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RESTRAINING BANKING LAW'S NOTORIOUS REGIME: THE D'OENCH, DUHME DOCTRINE AND THE FRAUD IN THE FACTUM DEFENSE

by

Robert C. Bird*

INTRODUCTION

More than 50 years ago, the United States Supreme Court issued a decision enforcing payment of a $5,000 demand promissory note of D'Oench, Duhme & Co., Inc. The Federal Deposit Insurance Corporation (FDIC) acquired the note after it took over the failed Belleville Bank & Trust Company of Belleville, Illinois.[1] D'Oench, Duhme & Co. claimed that the note could not be enforced against it because the company had given the note with the secret understanding that Belleville Bank would not call the note for payment. The Supreme Court held that the alleged secret agreement could not be a defense to the FDIC's action because D'Oench, Duhme & Co. lent itself to a scheme that tended to deceive banking authorities, namely the FDIC. In this relatively simple case, the D'Oench, Duhme doctrine was born.[2]

The D'Oench, Duhme doctrine is a common-law rule that precludes bank borrowers from asserting secret side agreements as defenses when the FDIC seeks to collect on notes acquired from a failed bank. The goal of the D'Oench, Duhme doctrine is to protect the FDIC from unwritten side agreements between borrowers and failed banks that would diminish the assets the FDIC acquires. The FDIC can value the assets of a failed bank based upon books and records available without fear of overvaluing a bank's assets because notes are tainted with secret unwritten agreements between the borrower and the bank.

Although the D'Oench, Duhme decision is not new, the effects of the D'Oench, Duhme doctrine can be felt today more than ever. Consider the following situations:

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- A loan officer at "Bank A" orally agrees with a contractor that the contractor's guaranty of a $1 million loan will be enforced only up to $250,000.
- A company with a $250,000 loan scheduled to mature in six months receives a letter from Bank A's president that assures the company's president that the loan will be renewed — just as it has been the last five times it matured. A copy of the letter is filed in the bank's president's correspondence file and a copy is put in the customer's loanjacket.
- A farmer signs an agreement with Bank A to purchase, at a very attractive price, an adjoining farm that was foreclosed by the bank six months before the date of the agreement. A bank vice president places the purchase agreement in the "collateral file" maintained for each property held for sale.

Under most conditions, contractor can count on having his guaranty limited, the company president knows that he will have continued access to funds, and the farmer can obtain the low-cost acreage. This is true, however, only if the bank remains solvent.

If the bank fails, the FDIC can close the bank and determine the next day without further discussion that the contractor will owe the fill $1 million, the company president will not receive further funds, and the farmer will not get his desired land. These conclusions will hold even though both the borrowers and the lender acted in good faith and had no reason to expect the bank to fail. Within as little as twenty-four hours these side agreements become a nullity.[3]

Part I introduces the D'Oench, Duhme doctrine. This part reveals that the doctrine has expanded from its judicial roots and makes the FDIC impervious to most defenses raised by the debtor of a failed bank. Part II examines one of the defenses remaining to debtors when the FDIC enforces a note — the fraud in the factum defense. Fraud in the factum, which occurs when a signatory to an instrument is mislead as to the fundamental nature of the document, can be used as a defense by a debtor even in the face of FDIC enforcement of a note. This part concludes that courts are subtly expanding the interpretation of fraud in the factum in D'Oench, Duhme cases. This article concludes that the fraud in the factum defense presents a useful opportunity for debtors faced with the FDIC enforcement of a note, especially in light of court's increased willingness to expansively apply the defense.

I. AN INTRODUCTION TO THE D'OENCH, DUHME DOCTRINE

The D'Oench, Duhme doctrine traces its roots to the 193 Os, when the Great Depression paralyzed the nation's economy and Congress needed to restore confidence in the banking industry. Congress enacted the Banking Act of 1933, which created the Federal Deposit Insurance Corporation (FDIC).[4] The FDIC provides deposit insurance to national banks, state chartered commercial banks, thrifts, savings and loans, and savings banks.[5] This FDIC insurance gave depositors a measure of confidence in the banking industry because depositors could be assured that a bank's financial problems would not result in the loss of their savings.

Congress also gave the FDIC the power to intervene when a bank fails. The FDIC has two general approaches for the takeover of an insured bank. First, the FDIC can liquidate the assets of a failed bank and pay depositors the full amount of their deposit. Funds not available in the bank's coffers would be paid from a deposit insurance find.[6] Regulators do not favor this approach because it requires an interruption of deposit availability and erodes confidence in the banking system.[7]

Second, the FDIC can employ a purchase and assumption transaction whereby the FDIC finds a financially secure bank to buy the loans from the failed bank.[8] This option is far more common because it minimizes interruptions in bank operations and eliminates depositor losses.[9] The FDIC, in its corporate capacity, buys any remaining assets of the failed bank that the purchasing bank refuses to purchase.[10] The FDIC attempts to realize on some the assets that were not acceptable to the purchasing bank.[11] The FDIC pursues the borrower for the debt, and it is within this context that the FDIC invokes the expansive powers of the D'Oench, Duhme doctrine.[12]

The D'Oench, Duhme doctrine, as noted *supra*,[13] holds in essence that a secret agreement between the borrower and the bank cannot be a defense to a suit by the FDIC to enforce the note.[14] The D'Oench, Duhme doctrine has expanded far beyond its humble beginnings. With the passage of the Federal Deposit Insurance Act of 1950,[15] Congress provided broad parameters regarding exactly what kind of agreement the FDIC must take into account when evaluating bank assets. The statute, which is applied in conjunction with the D'Oench, Duhme & Co. decision,[16] states:

> No agreement which tends to diminish or defeat the interest of the Corporation [FDIC] in any asset acquired by it under this section. . . shall be valid against the Corporation [FDIC] unless such agreement:

(1) is in writing,
(2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution,
(3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and
(4) has been, continuously, from the time of its execution, an official record of the depository institution.[17]

Any agreement[18] that does not fall within these requirements cannot be used as a defense. Accordingly, this statute, combined with the broad reading of interpreting cases, has stripped the bank debtor of most defenses against collection that would have been available to it before the bank failed.[19] Otherwise valid defenses such as conversion, fraud in the inducement, unjust enrichment, negligence and breach of fiduciary duty cannot be raised by the debtor against the FDIC.[20] The D'Oench, Duhme doctrine also thwarts certain statutory tort claims and defenses.[21] Most contract defenses are also barred.[22] Even lack of consideration cannot be asserted as a defense.[23] Overall, at least twenty—eight separate defenses raised by debtors have been determined to be invalid in the face of the D'Oench, Duhme doctrine.[24]

The rationale behind this doctrine is that it allows FDIC examiners to accurately assess the condition of a bank based on its books. In collecting assets or paying off liabilities, the FDIC often encounters agreements between failed banks and debtors that are not reflected in the bank's records. These hidden agreements can relieve debtors from paying their obligations or even form a basis of an action to collect damages from the FDIC.[25] As one court, *Bowen v. FDIC*,[26] notes:

> The [D'Oench, Duhme] doctrine means that the government has no duty to compile oral histories of the bank's customers and loan officers. Nor must the FDIC retain linguists and cryptologists to tease out the meaning of facially-unencumbered notes. Spreadsheet experts need not be joined by historians, soothsayers, and spiritualists in a Lewis Carroll-like search for a bank's unrecorded liabilities.[27]

If these recorded agreements were not enforced, they could cost the FDIC enormous amounts of money by preventing the collection of outstanding debts owed to the bank.[28] These costs are ultimately passed on to taxpayers. With the application of the D'Oench, Duhme doctrine, side oral agreements between the bank and the borrower will not infect the assessment process and impermissibly skew the validity of the recorded bank notes.[29]

In spite of this important purpose, the application of the D'Oench, Duhme doctrine has created draconian results. This doctrine gives the FDIC great power because it is protected from virtually any defense to the repayment of an outstanding obligation not preserved in the bank's records. The borrower has the extremely difficult responsibility of ensuring that the bank's records, something that the borrower has no control over, accurately reflect the transaction.[30] It is for the most part irrelevant that the borrower acted in good intent when consummating the transaction. [31] Rather, the borrower now has a defacto affirmative duty to be suspicious of the lender's records and practices, in contradiction of the assumption of good faith and fair dealing present in most other commercial transactions.[32]

Accordingly, the doctrine has received significant criticism amongst the judiciary for its harshness against unwitting debtors.[33] One court even went so far as to criticize the FDIC's power through the song, "Onward Christian Soldiers":

Onward Banking Soldiers,
Marching as if to war,
With D'Oench, Duhme and Congress
We'll prevail for sure.
We needn't worry,
We will win the fight
Since we lack accountability,
We are always right . . .[34]

The D'Oench, Duhme doctrine began with humble beginnings to help revive a flagging banking industry and protect the FDIC against secret agreements between the debtor and the bank. Today, the doctrine has unexpectedly mushroomed into a broadly interpreted legal juggernaut that virtually ensures success to the FDIC when attempting to enforce a note against the debtor of a failed bank.[35] This next section examines one of the few viable defenses to the D'Oench, Duhme doctrine,[36] the fraud in the factum defense.

II. The Fraud in the Factum Defense

A. Introduction to Fraud in the Factum

The doctrine of fraud in the factum is one of the few defenses still available to debtors challenging the enforceability of the notes from a failed bank. Fraud in the factum is fraud so severe that the very intention to contract by the defrauded party does not exist, thus rendering the instrument void.[37] It is "the sort of fraud that procures a party's signature to an instrument without knowledge of its true nature or contents."[38] It therefore exists when the alleged misrepresentation relates to the character of a document being signed, such as when one party believes he is giving out an autograph, when he is in fact entering into a contract.[39] If a person signs a contract, having been led to believe that it is only a receipt, the stage may also be set for fraud in the factum.[40] Thus, to constitute fraud in the factum a misrepresentation must go to the essential character of the document signed, not merely to its terms.[41]

All fraud is not fraud in the factum. As noted, fraud in the factum occurs when an individual "signs a document without full knowledge of the character or essential terms of the instrument."[42] On the other hand, fraud in the inducement occurs when a fraudulent statement exists within an otherwise valid agreement.[43] For example, fraud in the inducement may occur when parties knowingly sign a loan, but are misled regarding specific terms in the loan. Fraud in the inducement, unlike fraud in the factum, is not a permissible defense against D'Oench, Duhme notes.[44] Since fraud in the factum renders a note void, and not merely voidable like a note tainted by fraud in the inducement, there is no asset the FDIC possesses from which it can recover from the debtor.

To establish fraud in the factum within the D'Oench, Duhme context, a debtor must meet two requirements. First, the debtor must show that he was induced to sign the document by the bank's misrepresentation of the document's true nature.[45] Second, the debtor must show that had no reasonable opportunity to obtain knowledge of the document's basic character.[46] 'Reasonable opportunity' is determined by taking into account the "age of the party, his intelligence, education and business experience, his ability to read and understand English, the party's reason to rely on the representations or to have confidence in the party making them, and the apparent necessity for acting swiftly."[47]

The fraud in the factum defense is a long-standing doctrine stating that fundamental misrepresentation of an instrument by one party can render that instrument void. In the D'Oench, Duhme context it has become one of the few defenses available to debtors facing the FDIC. The next section analyses leading fraud in the factum cases. An analysis of these cases reveals that the fraud in the factum defense presents a useful doctrine for debtors to which courts are slowly giving a more flexible interpretation.

B. Fraud in the Factum Cases

1. The Supreme Court Speaks: *Langley v. FDIC*

The fraud in the factum defense is one of the few D'Oench, Duhme defenses that has received Supreme Court attention. In *Langky v. FDIC*,[48] a borrower challenged the enforcement of a note by claiming that the bank orally misrepresented the terms of the loan.[49] The Court found that the transaction constituted fraud in the inducement and concluded that D'Oench, Duhme barred it as a defense.[50] The court in passing compared fraud in the inducement to fraud in the factum. The court remarked that fraud in the factum renders an instrument void, not just voidable like fraud in the inducement, thus falling outside the confines of the D'Oench, Duhme doctrine.[51]

This seemingly casual statement by the Supreme Court has been interpreted as an approval of the fraud in factum defense.[52] However, some courts accept this language as no more than dicta.[53] In any event, lower courts such as the ones below have widely accepted fraud in the factum as a valid defense in D'Oench, Duhme cases.

2. Ignorance of the Nature of a Document: *FDIC v. Rusconi*

In *FDIC v. Rusconi*,[54] the defendants executed to the bank a mortgage to secure a guaranty on a note. The bank sought summary judgment on the notes and guaranty. The defendants contended that they had an agreement with the Bank that their liability would be limited to a single note.[55] More importantly, they also contended they did not know they were signing a guaranty and never intended to do so.[56] The defendants contended that when the guaranties were read together with the mortgage and notes, their meaning is ambiguous and created issues of fact.[57] The court concluded that a general issue of material fact existed regarding whether fraud in the factum existed, and denied summary judgment in favor of the bank.[58]

The *Rusconi* decision follows well-settled law. Fraud in the factum applies when a document's signatory is misled as to the fundamental nature of the instrument signed. Fortunately for borrowers, other courts have expanded cases like *Rusconi* and interpreted the fraud in the factum defense in a more flexible and fact sensitive manner.

3. Bank Fills in Blank Form and Modifies Terms: *FDIC v. Turner*

In lower courts, only a few cases have found at least the possibility of fraud in the factum beyond its traditional definition. In *FDIC v. Turner*,[59] Turner executed a blank guaranty in favor of the bank. A bank officer then fraudulently completed the guaranty.[60] The officer erased the original bank's name and inserted the name of another bank.[61] The guaranty was used for a transaction unrelated to Turner's loans.[62] The FDIC claimed that the fraud at issue is merely fraud in the inducement, not fraud in the factum, because the borrower knew the nature of the document signed. The court responded:

> It has been held that just filling in the blanks on an instrument is not fraud in the factum because the signer had an opportunity to obtain knowledge of the instrument's essential terms. *Federal Deposit Ins. Corporation v. Culver*, 640 F.Supp. 725 (D.C.Kan.1986). However, that is not the situation in the present case. Appellant, in this instance, was unaware of the essential terms of the instrument. Butcher [the bank president] induced Turner into signing a guaranty based on misrepresentations concerning the principle maker and the holding bank. This is not merely a case of an incomplete guaranty being fraudulently completed. Butcher erased the original bank's name and inserted the name of another bank. Turner had no opportunity to know that until it inadvertently came to his attention at a much later time.[63]

The court concluded that Turner, who was found to have no blame for the modification of the terms, could raise the fraud in the factum doctrine as a defense.[64]

The *Turner* decision aids borrowers because it extends the application of the fraud in the factum defense. As noted, the court distinguished Turner from fraud in the inducement because the bank president removed the original bank's name and inserted another. Borrowers citing *Turner* may contend that fraudulent filling in blanks of an agreement plus affirmative modification of agreement terms can arguably constitute fraud in the factum.

4. Material Alteration Through Attaching Old Signatures to New Documents: *FDIC v. Kagan*

In *FDIC v. Kagan*,[65] trustees of the Seacoast Realty Trust solicited investors to purchase an interest in a partnership to buy real estate.[66] These investors were friends of the trustees and inexperienced in real estate ventures.[67] Just before the closing, an attorney for the bank learned that the partnership was unexpectedly restructured.[68] As a result, the bank attorney required that the partnership secure the individual guaranties of the investors.[69] The trustees then presented each investor with a form of guarantee, advising them that they should sign these documents in order to secure tax advantages of the transaction, for which under tax law, they were required to be at risk.[70] The investors signed the documents.[71] Later, at the closing, the bank's attorney noted that the guarantees had defects making them worthless, and stated that they must be corrected.[72] A trustee did not secure new signatures, but simply tore off the signature pages to the old agreement and attached them to the revised documents.[73]

The court found that the investors did not know they were guaranteeing the mortgage note, nor did they intend to do so.[74] In addition, the court concluded that the inexperienced investors could not have foreseen the unilateral modification of the guaranties.[75] The court thus found that the FDIC was subject to the fraud in factum defense of the investors.

In *Kagan*, the court expanded fraud in the factum by finding its presence because of a material and severe alteration of a document's contents without their knowledge.[76] Like the Turner decision, supra, this finding differs from traditional fraud in the factum case where the signer of a document does not know the true nature of the text signed. This represents a broader interpretation of fraud in the factum that may be normally applied.

5. Misleading Statements & Pressure Contribute to Fraud: *Wilshire Credit Corp. v. Walsh*

Another D'Oench, Duhme case, arising at the state level, reveals even greater flexibility favoring debtors when raising a fraud in the factum defense. In *Wilshire Credit Corp. v. Walsh*,[77] the court found that there was "clear and convincing evidence that the note was procured by fraud in the factum. Mr. Cordani [president of the bank] told the defendants [the debtors] that they were merely signing to put up additional collateral when in fact he knew that was false."[78] The document was in fact a promissory note.[79] The courts also noted as relevant that the defendants were without counsel and in a rapid-fire fifteen-minute 'closing' where they were under pressure to sign.[80] The court thus concluded that the defendants had no reasonable opportunity to obtain knowledge of the character of the document they signed.[81]

This decision reveals that the environment surrounding a note signing can affect the viability of a fraud in the factum defense. The debtor in *Walsh* was without counsel, subject to a quick meeting, and forced to sign in a 'pressure' situation just prior to closing the bank and when he was about the leave the premises. The *Walsh* case also defined the contours of the duty to read[82] in a favorable light for debtors. If a debtor chooses not to read the document when it is presented, he risks being charged with having a 'reasonable opportunity' to view its contents and thus is denied the fraud in factum defense. Walsh stated:

> The general rule is that where a person of mature years who can read and write signs a formal written contract affecting his pecuniary interests it is that person's duty to read it and notice of its contents will be imputed to that person if he negligently fails to do so; but this rule is subject to qualifications, including intervention of fraud or artifice, or mistake not due to negligence, and applies only if nothing has been said or done to mislead the person sought to be charged or to put a person of reasonable business prudence off guard in the matter.[83]

This language can benefit debtors who succumb to misleading statements of a bank officer regarding a loan document. If a bank officer places the debtors at ease by assuring them of the nature of the document, and then the debtors sign based upon the officer's representations, this 'put a person of reasonable business prudence off guard' and help constitute fraud in the factum.

