentially does pose a systemic threat to the financial sector. As a result, it is incumbent upon Congress and other political actors to examine the complexity of the shadow banking system and initiate legislative and other actions to avoid yet another future crisis experienced less than a decade ago.

Whether or not MetLife will prevail will depend ultimately on the U.S. Supreme Court's interpretation concerning the limits of an administrative agency's regulatory interpretation of the Dodd-Frank Act. In *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984), the U.S. Supreme Court upheld the Environmental Protection Agency's interpretation of the Clean Air Act of 1977. In doing so, it engaged in a two-part analysis (called the "*Chevron* two-step test"), where a reviewing court determines:

> (a) First, always, is the question whether Congress has spoken directly to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court as well as the agency must give effect to the unambiguously expressed intent of Congress.
> If the Court determines Congress has not directly addressed the precise question at issue, the court does

> not simply impose its own construction of the statute
> ….
> (b) [I]f the statute is silent or ambiguous with respect to the specific question, the issue for the court is whether the agency's answer is based on a permissible construction of the statute[41].

The *Chevron* analysis was upheld in *Barnhart v. Walton.*[42] The *Barnhart* decision reversed the Court of Appeals and upheld the interpretation of the Social Security Administration with respect to the denial of disability benefits to individuals who are unable to engage in any substantial gainful activity unless the impairment has lasted or is expect to last for a continuous period of 2 months. The Court of Appeals had interpreted the statute that the 12-month period referred to impairment and not inability to so engage. The *Chevron* analysis appears to be limited to a formal adjudication or notice-and-comment rulemaking. "Interpretations such as those in opinion letters-like interpretations contained in policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law do not warrant *Chevron-style* deference."[43] The reason for the limitation given by the Supreme Court is that internal agency guidelines are not subject to the "rigors" of the Administrative Procedure Act, which includes notice and comment.[44]

Scholars and financial analysts disagree whether MetLife will succeed in its effort to thwart the efforts of FSOC. The company's shares declined slightly the day it instituted the action dropping 1.2% to $49.81/share. A senior analyst with

MetLife shareholder Snow Capital Management LP, Anna Wickland, believed that the litigation would go nowhere. Michael Barr, a University of Michigan law professor who assisted in the creation of the Dodd-Frank Act, indicated that MetLife faced a difficult legal battle to overturn the designation but Thomas Vartanian, chairman of the law firm of Dechert LLP that specializes in actions brought before the oversight council disagrees with the negative views and stated that MetLife had an excellent chance of prevailing in the litigation.[45]

In the light of the importance of shadow banking to our financial system and referring to previous Supreme Court cases delineating the powers of administrative agencies, it appears that MetLife should and will be regulated. Negotiations between MetLife and the Council, however, continue to this day with no resolution of the controversy, despite wide-spread consensus that MetLife and other nonbank financial intermediation businesses must be regulated.[46]

ENDNOTES

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[2] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, and Hayley Boesky, *Shadow Banking*, p. 2, Federal Reserve Bank of New York Staff Reports, No. 458 (July 2010, rev. Feb. 2012), http://www.scribd.com/doc/237269076/Pozsar-Adrian-Ashcraft-Boetsky-Shadow-Banking-Federal-Reserve-Bank-of-New-York-Staff-Reports-N-458-July-2010#scribd.

[3] Tobias Adrian, and Adam B. Ashcraft, *Shadow Banking Regulation*, Federal Reserve Bank of New York Staff Reports No. 559 (April 2012), p. 2, http://www.newyorkfed.org/research/staff_reports/sr559.html.
[4] *Definition of shadow banking*, FINANCIAL TIMES, http://lexicon.ft.com/Term?term=shadow-banking.
[5] Stijn Claessens, and Lev Ratnovski, *What is Shadow Banking?*, IMF Working Paper (Feb. 2014), www.imf.org/external/pubs/ft/wp/2014/wp1425.pdf.
[6] Investopedia, *Shadow Banking System*, www.investopedia.com/terms/s/shadow-banking-system.asp.
[7] Financial Stability Oversight Council, *supra*, note 33, p. 2.
[8] Dodd-Frank Act §112(a)(2). The Board of Governors is responsible for making recommendations for the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies supervised by the Board of Governors; and to identify systemically important financial market utilities and payment, clearing, and settlement activities.
[9] *Id.* §113(a)(2). Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies.
[10] Financial Stability Oversight Council, http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx#nonbank.
[11] The Financial Stability Oversight Council was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and is charged with three primary purposes:

1. To identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace.

2. To promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of failure.

3. To respond to emerging threats to the stability of the U.S. financial system.

http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf.