In D'Oench, Duhme cases, the fraud in the factum defense provides a limited measure of protection to debtors who were mislead or defrauded as to the basic nature of the document signed. Any fraud in factum defense must be distinguished against mere fraud in the inducement, which is not a viable defense against a FDIC-enforced instrument. These cases reveal that the fraud in the factum defense is broader that it may originally seem. As shown by the cases above, debtors who present evidence of unusual fraudulent activities or pressure by the bank can most likely use a fraud in the factum defense to fight FDIC enforcement of a failed bank note.

CONCLUSIONS

The D'Oench, Duhme doctrine has mushroomed from its humble beginnings into an expansive regime that gives extraordinary powers to the FDIC in enforcing debts owed to failed banks. Debtor defenses that would have been viable under other conditions are swept away by the D'Oench, Duhme doctrine's broad reach.

Fortunately, some defenses remain. One such example is the fraud in the factum defense. This defense should be used to deny the existence of an agreement where the debtor did not know the fundamental nature of the document. Other cases also reveal that courts are allowing some flexibility with fraud in the factum. If the debtor can show unusual modification of the agreement or misleading statements by a bank authority, a court may find that the fraud in the factum defense exists. As a result, the fraud in the factum defense presents a useful opportunity for debtors to shield themselves against the overarching power of the FDIC and its application of the D'Oench, Duhme doctrine.

ENDNOTES

[1] *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942). The FDIC has the power to assume the notes of a failed bank and enforce them against the debtors. *See infra* note 8 and accompanying text.

[2] *See generally* Joseph J. Ortego & Michael C. Marsh, *The New Parameters of D'Oench, Duhme*, 111 BANKING L.J. 189, 189 (1994).

[3] These examples were adapted from Thomas B. Hudson, *No Guaranties*, 68 BANKING MGMT. 3, 3-4 (1992).

[4] Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162, 168 (1933).

[5] Jeffrey R. Gleit, Note, *The Reports of the Demise of the D 'Oench Docfrmne Have Been Greatly Exaggerated: The Continuing Coexistence of the D 'Oench Doctrine and Section 1823(e)*, 28 HOFSTRA L. REV. 225, 226 (1999).

[6] Kevin A. Palmer, *The D'Oench Doctrine: A Proposalfor Reform*, 108 BANKING L.J. 565, 566 (1991).

[7] Id. *See also* Gleit, *supra* note 5, at 226-27.

[8] Palmer, *supra* note 6, at 566. *See also Gunter v. Hutcheson*, 674 F.2d 862, 865-66 (11th Cir. 1982) (describing purchase and assumption transaction in more depth).

[9] Palmer, *supra* note 6, at 566.

[10] Palmer, *supra* note 6, at 567.

[11] Palmer, *supra* note 6, at 567. *See also FDIC v. R-C Marketing & Leasing, Inc.*, 714 F. Supp. 1535, 1539 (D. Minn. 1989).

[12] *See Federal Deposit Ins. Corp. v. Bank of Boulder*, 865 F.2d 1134, 1136-38 (10th Cir. 1988) (describing in detail functions required after closure of insolvent financial institution).

[13] *See* text accompanying notes 1-2.

[14] Id. at 460.

[15] 64 Stat. 873 (codified as amended at 12 U.S.C. §§ 1811-183 1 (2000)).

[16] The statute and the 1942 Supreme Court decision are commonly applied as one unified doctrine. *E.g., Washington Properties Ltd. Partnership v. RTC*, 796 F. Supp. 542, 544 n.2 (D.D.C. 1992) (quotations omitted) ("case law based on *D 'Oench* and the statute has cross-pollinated such that it is very difficult to decide where the statute ends and *D 'Oench* begins. . . [T]he critical question is the total protection that *D'Oench* and the statute provide together.").

[17] 12 U.S.C. 1823(e) (2000).

[18] The term "agreement" for purposes of 12 U.S.C. § 1823(e) has been broadly defined. *See Langley v. FDIC*, 484 U.S. 86, 92-93 (1987).

[19] Chris Atkinson, Note, *Defensing the Indefensible: Exceptions to D'Oench and 12 U.S.C. § 1823(e)*, 53 FORDHAM L. REV. 1337, 1338 (1995).

[20] Id. at 1371.

[21] E.g., *Northeast Community Development Group v. FDIC*, 948 F. Supp. 1140, 1151 (D.N.H. 1995) ("The D'Oench doctrine 'bars defenses and affirmative claims whether cloaked in terms of contract or tort, as long as those claims arise out of an alleged secret agreement.'"). *See also McCullough v. FDIC*, 987 F.2d 870, 874 (1st Cir. 1993).

[22] Id. at 1366-67.

[23] *CMF Virginia Land Limited Partnership v. Brinson*, 806 F. Supp. 90, 94 (E.D. Va. 1992) (purchaser of failed bank note could bar defense of lack of consideration on a loan guaranty by asserting the D'Oench, Duhme doctrine).

[24] Atkinson, *supra* note 19, at 1375-78.

[25] Michael B. Kent, Jr., *The Court Giveth, and Congress Taketh Away: Statutory Preemption and the Federal Common Law D'Oench Doctrine*, 116 BANKING L.J. 214, 215 (1999).

[26] *Bowen v. FDIC*, 915 F.2d 1013 (5th Cir. 1990).

[27] Id. at 1016.

[28] Id.

[29] Atkinson, *supra* note 19, at 1338. *See also FDIC v. R-C Mktng. & Leasing, Inc.*, 714 F. Supp. 1535, 1539 (D. Minn. 1989) ("To protect the FDIC from [losses in valuing a failed bank's assets], the Supreme Court has held that a party who has acquiesced in the mischaracterization of an asset on the books of a failed bank is estopped from asserting a defense based on such mischaractenzation in an action brought by the FDIC to collect on the asset.").

[30] Palmer, *supra* note 6, at 575.

[31] *Holt v. FDIC*, 216 B.R. 71 (Bankr. D. Mass. 1997).

[32] Palmer, *supra* note 6, at 575. *See also* U.C.C. § 1-203 ("every contract or duty within this title imposes an obligation of good faith in its performance or enforcement.").

[33] *See, e.g., FDIC v. Bathgate*, 27 F.3d 850, 877 (3d Cir. 1994) (D'Oench, Duhme doctrine and § 1823(e) can lead to what might be considered harsh result); *Federal Deposit Ins. Corp. v. Kasal*, 913 F.2d 487, 492 (8th Cir. 1990), cert. denied, 498 U.S. 1119 (1991) (similar); In re NBW Commercial Paper Litigation, 826 F.Supp. 1448, 1476 (D.D.C. 1992) (court not ignorant of unusual results that D'Oench, Duhme doctrine generates, nor is court enamored of them); *L & R Prebuilt Homes, Inc. v. New England AllBank for Savings*, 783 F.Supp. 11, 14 (D.N.H. 1992) (court has empathy with plaintiffs position and dilemma but is powerless under law to grant remedial relief and is appalled by manner in which FDIC reacts to these situations).

[34] *Resolution Trust Corp. v. Ocotillo West Joint Venture*, 840 F. Supp. 1463, 1467 (D.N.M. 1993).

[35] Cherie Stephens Bock, Comment, *Alive, But Not Quite Kicking: Circuit Split Illustrates the Progressive Deterioration of the D 'Oench, Duhme Doctrine*, 42 ST. LOUIS UNIV. L.J. 945, 945 (1998) ("When the United States Supreme Court established the D'Oench, Duhme doctrine in the case bearing its name over fifty years ago, the Court likely never contemplated the extreme significance the doctrine would ultimately have on the banking industry.").

[36] Other defenses besides fraud in the factum that may be raised in spite of the D'Oench, Dulune doctrine are the presence of a bilateral agreement, conversion, equitable estoppel, payment, void liens, and usury. These defenses are noted in Atkinson, supra note 19, at 1378-8 1. See also Warren L. Dennis & John R. Simon, *Litigation with the FDJC and RTC: The Evolving* D'Oench *Doctrine Superpower Defense*, 47 THE BUS. LAWYER 1319, 1328-1332 (1992) (discussing defenses).

[37] Atkinson, *supra* note 19, at 1381.

[38] *Resolution Trust Corp. v. Kennelly*, 57 F.3d 819, 822 (9111 Cir. 1995)

[39] Id. *See also* Restatement (Second) of Contracts, § 163, Comments (a)-(c) (1981).

[40] *Vassapolli v. Rostoff*, 39 F.3d 27, 35 (1st Cir. 1994).

[41] *See, e.g.*, In re 604 Columbus Ave. Realty Trust, 968 F.2d 1132, 1346-47 (1st Cir. 1992).

[42] *FSLIC v. Gordy*. 928 F.2d 1558, 1565 (11th Cir. 1991).

[43] "Fraud in the 'inducement' typically occurs where a misrepresentation goes to the subject matter underlying the contract. Fraud in the 'factum,' or the 'execution,' on the other hand, occurs where 'the misrepresentation is regarded as going to the very character of the proposed contract itself, as when one party induces the other to sign a document by falsely stating that it has no legal effect.' E. Allan Farnsworth, Contracts § 4.10 (2d ed. 1990)." Matter of Arbitration Between Nuc. Elec. Ins. Ltd. (Cent. Power & Light Co.), 926 F. Supp. 428, 433 n.1 (S.D.N.Y. 1996).

[44] *See, e.g., Vasapolli v. Rostoff,* 39 F.3d 27 (1st Cir. 1994) (court finds that defendants induced into signing short-term notes that were in fact long-term notes constituted fraud in the inducement and not a valid defense).

[45] *FDIC v. Virginia Crossings Partnership*, 909 F.2d 306, 311 (8th Cir. 1990).

[46] Id.

[47] Id. (citing U.C.C. § 3-305(2)(c) com. 7).

[48] 484 U.S. 86, 93 (1987).

[49] Id. at 88-89.

[50] Id. at 93.

[51] Id. at 93-94.

[52] *E.g., FDIC v. Deglau*, 207 F.3d 153, 171 (3d Cir. 2000).

[53] *E.g., RTC v. Kennelly*, 57 F.3d 819, 822 (9th Cir. 1995).

[54] 808 F. Supp. 30 (D. Me. 1992).

[55] Id. at 35 n.7.

[56] Id.

[57] Id. at36.

[58] Id. at 40.

[59] 869 F.2d 270 (6th Cir. 1989).

[60] Id. at 274.

[61] Id.

[62] Id. at 272.

[63] Id. at 273.

[64] Id. at 274.

[65] 871 F. Supp. 1522 (D. Mass. 1995).

[66] Id. at 1523.

[67] Id. at 1524.

[68] Id.

[69] Id.

[70] Id.

[71] Id.

[72] Id. at 1524

[73] Id. at 1526. *See also FDIC v. R-C Marketing and Leasing, Inc.*, 714 F. Supp. 1535 (D. Minn. 1989) (allegation that defendant's signatures were procured through fraudulent misrepresentations as to the contents of the documents sufficient to survive summary judgment as fraud in factuin defense).

[74] Id.

[75] Id. at 1526.

[76] Id. at 1526 ("[The FDIC is] subject to the defense of fraud in the factum, *where the documents were materially altered without the know/edge of the defendants.* ") (emphasis added). The court distinguished Kagan from another case, *FDJC v. Caporale*, 931 F.2d 1 (1st Cir. 1991). "In *FDIC v. Caporale*, the defendants had executed notes in which the amounts were left blank. The court held that this was such negligence, because it was reasonably foreseeable that a bank officer might supply an amount greater than that agreed upon. In my opinion the plaintiff has not adduced sufficient evidence to warrant a finding that Kagan's alteration of the purported guarantees without notice reasonably foreseeable. Even if the evidence were legally sufficient, I would not find it so as a fact." Id.

[77] 1998 WL 473310 (Conn. Super. July 30, 1998).

[78] Id. at *4

[79] Id.

[80] Id. at *5

[81] Id.

[82] *Consolidated Edison Co. of New York v. United States*, 221 F.3d 364, 371 (2d Cir. 2000) ("[A] person who signs a written contract is bound by its terms regardless of his or her failure to read or understand its terms.").

[83] Id. at *4 (emphasis in original) (quoting *First Charter National Bank v. Ross*, 617 A.2d 909 (1992), *appeal dismissed*, 635 A.2d 796 (1994)).

THE "WORKS MADE FOR HIRE" DOCTRINE: A TRAP FOR THE UNWARY

by

Roy J. Girasa*

SUMMARY

A *work made for hire* is a work that is prepared by an employee on behalf of the employer within the scope of his or her employment. The Copyright Act specifies that the author[s] of a work are initially entitled to copyright protection. The difficulty arises when a work is prepared by a person who is also an employee of a company that is engaged in the same or similar type of activity as the author. Issues arise as to who owns the work or other related issues. The paper discusses the work made for hire doctrine, its use and, more particularly, the abuses by employers who often compel employees to sign agreements making otherwise independently produced works become subject to the employer's interest therein.

I. INTRODUCTION

An issue that has caused significant case law and commentaries among scholars in recent years is that of determining who is the rightful owner of a work coming within the protection of the Copyright Act of 1976. Consider the professor who prepares lectures at a university that is used for course development or as part of an Internet program of studies. The university furnishes the professor with the physical facilities to conduct his or her research, the computer and other peripheral mechanical devices including printer and software, an assistant who provides much of the research that formulates the basis of a published work, and so on. Consider also the artist whose work is commissioned by an organization that provides sketches and detailed instructions concerning the required output. Also, record companies often compel young, inexperienced artists to sign agreements waiving all rights to their works under intellectual property statutes thereby enriching the corporate entities and leaving the artist with little financial reward for the

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artist's creative endeavors. This paper will examine some of the issues, highlighting the latest case developments.

II. BASIC PRINCIPLES OF COPYRIGHT LAW

Copyright law has its constitutional basis under Article 1, Section 8 that provides:

> "The Congress shall have the power. . . [t]o promote the Progress of Science and the useful Arts, by securing for limited times to authors and Inventors the exclusive Right to their respective Writings and discoveries." Pursuant to its constitutional mandate the Congress commenced the passage of a series of acts in 1790 defining the scope and nature of protection to be given to authors. The latest enactment is the Copyright Act of 1976,[1] which has been amended by the Semiconductor Chip Protection Act of 1984, the Audio Home Recording Act of 1992, and the Digital Millennium Copyright Act of 1998.

Who is entitled to own the copyright of a work of authorship?[2] The Copyright Act, Section 201, states that the author[s] of a work is initially to copyright protection. If there are authors of a joint work, they are co-owners of the copyright. A joint work is defined in Section 101 of the Act as "a work prepared by two or more authors with the intention that their contributions be merged into inseparable or interdependent parts of a unitary whole."

A. *Works Made for Hire*

A *work made for hire* is a work that is prepared by an employee on behalf of the employer within the scope of his or her employment.[3] Thus, if one is paid for producing works eligible for copyright protection while employed by another person, the latter may be deemed to be the author and owner of the copyright. A critical issue that must be resolved is whether the creator of the work is an employee or an independent producer or contractor. If the person is an employee, then the employer under such circumstances will ordinarily prevail. If the person is an independent producer or contractor, the law requires that certain conditions be met before the employer can prevail in a claim for copyright ownership, including a signed written agreement between the parties that the work is one made for hire.

1. Employee-Independent Contractor Distinction

Courts have looked at the rules of agency law to make the differentiation between an employee and an independent contractor.[4] *The Restatement of the Law of Agency* (Second), Section 220, lists a number of factors that a Court will weigh in its determination. They are:

1. The extent of control which, by the agreement, the master [employer] may exercise over the details of the work;

2. Whether or not the one employed is engaged in a distinct occupation or business;

3. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;

4. The skill required in the particular occupation;

5. Whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;

6. The length of time for which the person is employed;

7. The method of payment, whether by the time or by the job;

8. Whether or not the work is a part of the regular business of the employer;

9. Whether or not the parties believe they are creating the relation of master and servant; and

10. Whether the principal is or is not in business.[5]

In essence, the more control an employer has over a work in a work environment, the more likely courts will find an employer-employee relationship. A person, working on an assembly line forty hours a week, with specified vacation days, where the employer deducts for FICA and normal tax deductions, and where the employer furnishes the place and equipment for the employment, will be deemed an employee rather than an independent contractor. The greater the independence of the person requested to perform a specific task, the greater the likelihood that such person is an independent producer. For example, calling upon someone to build a wing to an existing building would almost always establish an employer/independent contractor relationship.[6]

If the work is one that is the result of a request from an independent producer or contractor, then the issue arises of whether the creator of the work or the employer owns the copyright. The Copyright Act [Section 20 1(b)] states that to be considered as a "work made for hire" where the employer is deemed the author and owner of the copyright, it must be:

1. Specially ordered or commissioned for use as (a) a contribution to a collective work; (b) as a part of a motion picture or other audiovisual work; (c) as a sound recording; (d) as a translation; (e) as a supplementary work [a work secondary to that of another author such as providing a forward, illustrating, commenting on, adding bibliography and so on]; (f) as a compilation; (g) as an instructional text; (h) as a test; (i) as answer material for a test; or (I) or as an atlas; and

2. The parties agreed in a written instrument signed by them that the work is one made for hire.

In all other cases, the creator of the work is the author and owner of the work.