[12] *Supra*, note 30, p. 30.

[13] *MetLife Inc. v. Financial Stability Oversight Council,* Case 1:15-cv-00045. *See* also, Peter J. Wallison, *The regulators' war on shadow banking,* (Jan. 22, 2015), American Enterprise Institute, www.aei.org/+publication/regulators-war-shadow-banking/.

[14] Complaint Introduction pp.1-7.

[15] 17 U.S. (4 Wheat.) 36 (1819).

[16] National Banking Act of 1864, Ch. 106, 13 Stat. 99, June 3, 1864.

[17] For a detailed discussion of the history of traditional banking and banking regulation in general, see Roy Girasa, LAWS And REGULATION IN GLOBAL FINANCIAL MARKETS, Ch. 5, Palgrave Macmillan, 2013.

[18] Ch. 6, 38 Stat. 251, Dec. 23, 1913, 12 U.S.C. Ch. 3.

[19] Pub.L. 73-66, 48 Stat. 162, June 16, 1933.

[20] Pub.L. No. 103-328, 108 Stat. 2338, 12 U.S.C. 1811, Eff. Sept. 29, 1994.

[21] 12 U.S.C. 2901 et. seq.

[22] Pub.L. 106-102, 113 Stat. 1338, enacted Nov. 12, 1999.

[23] Pub.L. 111-203, H.R. 4173, enacted July 21, 2010.

[24] §606 of the Dodd-Frank Act.

[25] Pub.L. 81-797, 64 Stat. 873, enacted September 21, 1950.

[26] http://fdic.gov/news/board/2011Octno6.pdf.

[27] JP Morgan Chase & Co., Bank of America Corp., Citigroup, Inc., Wells Fargo & Co., and Goldman Sachs Group Inc.

[28] www.bis.org.bcbs.

[29] *Id.*

[30] Joint Final Rule of Office of the Comptroller of the Currency, Department of the Treasury, Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation, Risk-Based Capital Guidelines: Market, June 12, 2012, www.federalreserve.gov/about the fed/boar+dmeetings/market_risk_capital_final_FR_draft_20120607.pdf.

[31] *Id.*

[32] *Op. cit.*,no. 2, p. 2.

[33] Financial Stability Board, *Global Shadow Banking Monitoring Report 2013*, Executive Summary, p. 4. The updated sum of $75 trillion is noted by Simon Richards, *Bringing shadow banking out of the dark,* (Dec. 10, 2014), www.bobsguide.com/guide/news/2014/Dec/10/bringing-shadow-banking-out-of the-...

[34] *Id.*, p. 12.

[35] According to its website, the Financial Stability Board was established to: (a)assess vulnerabilities affecting the global financial system as well as to identify and review, on a timely and ongoing basis within a macro-prudential perspective, the regulatory, supervisory and related actions needed to address these vulnerabilities , and their outcomes; (b)promote coordination and information exchange among authorities responsible for financial stability; (c) monitor and advise on market developments and their implications for regulatory policy; (d)monitor and advise with regard to best practice in meeting regulatory standards; (e) undertake joint strategic reviews of the international standard setting bodies and coordinate their respective policy development work to ensure this work is timely, coordinated, focused on priorities and addresses gaps; (f) set guidelines for establishing and supporting supervisory colleges; (g) support contingency planning for cross-border crisis management, particularly with regard to systemically important firms; (h) collaborate with the International Monetary Fund (IMF) to conduct Early Warning Exercises; (i)promote member jurisdictions' implementation of agreed commitments, standards and policy recommendations, through monitoring of implementation, peer review and disclosure.
The FSB's decisions are not legally binding on its members but operate by moral suasion and peer pressure, in order to set internationally agreed policies and minimum standards that its members commit to implementing at national level. As obligations of membership, members of the FSB commit to pursue the maintenance of financial stability, maintain the openness and transparency of the financial sector, implement international financial standards and agree to undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program (FSAP) reports. http://www.financialstabilityboard.org/about/.
[36] *Id., p*p. 14-15.
[37] Steven L. Schwarcz, The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability, 90 *Notre Dame Law Review* (forthcoming). Available at: http://scholarship.law.duke.edu/faculty_scholarship/3155. A summary of the article discussed at the Harvard Law School Forum o Corporate Governance and Financial Regulation may be found at http://blogs.law.harvard.edu/corpgov/2014/02/06/the-governance-structure-of-shadow-banking/.
[38] Lauren LaCapra, and David Henry, A*nalysis: Five years after Lehman, risk moves into the shadows,* Reuters, (Sept. 12, 2013), www.reuters.com/article/2013/09/12/us-lehman-fiveyear-analysis-idUSBRE98B0562...

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[39] Financial Stability Oversight Council, Basis for the Financial Stability Oversight Council's Final Determination Regarding Metlife, Inc., p. 21-23 (Dec. 18, 2014), http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf

[40] Peter J. Wallison, *The regulators' war on shadow banking,* (Jan.2015), American Enterprise Institute Research, www.aei.org/+publication/regulators-war-shadow-banking/.

[41] *Chevron U.S.A. v. NRDC*, 467 U.S. 837, 842–843 (1984) See http://www.hawaiilibrary.net/articles/chevron_u.s.a.,_inc._v._natural_resources_defense_council,_inc.

[42] 535 U.S. 212 (2012).

[43] *Chiristensen v. Harris County*, 529 U.S. 576, 587 (2000).

[44] *Id*., citing *Reno v. Koray*, 515 U.S. 50, 61 (1995).

[45] Victoria McGrane and Leslie Scism, MetLife Suit Sets Up Battle Over Regulation, THE WALL STREET JOURNAL, (Jan. 14, 2015), www.wsj.com/articles/metlife-to=challenge-systemically –important-tag-1421152441.

[46] See July 7, 2015 AMERICAN BANKER statement http://www.americanbanker.com/bankthink/large-nonbanks-deserve-fsoc-scrutiny-1075244-1.html

Using the "Quiz Show" Scandals to Teach Issues of Ethics and the Media in a Business Law Class

by

Dr. Sharlene A. McEvoy

ABSTRACT

It was a big deal in the late 1950s but many students have difficulty understanding what the fuss was all about when it was revealed that television quiz shows were rigged. The incident can be a useful vehicle for teaching students about ethics, whistleblowing, the media, and government regulation.

INTRODUCTION

In the environment of the first decade of the twenty-first century where lying by government officials including Presidents is taken for granted, and cheating on a large scale (see Bernie Madoff) and on a smaller scale (manipulating test results to make schools look better than its competitors), the scandal involving the quiz shows of the 1950s seems like a quaint fable from an era of post World War II innocence.[1]

Despite how trivial this episode appears today, it shattered the trust of the American people and altered the lives of those who will be forever associated with it, in particular Charles Van Doren, the scion of a prominent literary family.

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This incident can be used as a device to teach a variety of topics of interest to business students, particularly ethics, whistleblowing, corporate responsibility, and government regulation.

This paper will explain how instructors can use the case in a business law class and how to incorporate both a documentary and a Hollywood film into the course material.

INTRODUCTION TO THE CASE STUDY

In the 1950s television was a relatively new form of entertainment for the American people. During the previous two decades the predominant diversions had been the movies and radio.

After World War II, the number of television sets sold soared into the millions as the box in the living room in the 1950s became as indispensable as the radio had been in the 1930s.

In fact the quiz shows that dominated the airwaves in the 1950s had their origin on the radio. In the early 1930s radio programs were mostly music, comedy, soap operas, news and sports,[2] but during the 1930s, quiz shows captured the public imagination and by 1940, fifty shows were on the air and by 1950 nearly two hundred. Among the more famous shows were "Stop the Music", "Information Please" and "Quiz Kids".[3]

When television replaced radio as the principal mode of entertainment, quiz shows joined the programming lineup. The first big hit was called the $64,000 Question, whose radio precursor had been called Take It or Leave It. The top prize was $64.00.[4]

Producer Louis Cowan knew that such a small prize would not lure viewers or contestants so it became $64,000, a fortune at a time when the average person earned approximately $4000 a year, a house in the New York City suburbs could be purchased for $10,000 and a new car cost less than $2000.[5]

The show became a hit drawing as many as 55 million viewers for one episode, at a time when the United States population was less than 150 million. People wrote letters begging to be considered as contestants. The $64,000 Question spawned many imitators, one of which was a show called "Twenty One".