B. Who is an Employee?

1. Pre-CCNV Decisions

Who is an employee? Prior to the U.S. Supreme Court's decision in *Community for Creative Non-Violence v. Reid,*[7] the courts of appeals for the several circuits and district courts had utilized a variety of theories in interpreting the relationship. As noted in Reid,[8] there were a number of formulations presented by the diverse courts of appeals:[9]

a. ***Right to Control.*** *In Peregrine v. Lauren Corp.*,[10] the District Court used the right to control test in determining whether a particular work was subject to the work-made-for-hire statutory provision of the Copyright Act of 1976. In granting the defendant employer's motion to dismiss a lawsuit instituted by the plaintiff photographer for copyright infringement [the photographer copyrighted the works when the defendant failed to pay for them], the Court stated that "a work for hire relationship exists when an employer has the right to control the party doing the work. . . ."[11] The defendant had failed to pay for photographs the advertising agency had commissioned of the plaintiff for use in an advertising brochure. The court noted that the plaintiffs work had been undertaken at the insistence of the employer who retained the right to supervise the plaintiffs work. The defendant had the right to veto and radically change the nature and scope of the plaintiffs photographs. Thus, the works fell within the work-made-for-hire provisions of the Copyright Act.[12]

b. ***Control Over Creation of Work.*** The Second Circuit utilized the formula of actual wielding of control over the creation of a particular work. In *Aldon Accessories Ltd v. Spiegel, Inc.,*[13] Aldon sued the famed defendant concerning its sale of brass unicorn statuettes that had allegedly violated the plaintiffs copyright. The statuettes were designed and sold exclusively by the plaintiff to commercial buyers. The plaintiffs principals had conceived of a novel line of statuettes depicting mythological creatures, which were then designed by a Japanese company on their behalf as roughly sketched by the principals. The designs were thereafter copyrighted. Thereafter, the plaintiff caused a Taiwanese company to manufacture brass versions of the statuettes, which were then advertised in the plaintiffs catalogs. A Spiegel buyer allegedly visited plaintiffs booth at a trade show and had a Taiwanese company produce them for the defendant. Spiegel stated that it did not violate plaintiffs copyright inasmuch as the artisans in Japan and Taiwan were independent contractors whose works were not properly copyrighted by the plaintiff. The issue was raised by the defendant concerning the trial judge's charge to the jury that stated:

> A work for hire is a work prepared by what the law calls an employee working within the scope of his employment. What that means is, a person acting under the direction and supervision of the hiring author, at the hiring author's instance and expense. It does not matter whether the for-hire creator is an employee in the sense of having a regular job with the hiring author. What matters is whether the hiring author caused the work to be made and exercised the right to direct and supervise the creation.[14]

The Court of Appeals affirmed the validity of the instruction to the jury. Congressional intent as expressed in the passage of the Copyright Act of 1976 did not narrow the employment relationship to include only "regular" employees; rather, employees also include those situations wherein the contractor "actually sufficiently supervised and directed " the creation of the work."[15]

c. ***Common Law Agency Law Meaning.*** The District of Columbia Circuit adopted the common law meaning for the definition of "employee." The view was expressed both by the D.C. Circuit in *Community for Creative Non-Violence v. Reid,*[16] *and by the Fifth Circuit in Easter Seal Society for Crippled Children & Adults of Louisiana, inc. v. Playboy Enterprises,*[17] In the *Easier Seal Society* action, an entertainer, Ronnie Kole, acting on behalf of the plaintiff, contracted with a public television station for the videotaping of a staged "Mardi-Gras-style parade and a Dixieland musical jam session. The videotape was edited into 1-minute segments for broadcast on the Easter Seal Telethon. Kole had made a number of suggestions to the TV station director concerning camera locations and particular scenes. Kole was the master of ceremonies for the jam session. The station decided technical questions concerning lighting, sound recording and other related aspects of the telecast. The station later used the videotape on several shows. Later, the station director received a request from a Canadian television producer for permission to copy some 40 minutes of the tape. Unbeknownst to the station, the tape was used in an adult film that was later broadcast by Playboy.

The Court made mention of the diverse interpretations of the meaning of "employee" for purposes of a work-made-for-hire citing the within stated cases, finding fault with a number of the said analyses. It rendered what it termed the "Literal" interpretation, namely, that a work is made for hire "if and only if the seller is an employee within the meaning of agency law, or the buyer and seller comply with the requirements of Section 101(2).[18] Copyright "employees" are those persons called "employees" or "servants" for purposes of agency law." Inasmuch as the television station was an independent contractor, the plaintiff was not the statutory author and, thus, the use of the field tapes by Playboy and by the other defendants did not infringe upon the plaintiffs rights.[19]

d. ***"Employees" as Formal, Salaried Employees.*** In *Dumas v. Gommerman,*[20] Dumas, the widow of the artist and representative of the estate of Patrick Nagel, sued the defendant to prevent the manufacturing, copying, and distribution of four lithographs created by Nagel, on contract with an advertising agency that acted on behalf of its client ITT Cannon. D'Arcy determined the sketches of the paintings, including content and aspects of the design, borders, and placement of figures therein. ITT Cannon later sold the lithographs to the defendant, Gommerman, including any copyrights attached thereto. Gommerman, over the objections of Dumas, began reproducing the lithographs as posters and took purchase orders with respect thereto. The Court of Appeals affirmed the determination of the District Court: that Nagel was not an "employee" for purposes of the work for hire exception of the

Copyright Act; and its issuance of an injunction barring Gommerman from reproducing and selling the posters. The Court concluded, after a review of the legislative history of the Act and commentaries of scholars, that: "Only the works of formal, salaried employees are covered by Section 101(1). Only certain types of specially commissioned works qualify as "work made for hire" under Section 101(2).[21] It specifically disagreed with the Second and Seventh Circuits and stated that the 1976 Act made changes that necessitated the said interpretation.[22]

2. The *CCNV v. Reid* Decision

The U.S. Supreme Court, seeing the conflict of interpretations among the several Circuits, decided to clarify the issue in determining who is an "employee" when Congress had not furnished its definition in a number of enactments. In Reid, the plaintiff, CCNV, is a nonprofit unincorporated associated dedicated to assist the homeless in the U.S. It conceived the idea of having a sculpture of a modern nativity scene wherein two homeless black parents and their newborn child are huddled over a steam gate. It commissioned a statue exemplifying the concept to be made by the defendant, Reid, called "Third World America." Reid agreed to create the statue without a fee other than the actual cost of materials and related expenses. The parties collaborated concerning the details of the project, including the nature of the sculpture, approval of sketches, the models to be used for the work, and other details. Thereafter, the parties disputed concerning who was entitled to claim copyright ownership. The issue was: Whether the work was one for hire thereby permitting CCNV to claim copyright ownership of the work?

The Court stated that it was not a work for hire and remanded the case for a determination whether the work was jointly authored thereby permitting both parties to share copyright ownership. Justice Thurgood Marshall, in setting forth the decision of the Court set forth and applied the Restatement's factors stated above in determining whether Reid or the CCNV was the owner of the work. In addition, several additional factors were added, namely, whether the hiring party has the right to assign additional projects to the hired party, the provision of employee benefits and the tax treatment of the hired party.[23] He noted that the Copyright Act of 1976 vests ownership initially in the author(s) of the work.[24] The author generally is the person who actually engages in the creative process, that is, the translation of an idea into a fixed, tangible expression that fulfills the requirements for copyright protection. The Act provides an exception to such ownership, to wit, where the works are those made for hire. Where the work is one created for hire, i.e., on behalf of an employer, then such work renders the employer the author of the work who is entitled to copyright ownership and protection.[25] If the work is for hire, "the employer or other person for whom the work was prepared is considered the author" and owns the copyright, unless there is a written agreement to the contrary. The importance of making the distinction will affect not only the initial ownership but also the owners' copyright duration under Section 3 02(a) of the Copyright Act his or her renewal rights under Section 304(a) [copyrights subsisting as of January 1, 1978], and the owners' termination rights under 203(a).

The issue that was decided by the Court was "whether "Third World America" is "a work prepared by an employee within the scope of his or her employment" under Section 10 1(1)." The Court, noting that the Act does not define the terms, recited the four interpretations stated hereinabove. It initially looked to the language of the Act and indicated that the statute did not define the terms "employee" or "scope of employment." Thus, "[w]here Congress uses terms that have accumulated settled meaning under... the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms."[26] The Court then indicated that, when Congress used the term "employee" without furnishing a definition, it concluded that Congress intended to describe the common law agency relationship of master-servant. inasmuch as the words "employee" and "employment" were not defined, it is presumed that the words retained their conventional meaning. In fact, the proof that Congress' intended to incorporate the agency law definition is found in its use of the use of the term, in Section 101(1) of the Act, "scope of employment," which term is a term of art in agency law.[27]

With respect to the factors evidencing an employer-employee relationship, the Court emphasized that: "No one of these factors is determinative."[28] The Court then indicated that it agreed with the decision of the D.C. Circuit, after an examination of the circumstances of this case in light of the said factors, that Reid was not an employee of CCNV but rather was an independent contractor. Although CCNV members had directed Reid to the extent of assuring that the produced work their specifications, the Court emphasized that the extent of control, which the hiring party had exercised over the details of the sculpture of the product, was not dispositive. All of the other circumstances were found by the Court to weigh heavily against finding an employment relationship.[29]

Reviewing the common law agency factors, it determined that: Reid is a sculptor; he occupation was a skilled occupation; Reid supplied his own tools; he used his own studio in Baltimore for the creation of the work; and there was no daily supervision of his activities. Reid was retained for a limited period of time (less than two months). For the entire period of the making of the sculpture and thereafter, CCNV had no right to assign additional projects to Reid. Although given a deadline for completion of the work, Reid had total freedom to decide when and how long to work. CCNV paid Reid the lump sum of $15,000, which sum was dependent on "completion of a specific job, a method by which independent contractors are often compensated." Reid had complete discretion in hiring and paying assistants. Creating sculptures is clearly not "regular business" for CCNV. Moreover, CCNV was in business. Finally, no payroll or social security taxes were paid by CCNV nor did it provide any employee benefits, or contribute to unemployment insurance or workers' compensation funds.[30]

Once it is proven that Reid was an independent contractor, whether the sculpture, "Third World America," is a work for hire depended on whether Section 101(2) of the Copyright Act was applicable. Proof of its application to the work was totally lacking. Accordingly, CCNV was not able to establish that the work-made-for-hire provision was applicable. Nevertheless, the Court indicated that factually CCNV nevertheless could be adjudicated a joint author of the sculpture if the District Court, upon remand of the case, determines that CCNV and Reid prepared the work "with the intention that their contributions be merged into inseparable or interdependent parts of a unitary whole." If such proof were established, then both CCNV and Reid would be co-owners of the copyright in the work.[31]

3. *Post-C CN V Decisions*

There were a number of cases that applied the Reid factors. In an oft-cited case, *Aymes v. Bonelli,*[32] the Second Circuit reversed the District Court's dismissal of a copyright infringement action that had determined a computer program created by the plaintiff on behalf of the defendant company was work-made-for-hire. The Court reviewed the Reid factors and disagreed with the lower court's alleged misapplication wherein it treated all factors as equally important. It emphasized that some factors may have little or no significance while others will be significant in almost all situations. The factors that will be significant in almost all cases include: "(1) the hiring party's right to control the manner and means of creation; (2) the skill required; (3) the provision of employee benefits; (4) the tax treatment of the hired party; and (5) whether the hiring party has the right to assign additional projects to the hired party."[33]

In *Eisenberg v. Advance Relocation & Storage, Inc.*[34] in a case wherein the issue of whether the plaintiff was an employee within the meaning of the Civil Rights Act of 1964, the Second Circuit reviewed the Reid factors noting that no single factor was dispositive of the case albeit the first factor, namely, "the extent to which the hiring party controls the manner and means by which the worker completes his or her assigned tasks" is to be given the greatest emphasis of all of the factors.[35] Inasmuch as the District Court placed undue emphasis on two of the Reid factors, namely, the employee-benefits factor and the tax treatment factor, and had not placed greater emphasis on the first factor, the Court reversed the dismissal of the litigation.

In *Nationwide Mutual Ins. Co. v. Darden,*[36] the Supreme Court, in an unanimous decision, appears to disagree with the Aymes and Eisenberg Courts' emphasis on particular factors. The Supreme Court recited anew its statement in *NLRB v. United Ins. of America,*[37] wherein it observed that inasmuch as the common law contains "no shorthand formula or magic phrase that can be applied to find the answer . . . all of the above incidents of the relationship must be assessed and weighed with no one factor being decisive."[38] It repeated its oft-stated rule that where Congress does not state a definition of the word "employee" in a particular statute, the settled meaning of the common law given to the conventional master-servant relationship is to be inferred by a court.[39]

The use of terminology by an employer in defining a relationship as one of an employer-independent contractor status does not negate a finding that an employer- employee relationship existed. Thus, in *Vizcaino v. Microsoft Corp.,*[40] the 9th Circuit determined that an employer-employee relationship existed between the company and certain workers who had signed certain agreements that stated the worker was "an Independent Contractor" on behalf of Microsoft and that nothing in the agreement was to be construed as creating an employer-employee relationship. In addition, the employee was made responsible for his or her federal and state taxes, withholding, social security, insurance and other benefits. The Court noted, however, that the workers were made subject to the company's control both as to the manner and means of the performance of their duties, that they worked for a substantial period rather than a one-time basis or limited period, that the company furnished the workplace and the equipment to be used, that they were subject to being discharged, and other factors that negated an employer-independent contractor status.[41]

In *Kirk v. Harter*, 188 F.3d 1105 (8th Cir. 1999), the Court of Appeals discussed the issue as to who is entitled to claim ownership of a protected work. Plaintiffs consisted of a partnership known as Iowa Pedigree, which was engaged in the business of aiding dog breeders and brokers to comply with the licensing and registration requirements of the American Kennel Club and the U.S. Department of Agriculture. It retained the services of the defendant who had written a computer program that permitted owners to track information concerning dogs bred and sold by the kennel. Harter, at the request of the plaintiffs, wrote a computer program to assist owners to comply with the said requirements. Defendant developed a number of programs for the plaintiffs, maintained their computers, and serviced the software of plaintiffs clients. In 1996, a number of customers terminated their relationship with plaintiffs and received services directly from the defendant. In a suit for copyright infringement and other claims, a jury found in favor of the plaintiffs. The Court of Appeals reversed.

The Court stated that the issue was whether Iowa Pedigree was the sole owner of the copyrights to the computer programs. "The Copyright Act provides that an employer is the author when an item is considered a work made for hire . . . . See also 17 U.S.C. Section 101 (defining work made for hire as "a "work prepared by an employee within the scope of his or her employment1');". . Whether the computer programs in this case are works made for hire turns on the nature of the employment relationship between lowa Pedigree and Harter . . . . "The Court then reviewed the facts of the case and concluded that the defendant was an independent contractor and not an employee and therefore the computer programs were not works made for hire. Thus, the plaintiff did not have exclusive right to the computer programs.

Section 201(b) of the Copyright Act specifies that a protected work becomes one for hire when the parties agreed in a written instrument signed by them that the work has the said designation. The issue arose in another action concerning the widow of the artist Patrick Nagel. In *Playboy Enterprises, Inc. v. Dumas,*[42] Playboy sued defendants for copyright infringement concerning some 285 pieces of artwork produced by a freelance writer, Patrick Nagel, for Playboy during the period of 1974-1984. Nagel routinely sent paintings to Playboy, which generally published the work in its semi-erotic magazine. Nagel used his own equipment, tolls, material, and workplace. He hired his own assistants, produced works for other corporate entities, and was not subject to payroll deduction. Each party was free to prepare and/or accept the work that was submitted. From 1974 to 1977, Playboy retained possession for the said artwork but commencing on April 1, 1977, Playboy began returning the artwork to the creator and inserted a legend on the work stating "Playboy's Artwork Reproduction Prohibited Without

Playboy's Permission." Specific sums were paid to the creator of the work dependent on the nature thereof

The endorsement on the checks paid from 1974-1979 contained the legend that the payee acknowledged that the fee was payment in full for the assignment of all rights, title, and interest thereto to Playboy. Commencing in September 1979, the legend stated that the payment was for services paid in full on as work-made-for-hire basis and that the payee assigned all copyright rights to Playboy. A further enhancement of the legend appeared with respect to checks paid commencing March 1981 that recited the same statement with the addition that the understanding could not be changed without a signed written agreement between the parties. Nagel's widow, Dumas, obtained copyrights to the said works and entered into an agreement with another company to publish and market limited editions of reproductions of Nagel's works. Playboy then sued for copyright infringement.

The Court cited the 1909 Copyright Act and prior precedent in declaring that a person who engages another to produce an artistic work at his or her expense is presumed to be the owner thereof. Inasmuch as Playboy had commissioned the works and paid for the said works, it is presumed to have been the owner of the copyright therein as to works produced before the Copyright Act of 1976. The Reid factors, according to the Second Circuit, do not apply where a work is produced at the hiring party's expense under the prior Act. Inasmuch as all of the works in the pre-1977 period were made at Playboy's instance and expense and were, therefore, works-made-for-hire. The failure to insert the legend in the pre-September 1979 endorsements that the works were made for hire does not preclude a finding of such status. The Court then reviewed the various legends and determined that the first legend that did not contain the "works for hire" statement would thus not have such status. With respect to the remaining legends, the Court remanded the case to the District Court to determine whether the works from January 1977-January 1978 were made at the instance of Playboy; whether the endorsements of the checks with the work for hire legends constituted an work-made-for-hire agreement; whether the works were "specially ordered or commissioned" under the 1976 Act; and whether the endorsement s under such legends did in fact transfer copyright ownership to Playboy.[43]

III. POTENTIAL CONSEQUENCES FOR THE UNWARY

A The Recording Industry Controversy

The Copyright Act grants copyright protection to "original works of authorship fixed in any tangible medium of expression . . . ."[44] The Act further grants certain exclusive rights in copyrighted works to owners of the copyright. They include that of reproduction, preparation of derivative works, distribution of copies, performance, and display.[45] In a 1999 amendment to the Act,[46] the Recording Industry Association of America, through its extensive lobbying activities, had inserted without debate in Congress the addition of "sound recordings"[47] to the "other audiovisual work" category in the definition of works made for hire. The result was that the recording artists and producers were no longer able to exercise their right of termination of copyright ownership for works transferred or licensed to recording companies.[48]

After the passage of the so-called "clarifying amendment" the Recording Academy that represents the artists was able to petition Congress to remove sound recordings from the said other audiovisual work category, thereby restoring the termination right of the artists. Although companies may continue to compel unsophisticated artists to sign contracts that state the license or grant is a work-made-for- hire, nevertheless, courts may disregard such designation without proof that the work falls under the statutory designation.[49] The difficulty presented by the recording industry is that without the work-made-for-hire designation any peripheral artist could enjoin the production and distribution of a record in future years. Thus, theoretically, any musician including backup players would be able to interfere with future recordings of an earlier work. Thus, Congress may still have to legislate solutions to the conflicting interests.[50]

B. *The Professor's Plight: Who Owns the Notes and Other Scholarly Output?*

1. *The Professor as Employee.*

The judicial road is muddy albeit somewhat in favor of the professor who engages in scholarly activity. The difficulty is that most professors would initially appear to be governed by the common law agency test enunciated in Reid. Reviewing the factors indicating a relationship of an employer-employee (formerly, master-servant) relationship, it is certainly arguable that professors are employees rather than independent contractors: (1) The university does exercise control over a professor, dictating the number of weeks, specific time frames for classes, type of courses, the locations of the classrooms, most often the text to be used, requirements of minimal teaching and scholarly output, attendance at meetings, and other indicia of control; (2) The university does engage in a distinct occupation or business, to wit, the education of students; (3) The third factor of the kind of occupation, and whether it is usually performed under the direction of the employer of whether the work is performed by a specialist without supervision is arguable a mixed factor. Professors presumably possess their own specialties and act with some supervision of their respective chairs and older colleagues; (4) The skill required mitigates in favor of the professor who brings his or her expertise to the classroom; (5) The employer clearly provides the supplies the instrumentalities to the professor, including office space, secretarial and other personnel assistance, computers, facsimile and copying machines, telephone, and other materials; (6) The employer also prevails concerning the length of time the professor is employed- most professors spend a virtual lifetime in the employ of the university; (7) The method of payment is by a specific weekly or semi-monthly sum in accordance with the annual contract rather than a one-sum transactional fee; (8) The scholarly activity is arguably a part of the regular business of the employer, although community college professors may argue than scholarly output is not a requirement but only a desired goal; (9) The ninth factor of the belief of the parties that an employer-employee relationship exists is tempered by the belief that there is a sizable degree of independence accorded to the professor; and (10) the university clearly is in business of furnishing education to student.

Thus, using the common law factors, a university has a rather strong case in arguing that a professor is a mere employee and that any work performed by the employee at the university or utilizing the university's resources belong to the university. Nevertheless, historically, professors have both precedents and reasonable expectations interests in their favor.[51]

2. The Professor as independent Contractor

If a professor is a mere employee of the university, then any work produced by the professor within the scope of his or her employment, in the absence of an agreement to the contrary, would subject to copyright ownership by the university. If the professor were an independent contractor, then a written, signed agreement would be necessary for the transfer of copyright ownership to the university. Nevertheless, court decisions appear to have created an exception.[52] In *Hays v. Sony Corp. of America,*[53] the so-called "teacher exception" was discussed. He stated:

> Until 1976, the statutory term "work made for hire" was not defined, and some courts had adopted a "teacher exception" whereby academic writing was presumed not to be work made for hire . . . . The authority for this conclusion was in fact scanty. . . but it was scanty not because the merit of the exception was doubted, but because, on the contrary,

virtually no one questioned that the academic author was entitled to copyright his writings. Although colleges and university teachers do academic writing as part of their employment responsibilities and use their employer's paper, copier, secretarial staff, and (often) computer facilities in that writing, the universal presumption and practice was that (in the absence of an explicit agreement as to who had the right to copyright) the right to copyright such writing belonged to the teacher rather than to the college or university. There were good reasons for the assumption. A college or university does not supervise its faculty in the preparation of academic books and articles, and is poorly equipped to exploit their writings, whether through publication or otherwise; we may set to one side cases where a school directs a teacher to prepare teaching materials and then directs its other teachers to use the materials too.[54]

The Court then raised the issue of whether the 1976 Act abolished the teacher exception. The difficulty is that the Act did not discuss or preserve, either in statutory form or in the legislative history, the preservation of the exception. As Judge Posner said in Hays, a literalist would have to conclude that the exception was abolished and, thus, writings by scholars may well constitute works for hire.[55] The court, nevertheless, stated a way around the difficulty is the wording of Section 20 1(b) that states: "In the case of a work made for hire, the employer or other person for whom the work was prepared is considered to be the author . . . [emphasis added]. Thus, an article or book prepared by a scholar, though generally required of professors, is arguable not prepared for the employing university.[56]

Due to the paucity of cases concerning the question of who owns the professor's scholarly output, it is incumbent that the issue be resolved between the university and its professors in the form of a written policy that is made part of the annual contract between the parties. Most, if not all, universities have undertaken such a policy. Relying upon the courts to continue a teacher exception may be dangerous in the light of the lack of clarity in the copyright enactment.

C. Moral Rights as Affected by the Work-Made-for-Hire

Moral rights in copyright law prior to 1990 were not recognized in the U.S., although courts used a variety of theories to give protection to artists and others that effectually granted such rights to them. With the passage of the Visual Arts Rights Act of 1990 [VARA],[57] the Copyright Act was amended so as to add a new visual art section [106A], which granted the author of a work the following additional rights heretofore countries.[58] U.S. enactment was pursuant to its entry into the recognized by most other Berne Convention for the Protection of Literary and Artistic Rights.[59]

These rights are as follows:

(1) *Attribution*, i.e., claim authorship of the work and prevent use of one's name as author of a work or visual art not created by him or her;

(2) *integrity*, i.e., prevent use of one's name of a work or visual art which was distorted, mutilated or otherwise modified which would injure his or her reputation; and

(3) *Prevention* of intentional distortion, mutilation, destruction or modification prejudicial to one's reputation and prevent destruction of any work of recognized statute. It is subject to modified exceptions concerning works that are part of a building structure.[60]

The rights are subject to prior consent or other waiver by the author.[61] Also, there are exceptions for works which become modified as a result of the passage of time, the inherent nature of the material, the result of conservation or due to the lighting or placement of a publicly presented visual art work.[62]

The potential conflict of moral rights and the work-made-for-hire provisions of the Copyright Act is illustrated by the decision of the Second circuit in *Carter v. Helmsley-Spear, Inc.*[63] Plaintiffs are three sculptors who created a work for installation in a lobby on behalf of the defendants' predecessor. When the defendants sought to remove or alter the work, the plaintiffs applied for an injunction that was granted by the District Court.[64] On appeal, the Court of Appeals reversed the finding that the work was not one for hire that would have permitted to prevent the alteration of the work during their lifetimes in accordance with the statutory provisions. Applying the Reid tests, the Court concluded that the factors favored the employers and, thus, the defendants were free to remove or otherwise alter the works of art. It found persuasive that the defendants could and actually did assign other projects to the plaintiffs other than those works destined for the lobby. The factors the Court found persuasive were: most supplies were furnished by the employer, the length of time of employment was lengthy (over two years with no definitive termination date), that the plaintiffs could not hire assistants without the employers' approval, the payment of a weekly salary coupled with payroll deductions, and the provision of life, health, and liability insurance benefits.

The Court discounted the factor of the freedom of the artists to control the nature and scope of the work. their significant skills, the lack of employee benefits, and the tax treatment.[65] Thus, although visual artists appear to possess extensive moral rights with respect to their works, the work-made-for-hire statutory provision may deny artists of these rights.[66]

IV. CONCLUSION

The conflict between employers who seek to own and exclusively disseminate the efforts of persons they deem to either employ or have commissioned and the persons who create the works will continue unabated. The balance that the Congress and the courts have to address concern the clarification of the definition of an employee, employer, and independent contractor and the respective rights of such persons. Until Congress has acted there will continue to be a confusion as to the factors that are to be applied in individual cases. Another concern is the lack of even-handedness between the corporate entities that possess the power to dictate the provisions in contracts making agreements work-made-for-hire even if the factors evidencing it are contrary to the designation. In the alternative, employers demand and receive assignments of copyrights to the great detriment to the creative persons. In order to protect the essential purpose of intellectual property laws, to wit to inspire further creative endeavors, there should be some safeguards accorded to those persons unable to use some modicum of power in contracting with far superior company with almost unlimited resources. This is particularly true in the entertainment industry where there are numerous stories where artists create works that do exceptionally well and, yet, they are compelled to file for bankruptcy protection because of the miniscule sums that their contracts provided.

ENDNOTES

[1] The Copyright Act of 1976, Pub. L. No. 94-553, 90 Stat. 2541 17 U.S.C. Sections 101-1010 (1988 & Supp. V 1993).

[2] Section 102 of the Copyright Act states that "works of authorship" include but are not limited to:

(1) literary works;
(2) musical works, including the accompanying words;
(3) dramatic works including any accompanying music;
(4) pantomimes and choreographic works;
(5) pictorial, graphic, and sculptural works;
(6) motion pictures and other audiovisual works;
(7) sound recordings; and
(8) architectural works.

Computer programs come within the scope of "literary works" under the Act. A "computer program is defined in Section 101 of the Act as "a set of statements or instructions to be used to bring about a certain result." "Literary works" are defined as "[w]orks, other than audiovisual works, expressed in words numbers, or other verbal or numerical symbols or indicia, regardless of the nature of the material objects such as books, periodicals, manuscripts, phonorecords, film, tapes, disks, or cards, in which they are embodied.

[3] The Copyright Act, Section 101. The statutory definition is as follows:

A"work made for hire" is —

(1) a work prepared by an employee within the scope of his or her employment; or,

(2) a work specially ordered or commissioned for use as a contribution to a collective work, as a part of a motion picture or other audiovisual work, as a translation, as a supplementary work, as a compilation, as an instructional text, as a test, as answer material for a test, or as an atlas, if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire. For the purpose of the foregoing sentence, a "supplementary work" is a work prepared for publication as a secondary adjunct to a work by another author for the purpose of introducing, concluding, illustration, explaining, revising, commenting upon, or assisting in the use of the other work, such as forewords, afterwords, pictorial illustrations, maps, charts, tables, editorial notes, musical arrangements, answer material for tests, bibliographies, appendixes, and indexes, and an "instructional text" is a literary, pictorial, or graphic work prepared for publication and with the purpose of use in systematic instructional activities.

* ** * *

The predecessor to the Copyright Act of 1976 also provided that an employer would be the author with respect to "works made for hire" without defining the meaning of the term. Copyright Act of 1909, ch. 1(1909), as amended by Act of July 30, 1947, ch. 391,61 Stat. 652.

[4] For example, see *Kirk v. Harter*, 188 F.3d 1005, 1007 (8th Cir. 1999).

[5] The Internal Revenue Service uses a 20-factor lest in making the determination. See Rev. Rul. 87-4 1, 1987-1 C.B. 296, 298-299.

[6] For an historical overview and judicial interpretation of the employer-employee relationship and the factors determining the relationship, see Richard R. Carlson, *Why the Law Still Can't Tell an Employee When It Sees One and How Jt Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L. 295 (2001).

[7] 490 U.S. 730 (1989).

[8] *Id.* at 738-739.

[9] For a discussion of the several theories preceding the Reid decision, see Mary Tepper, *Works Made For Hire and the Copyright Act of 1976—We're Finally Back Where We Started: Community for Creative Non-Violence v. Reid*, 109 S. Ct. 2166 (1989), 59 U. CIN. L. REV. 299 (1990) and Jennifer Sutherland Lubinski, *The Work For Hire Doctrine Under Community for*

Creative Non-Violence v. Reid: An Artist 's Fair Weather Friend, 46 CATH. U.L. REV. 119 (Fall 1996).

[10] 601 F. Supp. 828 (D.Co. 1985).

[11] *Id.* at 829.

[12] A similar view was rendered by Southern District Court in New York in *Town of Clarkstown v. Reeder*, 566 F. Supp. 137 (S.D.N.Y. 1983) in an action brought by the Town concerning the ownership of a Manual for use by a proposed Youth Court. The defendant, Reeder, who prepared the Manual, was a volunteer employee of the Town. Both the Town and Reeder alleged rightful ownership of the Manual.

The Court stated that the crucial factor in determining the issue of employment status "is whether the alleged employer has the right to direct and supervise the manner in which the writer performs his work" (at 141). After reciting numerous factual data evidencing the Youth Court's power to supervise and control the defendant Reeder's Manual, the Court found in favor of the plaintiff Town.

[13] 738 F.2d 548 (2d Cir. 1984).

[14] *Id.* at 551.

[15] *Id.* at 552. The Fourth Circuit adopted the same view in *Brunswick Beacon, Inc. v. Schock-Hopas Pub. Co.*, 810 F.2d 410 (4th Cir. 1987) wherein the issue concerned whether a newspaper that developed layouts for advertising copy or whether the advertisers were entitled to copyright protection for the said layouts. The Court agreed that the plaintiff should prevail citing Aldon approvingly in holding that advertisements for publication prepared by its employees gave the plaintiff the right to assert copyright ownership (*Id.*, at 413). The Seventh Circuit expressed a comparable view in *Evans Newton Inc. v. Chicago Systems Software*, 793 F.2d 889 (7th Cir. 1986). In Evans, the plaintiff had contracted with the defendants to accomplish the computer programming for its Project Basic, a program to be used by educational institutions. After completing the work, the defendant proceeded to market its own competing manual and computer program. The Court also cited Aldon with approval in finding that the work was one for hire Even though the defendant is an independent contractor, nevertheless, the proper issue is not whether the defendant was an independent contractor but whether the contractor "was so controlled and supervised in the creation of the particular work by the employing party that an employer-employee relationship existed." Evans, at 894 citing Aldon, at 552. The Court affirmed the finding of copyright infringement by the defendant whose work had been supervised by the plaintiff's personnel.

[16] 846 F.2d 1485 (D.C.Cir. 1988).

[17] 815 F.2d 323 (5th Cir. 1987).

[18] *Id.*, at 334-335.

[19] *Id.*, at 337. In a humorous note, the Court found the name of the case to rival that of United States v. 111 1/4 Dozen Packages of Article Labeled in Part Mrs. Moffat's Shoo Fly Powders for Drunkenness, 40 F. Supp. 208 (W.D.N.Y. 1941) and United States ex rel. Mayo v. Satan and

his Staff, 54 F.R.D. 282 (W.D.Pa. 1971).

[20] 865 F.2d 1093 (9'" Cir. 1989).

[21] *Id.* at 1102.

[22] *Id.* The Court made reference to the Aldon and Evans Newton decisions.

[23] The recited the factors as follows:

> [1] the hiring party's right to control the manner and means by which the product is accomplished . . .; [2] the skill required; [3] the source of the instrumentalities and tools; [4] the location of the work; [5] the duration of the relationship between the parties; [6] whether the hiring party has the right to assign additional projects to the hired party; [7] the extent of the hired party's discretion over when and how long to work; [8] the method of payment; [9] the hired party's role in hiring and paying assistants; [10] whether the work is part of the regular business of the hiring party; [11] whether the hiring party is in business; [12] the provision of employee benefits; and [13] the tax treatment of the hired party. Reid, at 490 U.S. 740-4 1.

[24] 17 U.S.C. Section 20 1(a).

[25] Section 201(b).

[26] Community for Creative Non-Violence at 739.

[27] *Id.* at 824-825.

[28] *Id* at 751.

[29] *Id.*

[30] *Id.* at 751-752.

[31] *Id.* at 833. Section 20 1(a) of the Copyright Act provides:

> Initial Ownership. - Copyright in a work protected under this title vests initially in the author or authors of the work. The authors of a joint work are co owners of copyright in the work.

[32] 980 F.2d 857 (2d Cir. 1992).

[33] *Id.* at 861. In Aymes, an officer of the defendant company, Island Recreational, had employed the plaintiff as a computer programmer. The company operated a chain of retail stores that sold swimming pools and related supplies. The plaintiff, while working for the defendant for a two-year period, created a series of programs under the general direction of the company president, Bonelli, who allegedly told Aymes that the programs would be used on one computer at one of the company's offices. Aymes worked alone at the defendant's offices, without assistants, and had a great deal of autonomy. Bonelli directed and instructed Aymes concerning what he desired from the program. Aymes worked semi-regular hours, was often paid after the

presentation of invoices, was paid by the project, and received bonuses for completion of particular projects on time. He did not receive health or other insurance benefits, was not deducted for federal or state taxes, and Island did not account for the plaintiffs payroll taxes. After leaving Island's employ and not having received back pay, Aymes registered the programs he had created. In a suit for copyright infringement instituted by Aymes, the Court of Appeals remanded the case to the District Court, finding the factors appeared to support Aymes' independent contractor status. Other than the factor in favor of Island of directing the creation of the program, the remaining relevant factors appeared to favor Aymes.