"Twenty One", a show based on blackjack, had been created by Don Enright and Jack Barry who had also invented two other successful shows, Juvenile Jury, a panel of young people who answered questions and Tic Tac Dough based on the tic-tac-toe game.[6]

Twenty-One first aired in 1956 and at the beginning it was not rigged. It also was a dull show because the contestants could not answer the questions.[7]

The day after the first show aired, the owner of its sponsor Pharmaceutical Inc., which made Geritol, called Enright and Barry and said that he never wanted to see a show like that again.[8] Enright and Barry decided to fix the show and they did it in two ways. First, they coached the contestants by providing the answers to the questions that were going to be asked on the show on which they would appear. Second, they selected guests that the audience would either root for or against. Enright said, "You want the viewer to react emotionally to a contestant. Whether he reacts favorable or negatively is really not that important."[9]

Enter Herbert Stempel, who later became the first whistleblower in the quiz show scandals. At the beginning however he was an accomplice in the deception.[10] A 29 year old college student and Army Veteran he had an I.Q. of 170 and answered 251 out of 363 questions correctly on the qualifying test.[11] After Stempel was chosen to be a contestant, Enright visited his home and asked him if he would like to win $25,000. Stempel agreed and was coached not only as to the questions and answers but also what to wear and how to appear stressed or overheated.[12] Stempel eventually won nearly $50,000 but Enright determined that it was time for him to lose after tying three games with Charles Van Doren. Stempel was ordered to answer a question incorrectly he knew very well: Best Picture for 1955. Stempel knew that the correct answer was "Marty" but as instructed, answered "On the Waterfront".[13] Charles Van Doren became the new Twenty-One Champion and went on a winning streak that eventually won him $139,000, a Time Magazine cover story, marriage proposals and a three year $150,000 contract to appear on such NBC shows as Today and Steve Allen among others.[14] Herb Stempel became jealous of Van Doren's celebrity, a status he had never achieved and decided to expose the fact that the show was rigged.

After explaining these facts, the instructor should show the PBS documentary, The American Experience: The Quiz Show Scandals[15] should be prepared to halt the viewing to discuss the following points:

Why were so many contestants willing to go along with the deception? Who was being deceived?

Did the sponsors of these shows put too much pressure on the producers to put on a show that was entertaining as opposed to being an honest contest?

Assignments (Using the Program Transcript)[16]

1. One of the challenges that students will face in studying this material is to know all the players involved in the scandal.

- Ask the students to present a case for and against each of the following:

  - Don Enright
  - Jack Barry
  - Al Freedman

2. Assign a team of two to three students to analyze each of the following shows and determine how each one figured in the

scandal:
- Tic Tac Dough
- Dotto
- $64,000 Question
- $64,000 Challenge
- Twenty One

Each student should be prepared to discuss how each show worked and how the show was rigged.

3. Ask students to discuss the role each of the major contestants who appeared on the shows. Assign a student to be an investigator and analyze the role or culpability of each.

- Patty Duke[17]
- Dr. Joyce Brothers[18]
- Vivienne Nearing
- James Snodgrass
- Marie Winn
- Edward Hilgemeier

THE ROLE OF HERB STEMPEL[19]

The major figures in the case among the contestants are Herb Stempel and Charles Van Doren. Students should be asked to compare all aspects of the background of both.

- Which man was the smarter of the two?

- Was the motivation for Stempel's coming forward to reveal that Twenty- One was fixed?

- Was it to get even with Enright who failed to find work for Stempel on other shows? Or was his primary motivation jealousy of the opportunities that Van Doren enjoyed including as co-host of The Today Show.

- Was Stempel truly a whistleblower? Ask students to discuss what is the definition of a whistleblower? Does a whistleblower have to have altruistic motives?

- Why was the press originally unwilling to publish Stempel’s allegations? Was it because of a lack of corroboration or because Enright had labeled him as “mentally unstable”?

- What event caused the scandal to go public?

Students should be assigned to read portions of Joseph Stone’s Prime Time and Misdemeanors.[20] Stone was the Assistant District Attorney who conducted grand jury investigations of the quiz show cheating. Among the relevant chapters of the book are those dealing with the testimony of contestants, many of whom lied. After they read Chapters 1-8,[21] students should be asked whether the grand jury should have been convened in the first place. As D.A. Stone admits, there really were no crimes committed. Draw students’ attention to the following quote:

At first blush, there appeared to be no grounds for prosecuting anyone involved in television quiz programs under the laws of New York. Our examination of the contracts between producers and sponsors showed that the program had not been represented as bona fide contests, therefore larceny by false pretense had not been committed. Neither did laws against misleading advertising seem to apply because, in New York at least to make a case for misleading advertising, it had to relate to the merchandise being offered for sale…..

….these considerations did not preclude the commission of a crime in the process of fixing a quiz show. Extortion had been alleged, and then was still the possibility that kickbacks were paid by contestants….

Nevertheless, even if we didn't uncover an actual crime in the operation of the quizzes, the grand jury was exercising a legitimate function by investigating a matter of considerable public concern.[22]

If there were no crimes involved and the contestants were willing participants, was the investigation as good use of the time and taxpayer money by the Manhattan District Attorney?

Another question to ask students is who was hurt by the actions of the producers of quiz shows. The producers and advertisers made money. The network featured shows that were highly rated, attracting millions of viewers who were drawn in by the drama that brought popular contestants into viewer's living rooms for many weeks.

The contestants won some money, received mail from admiring fans and enjoyed a fleeting fame. What harm was caused by rigging the shows?

THE ROLE OF CHARLES VAN DOREN

Perhaps the contestant who reaped the most publicity and later opprobrium from his participation as a contestant on "Twenty One" was Charles Van Doren.[23]

Ask two students to present the case for and against Van Doren. He maintained his silence about his role in the scandal despite the fact that Julian Kraiman acknowledged him in the closing credits as having contributed to the PBS program.[24]

It was not until 2008 that Van Doren broke his silence in an article that appeared in the New Yorker.[25]

Ask students to read this article with particular care and then pose the following questions:

- Does Van Doren display the pomposity that caused Stempel to resent him? Ask for examples.

- Did Van Doren know in advance that the show was fixed?

- If so, why did he agree to participate, given his family pedigree. He obviously believed that he had a family tradition to uphold. Or was he in competition with his famous father and uncle and desire to eclipse their fame?

- Does it surprise you that an educated man like Van Doren (B.A. St. John's College and Columbia University study at Sorbonne) and his position as an instructor of English at Columbia would agree to be subject to the kind of coaching he describes in his article?[26]

- Why did Van Doren not confide in his father and seek his advice?

- Do you think that Van Doren was naïve in believing that his participation in the quiz show would cause young people in America to become more interested in education? He also claimed that Freedman told him that quiz shows were entertaining and that fixing was a common practice.

- Is it plausible to believe that when several people were aware that Twenty One was rigged that someone among the producers or contestants would not eventually disclose what was going on?

- Why were only seventeen of the contestants indicted, arrested and arraigned when over one hundred had lied to the grand jury? Ask if students think that Van Doren was among those singled out because of his famous family? Why was Stempel not among those charged?

- What were the consequences of this episode? Through a family friend Van Doren got an editorial position at Encyclopedia Britannica, Freedman got an executive job at Penthouse and by the late 1960s Jack Barry and Don Enright returned to television and produced new shows.[27]

- Was this because the public has a short memory of that people have become more forgiving of ethical lapses?

- Did Van Doren make matters worse by stating that he had received no help with the answers to his lawyer, the district attorney, the grand jury and even to the Today Show audience. At one point he said, "It's silly and distressing to think that people don't have more faith in quiz shows."[28]

- Was it hubris that prompted Van Doren to offer to appear before the House Committee on Interstate and Foreign Commerce to proclaim his innocence? When the Committee subpoenaed him, he was forced to confess his involvement.[29]

CONGRESSIONAL ACTION

When the grand jury's presentment was sealed by Judge Mitchell Schweitzer, Congress called for an investigation. It was during those hearings, some held in executive session and others held publicly, that revealed the extent of the deception that had occurred. Van Doren was unmasked as a deceiver.[30]

Ask the students if they think that Van Doren's complicity in the rigging would have been revealed if he had not become a high profile public figure by accepting NBC's offer to work on The Today Show and other programs.[31]

Show the students a portion of the "Quiz Show"[32], the fictionalized version of the event produced by Robert Redford, in which Ralph Fiennes playing Van Doren read a statement to the Committee and was praised by some Congressmen and denounced by another. Ask the students about Congress' reaction. Why did the members react this way?

Ask the students to research what reforms were made by the Federal Communications Commission in the wake of the scandal and ask them to find out what happened to the main players in the drama. Some returned to obscurity while others "landed on their feet". Discuss these outcomes.