[34] 237 F.3d 111 (2d Cir. 2000).

[35] *Id.* at p. 114. In Eisenberg, the plaintiff alleged that she was sexually harassed at her place of employment in violation of the N.Y.S. Human Rights Law. The Court of Appeals reversed the dismissal of the action by the District Court noting that a court had to disregard the Reid factors that were either irrelevant or of indeterminate weight and weigh those factors that were particularly significant in determining whether agency existed. In doing so, the Court emphasized the first facto of control by the hiring party based on a number of prior decisions and that of Professor Seavy's discussion in his text on AGENCY (Section 84 @ 142 (1964). It disagreed with the lower court's interpretation of the *Aymes v. Bonelli* decision wherein the Court did place presumptive significance on five Reid factors but had not attached the weighing significance as the lower court interpretations of the decision. It said that an anti- discrimination case is to be viewed differently from a copyright case as illustrated in Aymes, wherein rights to intellectual property most often depend on contractual terms. Cases concerning discrimination rights differ inasmuch as they are based on public law rights granted by Congress.

[36] 503 U.S. 318 (1992).

[37] 390 U.S. at 258.

[38] Nationwide, supra note 35 at 324.

[39] *Id.* at 322-323. The Nationwide case concerned a lawsuit instituted by a former agent of the Company, Darden, whose company retirement benefits were terminated when he allegedly violated the company's restrictive covenant mandating that within a year of his termination and within a 25-mile radius, he could not sell competitive insurance policies. Having done so, the company disqualified him from receiving retirement benefits. The District Court had initially dismissed the action stating that Darden failed to meet the employee criteria, which decision was reversed on appeal by the 4"' Circuit, 796 F.2d 701, causing the District Court to reverse its prior ruling (717 F. Supp. 388). The Court of Appeals stated that a plaintiff, alleging retirement benefits under ERISA, would qualify upon a showing that he or she had a reasonable expectation of pension benefits, that he or she had relied upon the expectation, and that he or she lacked the power to contract out of the benefit plan forfeiture provisions.

[40] 120 F.3d 1006 (9th Cir. 1997).

[41] *Id.* at 1010.

[42] 53 F.3d 549 (2d Cir. 1995).

[43] *Id.* at 561-564

[44] *See supra* note 1.

[45] Section 106, Exclusive Rights in Copyrighted Works states as follows:

> Subject to sections 107 through 120, the owner of copyright under this title has the exclusive rights to do and to authorize any of the following:
>
> (1) to reproduce the copyrighted work in copies or phonorecords;
> (2) to prepare derivative works based upon the copyrighted work;
> (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
> (4) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;
> (5) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly; and
> (6) in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.

[46] THE INTELLECTUAL PROPERTY AND COMMUNICATIONS OMNIBUS REFORM ACT OF 1999, Pub. L. No. 106-113 Appendix I, 1011(d), 113 Stat. 1501 (codified at 17 U.S.C. 101 (1994 and Supp. V 1999).

[47] The Copyright Act of 1976, Section 101, defines "sound recordings" as "works that result from the fixation of a series of musical, spoken, or other sounds, but not including the sounds accompanying a motion picture or other audiovisual work, regardless of the nature of the material objects, such as disks, tapes, or other phonorecords, in which they are embodied."

[48] Section 203(a) concerns the right of termination of transfers and licenses granted by the author, generally to corporate distribution entities. It states:

> Conditions for Termination—In the case of any work other than a work made for hire [emphasis added], the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will, is subject to termination . . . .
>
> (3) Termination of the grant may be effected at any time during a period of five years beginning at the end of thirty-five years from the date of execution of the grant; or, if the grant covers the right of publication of the work, the period begins at the end of thirty- five years from the date of publication of the work under the grant or at the end of forty years from the date of execution of the grant, whichever terms ends earlier.

[49] THE WORK FOR HIRE AND COPYRIGHT CORRECTIONS ACT OF 2000, signed into law on October 27, 2000, Pub. L. No. 106-379, 114 Stat. 1444 (codified as amended at 17 U.S.C. Section 101 (1976). For a discussion of the topic, *see* Valerie A. Dearth, *1999 Amendment to Work Made for Hire. Doctrine Comes Full Circle: Where It Came From, What It's Been Through, and Where It is Now*, 19 CARDOZO ARTS & ENT. L.J. 215 (2001). Also, *see* Kathryn Starshak, *It's the End of the World as Musicians Know It, or Is It? Artists Battle the Record Industry and*

Congress to Restore Their. Termination Rights in Sound Recordings, 51 DE PAUL L. REV. 71 (Fall 2001).

[50] *See* discussion of Starshak *id.* at 120-123. For a discussion concerning the right of screenwriters, see Michael H. Davis, *The Screenwriter's Indestructible Right to Terminate Her Assignment of Copyright: Once a Story is "Pitched, "a Studio Can Never Obtain All Copyrights in the Story*, 18 CARDOZO ARTS & ENT. L.J. 93 (2000).

[51] An example of the potential conflict that may arise was illustrated by the dispute between Harvard Law Professor, Arthur Miller, and the University. Miller was retained by Concord Law School to prepare a new online course that would feature Miller's eleven-tape lecture series. Harvard claimed ownership of the copyright to Miller's lectures, which were similar to those he gave at Harvard. It also claimed that Miller had engaged in a conflict of interest. Miller alleged that the lectures, which did not require or feature any other participation by Miller with the Concord students, were akin to the publication of a book or articles and, thus, did not belong to Harvard.

[52] *See, Weinstein v. U. of Illinois*, 811 F.2d 1091 (7th Cir. 1987), in which Weinstein, an assistant professor of pharmacy administration, sued concerning the order of the placement of names in an article written with two other colleagues. The article concerned a clinical program for practicing pharmacists. Weinstein alleged that he had been assured and had agreed wit the colleagues that his name would appear first in the publication thereof. When he was denied tenure at the university, Weinstein alleged that the failure to place his name first injured his chances of receiving tenure. The Court of Appeals affirmed the dismissal granted by the District Court but disagreed as to the reasoning of the lower court that held the article in question was a work for hire. The case was dismissed for failure to state a federal claim. The Court said that had the article belonged to the university, Weinstein and his co-authors would have needed the permission to publish the article, which did not occur herein. At best, the copyright ownership would have been jointly held under Section 201(a) of the Copyright Act. For a discussion, see Georgia Holmes and Daniel A. Levin, *Who Owns Course Materials Prepared by a Teacher or Professor? The Application of Copyright Law to Teaching Materials in the Jnternet Age*, 2000 BYU EDUC. & L. J. 165, 177-179 (2000).

[53] 847 F.2d 412 (7th Cir. 1988).

[54] *Id.* at 416.

[55] *Id.*

[56] *Id.* For a detailed discussion, see Gregory Kent Loughlin, *Who Owns the Copyright to Faculty-Created Web Sites?: The Work-for-Hire Doctrine 's Applicability to Internet Resources Createdfor Distance Learning and Traditional Classroom Courses*, 41 B.C. L. REV. 549 (May 2000). See, also, Chanani Sandier, *Copyright Ownership. A Fundamental of "Academic Freedom,"* 12 ALB. L.J. SCI. & TECH. 231(2001). In Hays, the plaintiffs taught business courses at a local high school in Illinois. They prepared a manual for their students concerning the operation of the school's DEC word processors, which manual was given by the school to Sony for modification without the consent of the plaintiffs. Sony did make some modifications, leaving in tact much of the prior version. Sony never charged the school district any money for the preparation and did not distribute the manual elsewhere. The lawsuit was dismissed on

procedural grounds. The Court noted that the plaintiffs may have had an actionable claim for an injunction, albeit not for damages inasmuch as none was proven. It also stated that the manual would likely not be considered a work for hire because high school instructors, unlike their college counterparts, are not required to publish. *Hays* at 417.

[57] Pub. L. 101-650, 104 Stat. 5128.

[58] *The Visual Rights Act of 1990* became effective on June 1, 1991. It extended the protection to copyrighted works prior to said date, which the author had not transferred and to works created on or after June 1, 1991. Moral rights did not extend to works, which had been destroyed or mutilated before the said date [See footnote to section 1 06A of the Copyright Act]. For a discussion of moral rights, see ROY J. GIRASA, CYBERLAW: NATIONAL AND INTERNATIONAL PERSPECTIVES (Prentice Hall, 2002).

[59] Paris Act, July 24, 1971.

[60] 17 U.S.C. Section 106A.

[61] The right is subject to 17 U.S.C. sections 113(d), 106 and 107.

[62] 17 U.S.C. Section 106A(c). A *work of visual art* is a single painting, drawing, print, a sculpture or still photographic image for exhibition purposes and up to 200 signed and consecutively numbered such works. It does not include works for hire, U.S. Government works, poster, map, globe, chart, diagram, model, magazine, newspaper and the like [These are covered by other copyright provisions].

[63] 71 F.3d 77 (2d Cir. 1995).

[64] 852 F. Supp. 228 (S.D.N.Y. 1994).

[65] *Id.* at 87-88.

[66] For a discussion, *see* Vera Zlartarski, *"Moral" Rights and Other Moral Interests: Public Art Law in France, Russia, and the United States*, 23 Colum.-VLA J.L. & Arts 201, 219-224 (Spring, 1999).

HYBRID CARS AND THE CLEAN AIR ACT: RUSE TO CIRCUMVENT THE LAW OR PRACTICAL ALTERNATIVES TO PROTECT THE ENVIRONMENT

by

Sharlene A. McEvoy*

INTRODUCTION

In 2000, two car makers, Honda and Toyota began introducing cars that are cleaner and more fuel efficient into the United States market place combining the use of electricity and gasoline. The introduction of these vehicles came under the auspices of the Clean Air Act but in a time when Americans are purchasing larger and less fuel efficient vehicles like the sports utility vehicles (SUVs).

This paper will examine how these vehicles operate, how they are marketed, how fuel efficient they are and whether or not they appeal enough to consumers to be more than automotive curiosities purchased by eccentrics who are fond of novel gadgets.

I. THE MANDATE OF FEDERAL LAW

Among the most important federal laws for fighting pollution is the Clean Air Act, which is the primary federal statute regulating the emission of air pollutants.[1] The basic elements of the Clean Air Act were adopted in the Clean Air Act Amendments of 1970. In 1970, Congress required "the federal government to establish air quality goals"[2] and required the states to develop plans to achieve those goals. The 1970 amendments also required federal controls of auto emissions as well as other programs to control other sources of air pollution.[3]

By 1977, Congress found that the goals of the 1970 law had not been achieved so it passed special requirements for areas of the country that were not meeting air quality standards and made new rules for areas whose air quality exceeded those standards.[4]

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The 1990 Clean Air Act amendment "established new programs to promote the use of alternative fuels that pollute less than gasoline."[5] These alternative fuels include such alternative sources as ethanol, natural gas and electricity.

Sub part C of Title II of the Clean Air Act established requirements to encourage the development and use of "Clean Fuel vehicles that can use these alternative frets."[6]

The law also provided for the Clean Fleet Program in certain non-attainment areas of the country that are designated as extreme, severe or serious for ozone and certain non- attainment areas for carbon monoxide, fleets of automobiles and certain other mobile sources must meet stringent standards for clean fuel vehicles.[7]

Under the Act, a fleet is defined as any "group often or more vehicles used by a single operator and which is capable of being fueled from a central location.[8] The Act required that at least 150,000 clean fuel vehicles had to be sold in California starting in 1996 and 300,000 in 1999[9] but California deferred these deadlines.

But in California, as well as in Phoenix and Las Vegas, Nevada, Budget Rent a Car joined with a Los Angeles company, EV Rental to go into the business of renting low emission vehicles. EV Rental offered electric cars, natural gas fueled cars and hybrids. In late 2,000, Hertz began to rent such vehicles at Fisherman's Wharf in San Francisco.[10]

Another company, Zapworld has five outlets in California that rent electric vehicles only in warm weather. A major drawback of all-electric vehicles is that they have to be plugged into a wall socket or into a solar panel outlet for several hours.[11]

In addition, EV has an expert at the point of rental to explain to customers how the car operates. The orientation takes ten minutes and teaches the customer how to read the dashboard indicators, how to conserve power, where the battery is plugged and how to recharge or how to refuel the vehicle. At least one Budget agent is trained in the operation of EVS.[12]

One of the severe drawbacks of electric vehicles is that there may be no charging stations along the renter's route. In southern California, there are more than 300 recharging stations because electric vehicles need to be recharged every hundred miles or less. If a car is completely discharged it takes over five hours to recharge it. To complete a day trip, recharging can involve as little as two hours.[13]

With the paucity of charging stations and the recent California experience of power brownouts and blackouts, it is clear that the viability of electric vehicles is limited. Consequently most car rental companies have been slow to embrace them. Avis has no plans to add these cars to the fleet and Hertz only began the electric car business in the San Francisco area in late 2000.[14] Ironically it was northern California that was the hardest hit in the power crisis of January 2001. With the uncertainty of the availability of electric power in recent months, reliance on all-electric cars could be paralyzing to rental customers.

Among of the concerns of the Clean Air Act was the elimination of ozone from the air. Ozone is a form of oxygen that "contributes to respiratory problems and is related to the development of smog."[15] It is formed from certain automobile emissions and the emission of volatile organic compounds (VOCs) from stationary sources.[16] A key element of the ozone non-attainment program is the creation of the classification of Non- Attainment Areas which include the following categories:

Marginal
Moderate
Serious
Severe
Extreme

A marginal area has the lowest level of air pollution while an extreme area has the highest level of pollution.[17]

The *Clean Air Act* requires that states adopt "inspection and maintenance" programs to test vehicles to determine whether vehicles comply with automobile emission limits. In areas classified as serious, severe and extreme the Clean Air Act required states to begin imposing plans to reduce emission from cars. State plans can include improved mass transits or programs to encourage car-pooling.[18]

There is also the *Clean Fuel Vehicle Program.* This statute requires the increased use of cleaner vehicles that use fuels other than gasoline in areas classified as severe and extreme. The program encourages the development of electric cars or cars powered by natural gas or hydrogen.[19]

II. THE HISTORY OF ALTERNATIVE FUEL VEHICLES

Numerous experiments have been conducted during the past century to find alternative sources of fuel for automobiles. Since the 191 Os manufacturers have tried steam, pure alcohol, butane, peanut oil and such technologies as solar power, jet and turbine engines.[20]

Much of the modern efforts to curb automobile emissions particularly in California centered on all-electric vehicles. These vehicles have no emissions but they can cost $20,000 more to make than a similarly-sized gasoline-powered car. Such cars can only travel to 50-100 miles or so before the batteries need to be re-charged.[21]

Because of these limitations, hybrid cars are more likely than all-electric vehicles to solve air pollution problems and to lessen dependence on imported oil. Toyota has produced both electric and hybrid vehicles and claims that the public is not ready to accept all-electric vehicles because Toyota could not sell the cars.[22]

The hybrid technology idea is not as novel as it seems. In the early 1900s, German carmaker Ferdinand Porsche, built a hybrid that used "an internal combustion engine to spin a generator that sent power to electric motors in the wheels. The car could travel 38 miles on battery power alone.[23]

In 1905-1906, the Vaughan Machine Company of Peabody, Massachusetts manufactured the Gas-au Lec which was advertised as "the simplest gasoline car in the world." The 4-Cylinder 45 horsepowered car had an auxiliary electric motor that started the engine without a crank and provided extra power to reverse gear for climbing hills. The car did not capture the public's fancy.[24]

Nor did the Woods Dual Power Coupe produced in Chicago in 1916-18 which had an electric motor which powered the car up to 20 mph. After which a four cylinder gas engine took over. Woods had produced electric cars since 1899 and built a hybrid in 1905-1907. While the cars worked well, few sold at $3,000, in an era when gasoline was cheap and most cars sold for less than $500.[25]

Among the more promising alternatives to gasoline powered engines is fuel cell technology, which uses the energy released when hydrogen is combined with oxygen, with water as the byproduct.[26] In November 2000, Ford and Daimler Chrysler unveiled a prototype hydrogen car. But there are problems with this technology among the most prominent is money. The Department of Energy estimates that fuel cells would cost $141 per kilowatt. Carmakers believe that fuel cell engines cannot compete with gasoline-powered vehicles unless they cost less than $50 per kilowatt.[27]

A spokesman for a Canadian fuel-cell maker, Ballard Power Systems says that the company could compete with gasoline powered vehicles at $37 per kilowatt if it sold fuel cells for 300,000 cars.[28] Ford claims it can mass produce the fuel cell cars once 10,000 natural gas pumps are installed throughout the United States at $250,000 to $1.5 million each.[29]

The National Renewable Energy Laboratory is testing a way to extract nitrogen from algae but for the foreseeable future natural gas is a more viable option. While gasoline can be converted to hydrogen inside cars, this would mean a costly modification of the fuel cell system and to the emission of carbon. It is estimated that producing hydrogen for fuel cell use would cost $1.92 per gallon, approximately the price of premium unleaded gasoline in some areas.[30]

Amory Lovine has founded Hyper Car, Inc. and is planning to build a "super efficient sports vehicle which will get 99 mpg of gas and emit drinkable water. It is powered by a fuel cell that cleanly converts hydrogen into electricity."[31] To save fuel the car would be made of a light weight carbon filler, currently used to make fighter planes, tennis rackets and skis and would be driven by two joysticks. Lovine needs a quarter of a billion dollars to move the car from the drawing board to the highway.[32]

III. 2000: THE YEAR OF THE HYBRID: THE INTRODUCTION OF THE HONDA INSIGHT ANI) TOYOTA PRIUS

During 1999-2000, gasoline was priced as high as $1.80 to $2.00 a gallon in some parts of the country. It seemed like a propitious time for two major auto makers to introduce its high-mileage hybrid cars.