Finally, students should be asked to play the role of a reporter or historian who is asked to analyze the impact of the quiz show scandals and how a similar event would play out today. If it were revealed that Jeopardy, Wheel of Fortune or Survivor were rigged, what would the public reaction be? Would the President weigh in as President Eisenhower did.[33] Has the country become so inured to lying at all levels that such an event would pass relatively unnoticed.

CONCLUSION

Given the ubiquity of cheating and general public skepticism, would the Quiz Show scandal even cause a ripple today? Students should be asked to research the number of scandals involving cheating that have occurred during the past decades government and how the public reacted at all levels including business and education.[34]

The instructor might ask students to examine the so-called "reality" shows and research what safeguards are in place to protect against cheating.

Finally students should examine how much cheating they have engaged in or how much they know goes on in their educational careers and how effective are the measures to prevent these incidents. The answers may or may not be surprising.

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[1] David Halberstam, The Fifties, Random House 1993 at x. (hereinafter The Fifties).

[2] "The Rise of TV Quiz Shows" The American Experience, http://www.pbs.org/wgbh/amex/quizshow/peopleevents/pande05.html (hereinafter The Rise of TV Quiz Shows).

[3] Id.

[4] Id.

[5] Id.

[6] "Dan Enright" The American Experience, http://www.pbs.org/wgbh/amex/quizshow/peopleevents/pande 04.html (hereinafter Dan Enright)

[7] Id.

[8] Id.

[9] The Fifties at 649.

[10] Herbert Stempel, The American Experience, http://www.pbs.org/wgbh/amex/quizshow/peopleevents/pande01.html (hereinafter Herbert Stempel).

[11] Id.

[12] Id.

[13] Id.

[14] "Charles Van Doren". The American Experience, http://www.pbs.org/wgbh/amex/quizshow/peopleevents/pande02.html

(hereinafter Charles Van Doren).

15 The Quiz Show Scandal producer Julian Krainan. 1992 "Program Transcript" http:www.pbs.org/wgbh/amex/quizshow/filmmore/transcript/index.html (hereinafter "Program Transcript")

16 Id.

17 See also "Sonny Fox on contestant Patty Duke", The American Experience, http://www.pbs.org/wbbh/amex/quizshows/feature/part5.html. (hereinafter Sonny Fox on contestant Joyce Brothers).

18 See also "Sonny Fox on contestant Joyce Brothers' The American Experience. https://www.pbs.org/wgbh/amex/quizshow/sfeature/part5.html. (hereinafter Sonny Fox on contestant Joyce Brothers)

19 Herbert Stempel supra note 10. See also Herb Stempel Wikipedia. http://en.wikipedia.org/wiki/Herb_Stempel/ See also The Fifties, at 650-664.

20 Joseph Stone and Tim Yohn, Prime Time and Misdemeanors: Investigating the 1950s T.V. Quiz Scandal – A D.A.'s Account, Rutgers Univ. Press 1994. (hereinafter Prime Time and Misdemeanors).

21 Id. at 13-156.

22 Id. at 104-105.

23 Charles Van Doren, supra note 14.

24 The Fifties, supra note 1. at 666.

25 Charles Van Doren, "All the Answers"; The Quiz Show Scandals and the Aftermath, New Yorker, July 28, 2008, http://www.newyorker.com/reporting2008/07/28/080728fa_fact_vandoren?

printable=true... (hereinafter All the Answers).

[26] Charles Van Doren, supra note 14.

[27] Prime Time and Misdemeanors supra note 20 at 248.

[28] "All the Answers", supra note 25.

[29] Charles Van Doren, supra note 14.

[30] Id. See also The Fifties at 662. See also Quiz show produced by Robert Redford starring Ralph Fiennes, Rob Morrow, Paul Scofield 1993 for a fictionalized account of the scandal which tracks closely the Chapter 43 in The Fifties.

[31] Investigation of Television Quiz Shows, Hearings Before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, Eighty Sixth Congress 1st sess. PN 1992.8 U5IJ, Oct 6-12, 1959.

[32] Quiz "Show" A Robert Redford Film, A Wildwood Enterprises/Baltimon Picture Production, Running Time 133min 1993.

[33] Robert Hartmann, "President Wants TV Scandals Cleared Up. Eisenhower Shares Public Dismay; FTC and Justice Department Will Report, Los Angeles Times, Nov 5, 1959, http://www.pbs.org/wgbh/amex/quizshows/feature/article.html.

[34] Students may be interested in viewing "Quiz Show Scandal and Other Frauds" putting the quiz show scandals in the context of subsequent public deceptions. American Justice A-E 1995.