In the spring 2000, Honda was the first to introduce its mass-market car, the Insight. It first went on the market in December 1999 and since Honda had sold more than 1100 vehicles by June, 2000 it raised its sales target from 4000 to 6500 vehicles.[33]

Sixty-five hundred cars are not many in light of all the vehicles sold nationwide but it is double the number of strictly electric cars sold by all car manufacturers in the last several years.[34]

The question is whether hybrids are the solution to eliminating air pollution without having the drawbacks of purely electric vehicles which have a limited range and need to be recharged. Just as the hybrid is a vehicle that is caught between using electric battery and a gasoline engine, the concept of the hybrid is caught between the mandates of the law and the desires of environmentalists for pristine vehicles.

In September 2000, the California Air Resources Board declined to relax its mandate that requires that starting in 2003, 10% of all vehicles sold in the state must have no emissions or very low emissions[35]

Environmentalists are concerned that hybrids are a ploy by the auto industry to weaken air quality goals because the hybrids still emit a low level of pollution. Environmentalists believe that the solution to air pollution is a true zero emission vehicle.

Indeed, engineers at the automobile manufacturers know that hybrids cannot fulfill the goals of environmentalists. In May 2000 at the twelfth running of the American Tour de Sol, an alternative vehicle race, the Honda Insight had a fuel economy of 92 miles per gallon. In second place was the General Motors two-seat EV1 electric car with a fuel economy of 68 miles per gallon (mpg).[36]

But most disturbing was the Insight's "global warming potential," which includes carbon dioxide and tailpipe gas emissions such as methane and nitrous oxide, which was double that of the EV 1 car. Even the most efficient gasoline engine "is only about 18% efficient in turning gas into usable energy." But even though the Insight gave off twice as much greenhouse gas as the EV 1, "it was still a huge improvement over most cars on the road. It had only a quarter of the emissions of a conventional gasoline-powered Saturn driven on the same route."[37]

HOW DOES A HYBRID WORK?

While it would take many pages to fully describe how the hybrid system is engineered, the basic process that both the Honda Insight and Toyota Prius (Latin for "to go before")[38] is a compact electric motor that works with a small gasoline-powered engine to provide mobility. Both motors serve as the car's starter. Neither car functions as pure electric cars during normal driving. Both cars contain a lithium ion battery that recharges when the car is coasting and braking. When the "ignition" key is turned on, there is no conventional starter noise. The gas engine comes to life from the power of the electric motor.

While both cars operate like a conventional car, while in motion, when the car stops, the engine shuts off As soon as the accelerator is pressed (or the clutch in the Insight, the Prius offers only an automatic transmission) the engine restarts immediately. Such a system conserves fuel.[39]

SYSTEM OPERATION[40]

The system works in five steps:

1. *Starting and Driving at Low Speeds*
   The battery powers the electric motor which drives the vehicle.

2. *Normal Driving*
   Energy is divided between the wheels and the generator.

3. *Full Acceleration*
   The system for normal driving is used with additional battery power.

4. *Deceleration or Braking*
   The wheels drive the electric motor and the power is returned to the battery. The gasoline engine may shut off depending on the speed of the vehicle, whether the air conditioner is operating. The gas engine is off unless the air-conditioner is being used or the high voltage battery is charging.

5. *Stopping*
   If the air conditioner is not being used or the battery is charging, the gas engine is off

WHICH HYBRID: THE INSIGHT OR THE PRIUS OR SOMETHING ELSE?

Both hybrids introduced in 2000 have pros and cons in terms of quality, emissions mileage and safety that may make either car more or less desirable for some purchasers. The two-door coupe, Insight seats only two people because it has no back seat. It has only a five speed manual transmission and its gas engine is a one liter three cylinder, smaller than the power pack in many Honda motorcycles.[41] Honda claims that because the Insight has a lightweight (at 1887 lbs.) aluminum body, aerodynamic design, and assistance from the batteries, the Insight behaves like a 1.5 liter subcompact.[42] The Insight is classified as a ULEV, which means it is an ULTRA LOW EMISSIONS VEHICLE.

The best thing about the Insight is its gas mileage. The car gets 61 mpg in the city and 70 on the highway.[43] The disadvantage of the car is its stiff, noisy ride and its stiff five-speed transmission which is described as fatiguing to drive. David Champion, Director of the Consumer Reports Auto Test Facility said, "It's hard work to drive around. You're always changing gears." Many owners say they have quickly learned to shift quickly from second to fifth gear.[44]

Because of this nuance, Champion predicts that the Insight's long-term popularity will be limited. He said, "I think this car will mostly appeal to die-hard environmentalists."[45]

One Insight owner has stated that his gasoline bill went from $50.00 per week to $7.50 per week. Such savings add up to $217 per month or more than $2,500 per year.[46] The base price of the Insight ranges from $18,800 to $20,000.[47]

By contrast, the Toyota Prius would seem to have a broader appeal. It is a four door mid-sized sedan and is larger (at 2765 lbs.) and more powerful than the Insight. It is designed to hold five adults, has a trunk, traditional gauges, and a softer ride.[48]

The Prius is described as the world's first mass produced hybrid vehicle because it has been sold in Japan since 1997 although the Insight beat the Prius to the American market in late 1999.[49]

The Prius "sacrifices some fuel economy for practicality."[50] It has an automatic transmission which is less fuel-efficient than the five speed Honda.

One of the disadvantages of the Prius is its lack of cargo space because the trunk is very small. Also the acceleration is sluggish because the car can go from 0 to 60 in twelve seconds compared with the Toyota Echo's 0 to 60 in ten seconds.[51]

The price of a Prius may also be deterrent. It sells for $20,450, which is high-priced compared to gasoline-powered cars of comparable size. For example, the Prius sells for more than $4000 more than a Corolla and $6,000 more than an Echo.[52] Moreover, fuel costs for the Prius are projected at being about $200 less than the Corolla or Echo, so it would take several years to recoup the difference in the purchase price.[53]

The Prius is rated as a "SULEV" which stands for a Super Ultra Low

Emissions Vehicle which under California rules is the best rating short of zero. The EPA estimates that a Prius driven 15,000 miles a year will emit four tons of greenhouse gases such as carbon dioxide. That is well below 5.5 tons per year from comparable small cars.[54]

According to EPA ratings the Prius gets 52 mpg in the city and 45 mpg on the highway.[55] What about servicing these vehicles? It is clear that both the Insight and Prius owners will have to rely on the respective Honda and Toyota dealerships for service[56] but Prius will create more problems because while the Insight's small gasoline engine runs all the time, even if the electric motor fails, the car can still operate. If the Prius breaks down, the problem is more complex because it requires its electric motor to get started.[57] To remedy these potential problems, Toyota has warranted all hybrid parts for 8 years or 100,000 miles. It also has a 3 year/36,000 miles bumper to bumper warranty that covers all routine maintenance. The Prius also has a free 24-hour roadside assistance and free towing anywhere in the country in addition to a free loaner car.[58] Toyota hoped to sell 12,000 units of the 2001 Prius[59]

IV. OTHER HYBRIDS

While the Insight and Prius are in the vanguard, other companies are developing hybrids but their cars are not going to be ready until 2003. Ford will roll out its hybrid, Escape Sport Utility in that year and Toyota is also working on a hybrid, SUV[60]

Daimler Chrysler recently unveiled its new Dodge Durango, which is modified to get 30% of its horsepower from an electric motor instead of from a gasoline engine which improves fuel economy. "The improvement is just three miles per gallon but on a big sport utility like the Durango, that is a fuel saving of 20%![61]

The technology in the Durango is simpler than that of the Insight or the Prius. An ordinary V-6 gasoline engine in the front drives wheels in the back. The electric motor under the front of the car turns the front wheels. When the driver pushes the brake pedals, the electric motor switches into a generator causing the car to lose momentum and convert that into current to recharge the batteries.[62]

Since the Durango is primarily a gasoline-powered vehicle, and weighs the same as an all gasoline counterpart, it is described as a "mild hybrid" since the Insight and Prius were designed to be hybrids from the beginning, they are described as "heavy hybrids."[63]

Daimler Chrysler said that each hybrid Durango would cost an additional $3,000 to make so it is lobbying for special tax credits. If the company decides to make the car, it would go on sale in 2003.[64]

V. MARKETING ISSUES: TECHNOLOGY FOR THE MASSES OR JUST THE "GREENS"

Both Toyota and Honda are said to be losing money on each hybrid they sell.[65] Because of this, the companies have stinted on advertising the cars and some dealers are reluctant to handle them because of low profit margins.[66]

Both companies have run television advertisements. The Honda voiceovers are done by Richard Dreyfuss and tout the environmental friendliness of the vehicle. Toyota has run ads in Fortune and major magazines such as Newsweek, Vanity Fair, Time, Popular Science, Sierra, and the New York Times Sunday Magazine. The ads illustrate a cartoon of many white cars going one way with a green leaf shaped like car captioned "Going Our Way"? In small print at the bottom of the ad appear the words:

> It's time to take cars in a new direction. Along a cleaner more open road that travels the outskirts of convention. That's why we've created the Toyota Hybrid system, the power inside our breakthrough gas/electric vehicle, the Prius. Toyota is the first company to mass-produce a hybrid vehicle, and we're working to develop even more advanced technologies down the road. Fasten your seat belts. It's going to be an exciting ride. WWW Toyota.comlecologic 800 GO TOYOTA TODAY TOMORROW TOYOTA[67]

In another ad, a pile of white cars is topped by a green leafed shaped car. The caption reads: "It's a clean job, but somebody's got to do it." In small print:

> Cars come and go, but they leave behind more than meets the eye. Exhaust emissions for example. That's why we've developed the Toyota hybrid system, the power inside our breakthrough gas/electric vehicle, the Prius. It reduces smog-forming exhausts by up to 90% and is one giant step to eliminate them altogether. When it comes to making a cleaner car, we're not afraid to get our hands dirty. WWW Toyota.com/ecologic 800 GO-TOYOTA[68]

Toyota's campaign touts the Prius as a "high tech buff's dream and a car for the environmental conscious consumer."[69] As one article put it:

As befits an upstart the advertising mixes wry humor with the promises of techno-wizardry. One print ad created by New York ad agency, Oasis shows the car slowing down to stop at a red light. The line "When it sees red, it charges referring to how the technology allows the battery to recharge as the car slides into neutral while stopping. Another ad, slated to run outdoors, puts the Prius in the middle of an oil field, with the line "The new car for a used world." Both the TV and print ads use the tag line Toyota Prius/Genius.[70]

Toyota's Vice President of Marketing, Steve Sturm said, "Toyota hoped to tap the early adopters and those concerned about the environment."[71] Its ad campaign was targeted to a small group of consumers so the advertising budget which included television, print media, the internet and outdoor billboards was a modest $15 million compared with $60 million spent on the Camry.[72]

Television ads did not begin airing until July 31, 2000 on environmentally oriented cable channels like Discovery and Animal Planet as well as PBS, CNBC, A&E and some prime time shows. One television ad depicts a family driving their Prius through the jungle. A gang of monkeys look at the Prius and applaud.[73] The voice-over says: "Nature approves."

The target audience for the hybrid is:
- An adult35-54
- Male 52% -- Female 48%
- Highly educated (College Grad.)
- 2-4 in Household
- 50% with children under 18
- Upscale household income -- $75,000+
- Predominantly urban and metro suburban dwellers
- Interested in Prius as a second or third vehicle in household fleet[74]

Toyota developed a Target Buyer profile of a customer "as environmentally concerned but not an activist, as a person who is concerned about the environment and who will take steps to make the world a better place to live. He or she wants to do the "right" thing for the next generation.[75] Toyota believed that its potential customer was a pragmatist, comfortable with technology but unwilling to adapt to it just for the sake of technology.

Toyota's focus groups believed that the Prius was less harmful to the environment, innovative and technologically state of the art.[76]

Despite its plans to have the Prius in its showrooms by August 2000,[77] Toyota lagged in its ability to get the car on the market. During the summer, 2000, interested customers had a difficult time obtaining information or a test drive from Toyota dealers.[78]

While information about the Prius was in the media in the spring of 2000, test drive vehicles did not arrive in New England until the end of July one-month behind schedule.

Some dealers were reluctant to handle the care because it was not an easy sell because of its unfamiliar technology, high cost and scarcity.[79] Some dealers chose not to sell the car at all because of low profit margins.

While Toyota's Web site stated that an order placed in August would yield a Prius in November to mid-December,[80] for a Honda the wait was one to two months.[81]

One Toyota dealer characterized consumer interest in the Prius was "low to medium."[82] Because Toyota believed that the car would appeal to those who like gadgets, Toyota decided to sell the car differently. Since the company believed that the Internet users were its most likely target market, it used its website, prius, toyota.com to direct prospective customers to dealers.[83]

Toyota also wanted interested customers to take the car for a daylong test drive but because the interest was so strong, dealers found they could not spare the car for such a long period.[84] Clearly Toyota underestimated the interest in and demand for the vehicle and lagged behind in making the car available for test drives and in filling orders.

THE FUTURE OF CLEAN FUEL VEHICLES

After intense lobbying by both automakers and environmentalists, the California Air Resource Board decided to maintain its requirement of zero emissions from 10% of the cars sold by major manufacturers in 2003. Hybrids would get 'partial credit toward that target but 4% of cars sold would have to be zero-emission cars.[85]

Despite the fact that both the Honda Insight and Toyota Prius have received citations for automotive excellence from the Sierra Club in 2000,[86] environmentalists believe that the best solution to combat air pollution is the all-electric zero emission vehicles. Hybrids still employ gasoline engines and still emit pollution into the air.[87]

Yet a spokesman for the Sierra Club conceded that mass marketing of hybrids "could save more oil than is produced on Alaska's North Slope."[88] "If just 50% of the cars had hybrid engines, we would save between 1.5 million and 2 million barrels of oil a day."[89]

Carmakers say that it will be impossible to meet California's 4% goal by 2003 because of the technical difficulties associated with all-electric cars and the fact that consumers will not accept the inconvenience of using them. Fuel cells which are more practical are also more expensive and are not expected to be available until 2010.

Automobile manufacturers believe that "a greater improvement in air quality can be achieved by selling a larger number of pretty clean hybrids than trying and failing to sell a smaller number of totally clean electrics."[90]

Environmentalists believe that manufacturers have not tried hard enough to develop practical electric vehicles and they do not want hybrids to be the solution because the ultimate goal should be zero emissions. California's requirement has served as a prod to manufacturers to develop new technologies.[91]

In the immediate future hybrid cars are the most practical solution to both the problems of air pollution and dependence on oil. While hybrids are "second best from a greenhouse gas standpoint,"[92] there are less expensive (at approximately $20,000 for both the Insight and Prius) and they can travel much farther without the need for recharging.

Until the technology is farther advanced, there will have to be tradeoffs in the battle to stop air pollution. For example in the 1990 Clean Air Act Amendments, Congress adopted a system of Marketable Sulfur Allowances which permits facilities that reduce their sulfur emissions below their allocation to sell their excess allowances to other facilities.[93]

At one time MTBE methyl tertiary butyl ether was regarded as a gasoline additive that would reduce air pollution because it was less toxic than the lead in gasoline that it replaced. It was sold in 20 states and was put in 40% of gasoline in the United States before its negative health effects were understood.[94] It can cause asthma and skin irritation and once in the body alters the immune system. It also migrates into ground water and is hard to clean. The Sierra Club, which once argued in favor of MTBE urged the Environmental Protection Agency to ban it. The EPA has begun to phase it out.[95] Catalytic converters which were added to cars under the requirements of the Clean Air Act have been found to provide nitrous oxide.[96]

The question is whether hybrids will capture the imagination of the public. If the price of gasoline goes higher to $2.50 or $3.00 in the face of OPEC decisions to decrease oil production, the public might embrace the hybrid. If Ford and General Motors among others enter the market as Ford has promised to do with the 2003 Escape[97] then the hybrid will likely become more popular. If gas prices were to decrease to less than a dollar a gallon, consumers would be less concerned about conservation.[98]

The Director of the Economic Development Center of Carnegie Mellon University, Don Smith said that:

> While historically it's been difficult to get people to leave the status quo and embrace new technology,[99] on the who!e we have seen new technology embraced much more quickly than in the past. It took almost two decades for a million black and white televisions to be sold. And yet D.V.D. players sold a million units in the first year. So the pace of new technology acceptance or technology diffusion has picked up a lot.[100]

Another factor that would encourage the popularity of hybrids would be government policy. The Clinton administration proposed a $4000 tax credit for buyers of high- mileage vehicles.[101]

If Congress were to vote to raise the efficiency standards for cars and trucks, it would provide an impetus to the development of more efficient vehicles.[102] If more states were to join California, New York and Massachusetts[103] in demanding that emission-free cars be sold, there would be acceleration in the development of such vehicles.

The Bush administration will not likely press the auto industry to meet more demanding environmental requirements. The auto industry has successfully kept CAFE (Corporate Average Fuel Economy) rules at 27.5 mpg for cars and 20.7 mpg for trucks since 1995.[104] A Congress controlled by Republicans is not likely to raise the standards especially since President George W. Bush's Chief of Staff is former General Motors Lobbyist Andrew Card. The Secretary of Energy, Spencer Abraham, a former Michigan Senator led congressional effects to cap fuel economy standards. Abraham received $656,050 from automotive interests in his losing Senate campaign. The industry contributed 1.2 million dollars to Bush's campaign while donating only $114,540 to the Gore's campaign.[105]

Bush also has appointed Gale Norton to be Secretary of the Interior. She served in James Watt's Interior Department "where she helped to prepare a plan to explore for oil on part of Alaska's Arctic National Wildlife Refuge."[106] Bush plans to allow drilling in the refuge.[107]

With Republicans in control of both Houses of Congress and the Presidency, less oil consumption is not likely to be high on the national agenda. It was Al Gore, the defeated 2000 Presidential Candidate who urged in his 1992 book, Earth in the Balance, that the internal combustion engine be completely eliminated in twenty-five years.[108] The hybrids are a small faltering step toward that goal.

ENDNOTES

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[3] Id.

[4] Id

[5] Id. at 109.

[6] Sec 7581 (2) Environmental Law at 109.

[7] Id. Sec. 182 (c)(4) Sec. 7511 a (c)(4).

[8] Id. See 241 (5)42 U.S.C. Sec. 7581 (5).

[9] Id. Sec 249, 42 U.S.C. 7589.

[10] Betsy Wade, "Electric Rentals Gaining a Niche, Travel Section, N.Y.Times, Dec. 24, 2000 at 2.

[11] Id.

[12] Id.

[13] Id.

[14] Id.

[15] Environmental Law supra, note 1 at 124.

[16] Id.

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[18] Id. at 125.

[19] Id. Purchasers of the hybrids may also be entitled to a Federal tax deduction up to $2,000 for hybrid purchases completed on or before December 31, 2001. (IRC section 1 79A) State income tax benefits may also be available in AZ, AR, CT, CO, DE, DC, GA, HI, ID, IL, IN, IA, KS, NY, LA, ME, MD, MA, MI, MN, MO, MT, NE, NM, NY, NC, ND, OH, OK, OR, RI, SC, UT, VT, VA, WV, WI. Separate tax benefits specifically directed toward hybrid vehicles are available in LA, NJ), NY, and VA. Toyota Prius, Manual for Dealers, Toyota Motor Sales, U.S.A. (Courtesy Khalani Lopa, Internet CT Sales Manager, Colonial Toyota, Milford, CT) at 19 (hereinafter Manual for Dealers).

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[30] Id.

[31] Jeffrey Ball, "One Quest to Build a Truly 'Clean' Car Has Gathered Steam," Wall St. J. Jan 9, 2001 at 1.

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[36] Mathew L. Wald, "Balancing Hybrids vs. Electrics on the Environmental Scale," The N.Y. Times, June 4, 2000 at 12-1.

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[38] Manual for Dealers

[39] Honda Insight vs. Toyota Prius, Motor Trends, Jan 2001 at 111-112.

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[41] Jonathan Welsh, "Drive Buys: Honda Insight: A Car With An Extra Charge, Wall St. J, Mar 10,2000 at WI5C. (Hereinafter: "A Car with an Extra Charge.")

[42] High-Mileage, High-Stakes Hybrid, supra note 33.

[43] *Honda Insight v. Toyota Prius* supra, note 39 at 112.

[44] James A. Russell "Hybrid Cars Bring Future to Your Driveway." Waterbury Republican, Sept. 16, 2000 7C and 12C. (Hereinafter "Hybrid Cars Bring Future To Your Driveway")

[45] Id.

[46] Id. at 7C and 12C.

[47] "A Car with an Extra Charge," supra, note 41.

[48] *Honda Insight v. Toyota Prius*, supra note 39 at 112.

[49] "Hybrid Cars Bring Future to Your Driveway," supra. note 44 at 7C.

[50] Id.

[51] "It's Easier to be Green" supra, note 35.

[52] Id.

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[69] Kathryn Kranhold, 'Toyota Makes a Bet on a New Hybrid Prius," Wall St. J., July 20, 2000 at B-l 8.

[70] Id.

[71] Id.

[72] Id.

[73] Id.

[74] Toyota Manual for Dealers: Prius, supra. note 38 at 9.

[75] Id.

[76] Id.

[77] Toyota Prius Manual for Dealers, supra note 3a.

[78] Bruce Mohl, "Though Driven to be Green, It's Tough to Test New Toyota," The Boston Globe. Aug. 20, 2000 at G2. (hereinafter "Though Driven to be Green").

[79] Id.

[80] In the author's experience, the car was promised in November, then in late November, then December. It was finally delivered in January, 2001.

[81] "Though Driven to be Green, supra, note 78.

[82] Id.

[83] Id.

[84] Id.

[85] "It's Easier to be Green," supra note 35.

[86] David Whitney "Hybrid Cars Steer Future" Waterbury Republican. Apr. 24,2000 at 1 1A.

[87] "Its Easier to be Green. supra. note 35.

[88] "Hybrid Cars Steer Future," supra, note 86.

[89] Id.

[90] "High Mileage, I-ugh Stakes Hybri," (supra, note 33). 91 Id.

[91] Id.

[92] Id.

[93] "Balancing Hybrids w. Electrics on the Environmental Scale," (supra, note 22) See 403(b) 42 U.S.C. See 76516(b).

[94] Matthew L. Wald, "Agency Will Ask Congress to Drop Gasoline Additive," N.Y Times July27, 1999 at A-I and A16.

[95] Id. at A-1.

[96] "Balancing Hybrids vs. Eiectrics on the Environmental Scale," supra, Note 36.

[97] "Gore Predicts Cars With Better Mileage," Waterbury Republican, Mar. 31, 2000 at supra 2.

[98] "Hybrid Cars Bring the Future to Your Driveway," supra. note 44 at 12C.

[99] 1d.

[100] Id.

[101] "Gore Predicts Cars with Better Mileage" supra, note 97.

[102] "Hybrid Cars Steer Future," (supra, note 86)

[103] Economics of Fuel Cell Cars, supra, note 26.

[104] Stephen Power, "Auto Makers Are Eager to Rev Up Under New Bush Administration," Wall St. 1. Jan. 18, 2001 at A28. (hereinafter "Auto Makers Are Eager to Rev Up.")

[105] Id.

[106] John J. Fialka, "Norton Faces Tough Scrutiny of Her Words, Activities at Hearing, Wall St.J. Jan 18, 200 at A-28.

[107] "Auto Makers Are Eager to Rev Up," supra, note 104.

[108] Al Gore, Earth in the Balance NY: Houghton, Muffin Company, 1992 at 325-326.

PRESIDENTIAL PARDONS AND FUGITIVES OF UNITED STATES – MARC RICH AND PINCUS GREEN

by

Saul S. Le Vine*

Due to the intense scrutiny and criticisms of the pardons for United States fugitives Marc Rich and Pincus Green in the year 2000, many legitimate concerns have arisen as to the question of presidential pardons and whether or not *these* pardons were proper.

Whatever damage President Clinton's pardon of fugitive financier Marc Rich has done to his own reputation, the greater concern is with the damage he may have inflicted to the concept and foundation of the privilege of executive clemency. The concept of executive clemency is part of our system of checks and balances under the Constitution. It is an opportunity for a fair-minded individual to right a wrong and to execute justice in the administration in the nation's criminal laws.

The Constitution vests the federal pardon power exclusively with the President. Article II Section 2 provides that . . . "he [the President] shall have the power to grant reprieves and pardons for offenses against the United States, except in cases of impeachment."[1] The Constitution gives the President broad powers to pardon and reprieve which cannot be reviewed. The President has the right to reprieve and pardon for all offenses and crimes "except for impeachment" against the United States.

The Supreme Court first addressed the pardoning power in *United States v. Wilson*. In Wilson, the defendant had been charged with two offenses: (1) putting the life of a mail carrier in jeopardy, and (2) robbery of the mail. After his conviction on the first offense, Wilson received a pardon from President Jackson for that crime. Wilson was then tried and convicted of the second offense, expressly waiving any benefits that he might have acquired from the pardon of the first offense. The trial court certified two questions to the Supreme Court. First, did the pardon of the first offense block prosecution of the second, included offense? Second, could Wilson derive benefit from the pardon without bringing it before the trial court? Without reaching the first question, Chief Justice Marshall answered the second question in the negative,

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holding that "the pardon in the proceedings mentioned, not having been brought judicially before the court by plea, motion, or otherwise, cannot be noticed by the judges."

This case is significant, not so much for its narrow holding, but for Marshall's articulation of the definition of a pardon. He stated, "A pardon is an act of grace, proceeding from the power entrusted with the execution of the laws, which exempts the individual on whom it is bestowed from the punishment the law inflicts for a crime he has committed.. .A pardon is a deed to the validity of which delivery is essential, and delivery is not complete without acceptance." This conception of a pardon as a "private act of grace" guided the Court for the next half century.

In *United States v. Klein*[2] the Supreme Court ruled that the pardon power is granted by the President and it is granted without limit.

In the *Biddle v. Perovich*[3] case, the United States Supreme Court determined that the pardon is a determination by the President of the ultimate authority. The public welfare will be better served by issuing such a pardon. The President of the United States has the ultimate authority to conclude that a pardon or a commutation of sentence is warranted for various reasons:

1. the sentence was excessive or unjust;
2. the restoration of full citizenship and voting rights to persons who have served their sentences and have since become model "citizens";
3. personal circumstances that warrant compassion;
4. an omnibus provision which states "other unique circumstances."

Within the executive branch, pardon can play an important role in carrying out the President's obligation to oversee that the laws are executed faithfully in two ways. First, it enables the President to intercede directly to change the outcome of a case that he believes was wrongly handled by his subordinates where no judicial remedy is available.[4] Second, it permits him to send a direct and powerful message to his subordinates about how he wants the law to be enforced in the future, including the particular manner in which they should exercise their discretion. It enables him to correct legal errors that for one reason or another could not be corrected by the Courts, and to make equitable accommodations where a sentence has been imposed according to the strict requirements of the law, but nonetheless seems unfair.[5]

It is especially important that the public be confident in clemency "as the fail safe of the justice system in capital cases." Are we now moving forward through the federal system for the first time in many years?

At the other end of the clemency spectrum, the President can use the opportunity provided by the post-sentencing pardons to emphasize the rehabilitative goals of the justice system by recognizing criminal justice success stories.

The founding fathers and framers of the Constitution granted the President through its Executive branch the right to have the freedom to pardon whenever he deemed it to be right and proper. However, since the formation of our country and its inception, the pardon right granted to the President has always been inherently controversial.

A person seeking executive clemency must do so by formal petition addressed to the President, submitted to and through the pardon attorney at the Department of Justice.[6] The applicable regulations provide that a pardon petition should not be filed until at least five years after the petitioner has been released from confinement, or five years from the date of conviction, if no confinement was imposed.[7]

The regulations also provide that, except upon a showing of exceptional circumstances, a petition for commutation of a sentence should not be filed if other forms of judicial or administrative relief are available.[8] Thereafter, the petition is reviewed by the pardon attorney, who initiates and directs an investigation and prepares a report and recommendation for submission to the President through the Attorney General.[9] The pardon attorney may solicit comments from victims of a crime,[10] and routinely request recommendations and comments from the United States attorney in the district where the petitioner was convicted.[11]

Among the factors considered in recommending for and against a petition are the petitioner's postconviction conduct, character and reputation; the seriousness and relative recentness of the offense; the degree to which the petitioner has *accepted responsibility and shown remorse* (emphasis added), and the need for the requested relief.[12]

The grounds for commuting a sentence may include disparity or undue severity of the sentence, illness or age, or some exceptional service to the government, which was not reflected in the sentence.[13] These procedures are advisory only.[14] Among the many criticisms leveled at the recent Clinton acts of clemency or pardons is that he departed from these federal regulations, most notably in failing to solicit the comments and recommendations, let alone heed the recommendations of the federal prosecutor involved.

In addition to the pardons, other methods to reduce sentences or punishments are available to the President. These methods are: commutation, remissions of fines, amnesty and reprieve, and clemency. A pardon may be granted either before or after a conviction and essentially erases the criminal liability or conviction. Commutations are limited because a sentence is reduced often to time served and remissions of fines and forfeitures, which provide relief from the financial burdens of some criminal penalties. In contrast to a pardon, neither remission nor commutation removes civil disabilities attending conviction.

Most (although by no means all) pardons are granted after the recipient has completed his or her sentence. In such cases, the primary effect of a pardon is to restore civil rights lost as a result of conviction.[15] The Courts have generally adhered to the view that a pardon does *not* erase the fact of the underlying misconduct.[16]

The constitutional power extends only to crimes against the United States. While a presidential pardon would bar subsequent state prosecution for a pardon crime,[17] it presumably would have no impact on the state's ability to prosecute the defendant for violation of an independent state law. Thus, while Mr. Clinton's pardon of Marc Rich removes the threat of criminal liability for federal tax evasion and illegal trading with Iran, it might well leave him open to prosecution for violation of state criminal and tax laws, depending on the effect that his fugitive status may have on the applicable tolling provisions of the statute of limitations.

There are additional egregious controversies in connection with Mr. Clinton's pardons other than Marc Rich. Others to draw criticism are those who received last minute pardons such as Susan McDougal, who spent months in person for refusing to testify against Clinton; John Deutch, former Director of the CIA; Henry Cisneros, former Director of HUD; and the President's own brother, Roger Clinton convicted of conspiracy to distribute cocaine. In 1999, President Clinton sparked outrage, resulting in congressional hearing from his offer of clemency to 16 Puerto Rican Nationalists, convicted in connection with a series of bombings in the 1970s.[18]

Mr. Clinton did not invent the controversial use of the President's pardon power. Several noteworthy cases exist, first his predecessor George H.W. Bush (who normally did not exercise the pardon power) pardoned six of his colleagues caught up in the fran-contra scandal. This act[19] aroused outrage and accusation that he was protecting his own interests in the process. Similarly, Jimmy Carter took considerable heat for his amnesty of Vietnam War protestors and Gerald Ford's pardon of Richard Nixon, which heralded by some as putting an end to a political crisis, was decried by many others.[20]

Even before the Marc Rich pardon, the institution of executive clemency has been under attack. Those attacks have come not only from critics decrying its application in specific cases, but also from within the government as well.

In fact, the use of the pardon power has been on a steady decline. Until fairly recently, pardons were routinely granted, not just at the end of a President's term, or during the holiday season, but "as part of the ordinary housekeeping work of the Presidency."[21] Every president from Franklin Roosevelt through Jimmy Carter acted favorably on close to a third of the pardon petitions presented to them. Under President Reagan, executive clemency became less common, dropping to only 13 percent, and rarer still during the first George Bush presidency, when only four percent of the clemency petitions were favorably acted on. Before Mr. Clinton's spate of pardons and commutations as he was leaving office, he too had granted fewer than five percent of the clemency petitions submitted to him.[22]

Now let us examine the most colorful of Mr. Clinton's acts of clemency. The facts of the case are as follows:

Marc Rich and Pincus Green were co-defendants in a hard-fought 65 count racketeering indictment accusing them of tax evasion, oil profiteering and unlawfully trading with Iran during the hostage crisis (treason). At that time, the co-defendants were living in Switzerland and thus able to avoid prosecution. As a result of their failure to make themselves available to the United States jurisdiction, they could not come back to the United States as free men.

Who is Marc Rich? Marc Rich was born Marc Reich in 1934, the son of a poor Jewish scrap metal trader/dealer in Antwerp, Belgium. As a result of the turmoil in Europe, the Reich family left Belgium, moved to France, and then to the United States in 1941, residing first in New York City and Philadelphia before settling in Kansas City. Marc's father opened a costume jewelry shop and changed the family name. Marc's father later sold the business and moved to Queens, New York in 1950, where he joined a partner and became a successful commodity trader.

It is noted that Marc Rich was not a good student, but he had a sharp mind and eventually learned five languages. He attended New York University but dropped out several years later without receiving a degree.

He took a mailroom job at 19 years of age with Philipp Brothers, a commodity brokerage firm that eventually was merged into Salomon Brothers. As recounted by A. Craig Copetas, author of "Metal Man," Rich worked his way through the shipping department and eventually became involved and landed his first merger deal, acquiring rights to most of the production of the two largest makers of mercury, which was then in high demand. Thereafter, Rich was sent on business trips to Cuba, South America and Europe.

He eventually met his wife, Denise Joy Eisenberg, an heir to the Florsheim shoe fortune. They were married in 1966. In 1967, Philipp Brothers transferred Mr. Rich to Madrid and he began working with a fellow associate trader Pincus ("Pinky") Green. They were considered the original odd couple; Rich was immaculate, elegant and dressed in sartorial splendor, while Green, an orthodox Jew with no worldly style or educational background, wore dirty shirts and filthy sneakers. What a contrast!! Together, the two helped transform the world oil market, developing a trading system that allowed Philipp Brothers to bypass the seven (7) major oil companies, who at that time controlled the world oil supply.

The system Messrs. Rich and Green developed came to be known as "spot trading"which resulted in enormous oil profits from their deals for Phillip Brothers. Having earned billions for his employer, the story is Rich thought he was being groomed to become "president" of Philipp Brothers. According to Mr. Copetas, Messrs. Rich and Green demanded huge multi-million dollar bonuses from Philipp Brothers. The company would not grant them those bonuses and they resigned in 1973.

Eventually, when Marc separated from Philipp Brothers, his father who was involved as an owner and director in a Bolivian bank gave him the money and secured the loans to set him up to compete against Philipp Brothers. "Without this Marc could not have started his business."[23] Thus began Marc Rich and Co. AG, the Swiss based holding company of Rich's trading empire with offices in major cities throughout the world.

Messrs. Rich and Green's legal problems are traced to the oil crisis in 1973. The Arab oil embargo had driven crude prices through the roof. The United States sought to stabilize the market with a complex system meant to cap prices and increase our domestic production. The Department of Energy regulations created three classifications of American crude:

1. Oil from "old" wells pumping, which was before 1972 production levels could sell for no more than $8.00 a barrel.
2. Oil from "new" wells, i.e. those opened since 1973, or production in excess of the 1972 levels was capped at $10.00 a barrel.
3. "Stripper" oil, i.e., oil from small wells pumping less than 10 barrels a day on average, went for whatever the market would bear.

Marc Rich seized upon the opportunity for playing games with the system, as will be described below. Through machinations both legal and illegal, he was buying "old" or "new" oil for as little as $6.00 a barrel, and through a series of complex transactions known as "daisy chaining" or "flipping," selling that oil at $40.00 a barrel. Mr. Copetas states that the Energy Department estimated that between the period of 1973 and 1981, such maneuvers added up to at least 400 million $6.00 barrels being sold at "stripper" oil prices.

Before the Iranian embargo, there were only 12 oil resellers in the United States. By 1978, 500 companies were in business. One of the firms, "West Texas Marketing" of Abilene, Texas, sold "daisy chained" crude to Mr. Rich. When the two principals of West Texas Marketing were caught by Federal Prosecutors in 1981 for illegally recertifying price controlled domestic crude oil, they were sentenced to 14 months in prison. At that time they began cooperating with the investigation and for the first time disclosed Mr. Rich's participation as a major purchaser and dealer. When the Federal Prosecutors and the FBI reviewed the seized documents of West Texas Marketing, their ledgers documented the entire scheme or conspiracy, etc. This revealed that Marc Rich's companies, its subsidiaries, affiliates and other allied companies were all into "daisy chaining" in a very large way.

Messrs. Rich and Green effectively oversaw a massive scheme to evade price and profit controls and corporate income taxes through numerous "sham transactions" covered up by the creation of "false invoices" and fraudulent sales reports to the Department of Energy. The illicit profits were deposited either in bank accounts of resellers (alleged co-conspirators) or were transferred out of the country through additional "sham transactions," so that the Rich companies could evade all taxes that would be due in connection with these windfall profits.

In addition, the prosecutors discovered that Rich's companies had also dealt in Iranian oil for the period 1979 through the 1981 hostage crisis, long after the trade embargo had been imposed by the then President Jimmy Carter. The United States Attorney for the Southern District of New York and its prosecuting attorney at that time, Mr. Sandy Weinberg, subpoenaed 50 witnesses and more than one million documents. Rich and his associates failed and/or refused to comply, to communicate with them, to cooperate with them, or even to attempt to negotiate with them at any time. The Prosecutors thereafter secured a Contempt of Court citation to produce corporate documents held at its Swiss headquarters, or pay fines of $50,000 a day. The fines eventually totaled 21 million dollars after a litigation (solely against the corporations), since Messrs. Rich and Green refused to appear in personam. The case eventually went through all of the Federal courts and the United States Supreme Court refused to review the case.[24]

In another incident, the Internal Revenue Service agents received a tip and delayed a Zurich bound Swiss Air flight at John F. Kennedy (JFK) airport in New York, so that they could secure two (2) "steamer trunks" full of Rich's company documents. Rich's lawyers at that time stated that they were merely shipping papers to Switzerland, so that they could "cull out" material so as to be responsive to government subpoenas.[25]

The indictment charged Messrs. Rich and Green with racketeering, mail and wire fraud, tax evasion, and for dealing with Iran, trading with the enemy (treason). Prior to the indictment, Messrs. Rich and Green had already returned to Switzerland where these charges were not extraditable offenses (emphasis added). Thereafter, Messrs. Rich and Green attempted to renounce their American citizenship (apparently unsuccessfully) and became citizens of Spain in 1982 and of Israel in 1983.

As a result of a separate indictment, two of Rich's corporations pleaded guilty; they paid 150 million dollars in settlement and 813 million dollars in fines and court costs. There were several other sums paid as part of the corporate settlement.[26]

Even though Rich achieved enormous success, he was still in self-imposed exile from the United States, and could not set foot on American soil without being sent to jail for at least three (3) years. Prosecutors refused repeated attempts to open negotiations insisting that Messrs. Rich and Green return to the United States first and submit to our jurisdiction. Many organizations to whom Messrs. Rich and Green made substantial charitable contributions, as well as to certain persons whom he paid fees, etc., attempted to lobby for a pardon which had been, up to this time, unsuccessful.

Bad guys (and alleged bad guys) always have skipped town. And marshals have brought them back. In the meantime, what is the rest of the justice system supposed to do?

Not many people know. The fugitivity or fugitive disentitlement doctrine is not one of the better-known tenets of our justice system. And the term has come into more common parlance in connection with President Bill Clinton's pardon of infamous financier Marc Rich.

In its essence, the fugitivity doctrine says that no person while a fugitive from the American justice system can seek the aid of that system for any purpose. The wheels of justice grind only for those who stick around.

Today the question of fugitivity still comes up occasionally. While the language in the opinions suggests that courts have discretion as to whether to apply it in any given case, the rationale underlying the doctrine makes it hard to get around. Take it or leave it.

The first justification given for the fugitivity doctrine is that it keeps the playing field even. If a judge (or any other official within the justice system) processes the claims of a fugitive, the results are skewed in favor or the runaway. He can win, but he cannot really lose.

The fugitive may embrace a favorable decision (and come in from the cold), but escape the consequences of an unfavorable decision by staying away. Sometimes, he can take advantage of the positive parts of a decision while still ignoring the negative parts.

Consider the Marc Rich pardon. President Clinton conditioned the pardon on Rich's waiving any defenses that he might have to civil tax liability. But the existence of that waiver rests on the thin reed that Rich's attorney promised it. The pardon was complete when signed. And if civil tax claims are ever brought, Rich is free to hire a new lawyer and assert whatever defenses he may have.

A second justification for the fugitivity doctrine is that it "disentitles" the fugitive from using the very system that he has scorned. If the justice system is not trusted by the fugitive to handle his case in chief, then he should not be able to invoke that same system to get something that he does want.

The third justification is the most obvious — that refusal to help a fugitive discourages flight and encourages voluntary surrender. Clearly, a defendant would rather negotiate the unfairness of RICO charges from a comfortable abode in Switzerland than from a hardbacked chair in the U.S. Attorney's Office in Manhattan.

This is especially true when defendants have been trying, unsuccessfully, to make the same "unfair" point about RICO for the last 30 years.

In fact, a goodly number of the fugitivity cases that reach the appellate courts involve people newly residing in Switzerland. Rich is just the latest.

It's not that we don't have an extradition treaty with Switzerland, but rather that it is only narrowly applicable to those claiming Swiss nationality — which is fairly easy to get for persons of means.

Given that and the convenient and discreet Swiss banking system, it's not surprising that so many cause celebre fugitives end up as Swiss taxpayers.

You might still ask: Is a presidential pardon subject to the fugitivity doctrine? Bruce Lindsey, former deputy counsel to President Clinton, thought it was. Lindsey told a congressional committee that, as to Rich's fugitive status, "for me, it was the beginning and end of the discussion."

Obviously, if the doctrine is discretionary in the first place, saying it applies to pardon applications does not answer the whole question.

But the president is clearly in the law enforcement mix, and all the justifications given for the doctrine that deal with discouraging flight and encouraging surrender, re relevant to the pardon situation.

That surely explains why there is such an outcry from law enforcement about the Rich pardon, even among non-Clinton-haters.

Mary Jo White, the U.S. attorney for the Southern District of New York, considers herself a good Democrat, yet began investigation the Rich pardon. Two former prosecutors, who also descried themselves as Democrats, told Congress that they objected to the pardon in large part because of the fugitivity problem.

While partisan hay is being made with the congressional investigations, saturation press coverage, and accusations of financial skullduggery, many law enforcement critics simply see Marc Rich as a disentitled person. And they are not buying his lawyer's suggestion that the actions of the legal system in this case were so unjust as to shock the conscience and justify his running away.

Our legal system does not have a lot of sympathy for those who take off. While the revival of the television series has sought to make a fugitive's life seem exciting, the truth is that for most, being on the lam is hard time. We come down on anyone who aids a fugitive, and even parents are pressured to cooperate in the capture of their fugitive child.

With very few exceptions, everybody in the U.S. justice system insists that if a person wants the benefits of that system, he must submit to its jurisdiction. We want the prodigal son to come home but all is not forgiven first.

Surely, the same reasoning applies to someone seeking clemency from the commander in chief of the system. That may explain why not many ex-fugitives have presidential pardons hanging on their walls.

The former Director of the FBI field office in New York, James Kallstrom, recounts that the FBI, the Internal Revenue Service, and the United States Marshals all wanted him. Several attempts were made to lure him into other foreign jurisdictions in order to bring him back to the United States by extradition. They all failed.[27] The prosecutors on his case have said they were blindsided by the pardon. Mr. Rich's attorney, Jack Quinn, (former counsel to President Clinton) states that he advised Deputy Attorney General Eric Holder on November 21st, that he planned to seek a pardon for Mr. Rich. The formal notification was never fully given to the Attorney General's office. No other representative of the Attorney General's office knew of this statement. On the eve of George W.Bush's inauguration, Mr. Clinton's last night in office, contacted Mr. Quinn to discuss the matter and no further disclosure was made to anyone.

In the final hours of the Clinton administration, the White House counsel's office called the Pardon Attorney's office at the Justice Department with a list of names under consideration, including Mr. Rich's. The Pardon Attorney had to conduct its customary FBI background check on all of the names in a rush. There was no time to make a formal recommendation on the Rich case. The Department has informal guidelines for considering whether to check pardon requests.[28] In general, pardon candidates are required to have been convicted (that is the key to the case), to have exhausted all appeals, to have completed their sentences and to live in the United States.

Messrs. Rich and Green satisfied none of these guidelines. Ordinarily, Messrs. Rich and Green should have been denied pardons simply because they never returned to the United States to face the charges against them; were never convicted of a crime; never served time; and were not present in the United States. The President was fully aware of and took into account the fact that the United States Attorney for the Southern District of New York did not support these pardons. In fact, he had vehemently opposed them.

The manner in which the action taken by the President revealed that the Department of Justice had no real time to review this specific case. They, therefore, had no ability to advise the President as to the justification of such a pardon. The fact that not one iota of compliance with the normal pardon application procedures took place in this situation seems to create a cloud of suspicion as to what has occurred. In his op-ed article in the New York Times, Sunday, February 18, 2001,[29] former President Clinton tries to justify his granting of the pardon by arguing that he was asked by many friends and acquaintances, both Republicans and Democrats, as well as heads of foreign governments, most specifically Israel, to grant this pardon.

Personally, I take umbrage at the President's statement that he based his decision for the pardon upon the request and support of Ehud Barak, Israel's Prime Minister. That is utter nonsense, unless he was eliciting concessions from Israel to enter into a peace agreement which would afterward "immortalize" him and his efforts. It is more likely this was an excuse to obfuscate and confuse the real issue of "charitable and political contributions" being made to his library, his wife's Senatorial campaign, and the Democratic Party. I must specifically point out that all Israeli and other government requests made in conjunction with the "Jonathan Pollard spy case" have consistently been turned down.

Therefore, why at this time would the President listen to the Prime Minister of Israel and grant such a pardon in a case involving two individuals, Messrs. Rich and Green, who have flaunted each and every part of our legal system? The President's former White House counsel, Jack Quinn, Hugh Rodham, his brother-in-law, as attorney for several other pardoned parties, raised issues that did not comfort and clarify the reasons for the President's actions. The decision does not seem to be objective. It reeks of intrigue.

Also discrediting the president's motives is the disclosure that his brother-in-law Hugh Rodham, a Florida attorney involved in two additional pardon matters (both California convicted felons) reflects his collecting substantial fees (approximately $400,000) for the pardons were on a contingent fee basis, does not bode well for Mr. Clinton.

The former President stated that his reason for the pardons was not any type of quid pro quo. I seriously question his motives and that statement.

CONCLUSION

There are many opinions throughout the nation, which are divided. On one point, therefore, we have always been united and have expressed our opinion: that the rule of law itself is a fundamental perception in American life. Not simply American legal life, but American political and social life. No person is above the law.

Tempered with that is the American penchant for justice. We are a merciful people. We have built into the system the means to be reasonable and fair, even in the face of admitted wrongdoing. Rehabilitation and redemption are part of our philosophy of jurisprudence. In the case of Marc Rich and Pincus Green, however, substantial damage is done not only to the rule of law but also to the notion of forgiveness. Those who were cynical before will find a fertile ground for continuing contempt for the American legal process. Messrs. Rich and Green were not persons who committed a crime on the spur of the moment. They were not members of society's poorer classes driven to crime by desperation. They were not parties whose conviction was surrounded by controversial evidence or racial motivation. They were successful and sophisticated businessmen indicted for "allegedly evading 48 million dollars in taxes, masterminding a huge oil process rigging scheme, and illegally buying oil from Iran during the 1979 hostage crisis."[30]

What are the grounds for their pardons? Never mind that he chose to stay in Europe rather than litigate his innocence through the Court system. Never mind that federal prosecutors were not consulted about the pardon since Messrs. Rich and Green are living lives of philanthropists abroad (with, if the indictments are correct, presumably illegal money) are to be entitled to the benefit of a pardon. Never mind as well that one of the principal proponents of the pardon Marc Rich's ex-wife Denise Rich was a high-profile fund-raiser and donor, not only to Senator Clinton's campaign, but to the Democratic party in general, and the Clinton White House in particular. Her letter to the President "as a friend and admirer" of his asked for a pardon on the grounds that "exile for 17 years is enough."

Ironically, Israel's Prime Minister Barak also supported and requested Rich's pardon on the grounds that Rich allegedly and apparently aided Israeli intelligence officials; Barak's similar arguments on behalf of convicted spy Jonathan Pollard were not as persuasive.

Although the use of executive clemency has markedly declined, calls for its reform are growing louder. Some have argued for the replacement of executive discretion with clearly defined standards that would permit clemency only in narrow circumstances to correct some objectively determined injustice. Others have called for a separation between the 'justice-enhancing" clemency function to be administered by a commission guided by procedures analogous to those applicable in parole proceedings and the justice-neutral clemency decisions to be made by the executive, subject to override by the legislature.[31]

Perhaps the most disturbing aspect of the pardon controversy is not the damage done to the reputation or legacy of one man; rather it is the impact that it has had on the otherwise salutary pardon function. Particularly in this era of mandatory minimum sentences, sentencing by the numbers under the guidelines, and three-strikes-you're-out style justice, the executive clemency power should be further fortified rather than subject to the erosion that inevitably will result from intense scrutiny and criticism by the body politic. What ought to emerge from the controversy is some more systematic way of identifying cases meriting relief from excessively lengthy sentences or other inequitable results. Improvements in the process will have to await the conclusion of congressional and grand jury investigations.

Many presidents have been involved in the ability to reprieve and pardon, and as a result of same, have come under fire from the public and media. The controversy involved in the Marc Rich and Pincus Green pardons are far more egregious than we could have imagined. It has created numerous questions as to whether or not there was a form of quid pro quo in connection with these pardons.

Had Messrs. Rich and Green returned to the United States and had been convicted, after facing charges, I might feel differently about this pardon. One of the basic tenets of sentencing is whether the criminal has shown remorse and a willingness to accept responsibility (emphasis added). In this case, we are left with a man who openly flaunted the Justice Department of the United States under several presidential (both Democratic and Republican) administrations, and whose pardon is tainted with a blatant appearance of payback for campaign contributions.

Sneaking this pardon under the wire further attests to its unctuousness. The message seems to be loud and clear: Break the law, don't get caught, then buy your way out (emphasis added).

I would like to direct your attention to Samuel's rebuke to Saul after Saul claimed he saved and had pity on the best sheep of the Amaleketes in order to sacrifice to the Lord your God (1 Samuel 15:15).

And Samuel said to Saul, "Does the Lord delight in burnt offerings and sacrifices as much as obedience to the Lord's command? Surely, obedience is better than sacrifice, compliance better than the fat of rams."

"Suffering enough" has become a replacement for due process. If you are not wealthy enough to afford the Marc Rich and Pincus Green approach, you simply have to fend with the rule of law like the rest of us.

END NOTES

[1] U.S. Const. Art II, Sec. 2, cl.1

[2] *United States v. Klein*, 80 U.S.128 (1871).

[3] *Biddle v. Perovich*, 274 U.S.480 (1927).

[4] Of Pardons, Politics and Collar Buttons: Reflections on the President's Duty to Be Merciful — Margaret Colgate Love, Fordham Urban Law Journal *Vol.27 @ 1507*

[5] 3 U.S. Dept. of Justice The Attorney General's Survey of Release Procedures: Pardon 299(1939)

[6] 28 C.F.R. @1.1

[7] 28 C.F.R. @ 1.2

[8] 28 C.F.R. @1.3

[9] 28 C.F.R. @0.35 and 0.36

[10] 28 C.F.R. @1.6

[11] United States Attorneys Manual @1-2.108

[12] *Id.*

[13] *Id.*

[14] 28 C.F.R. @1.11

[15] Robert Morvillo, "Consequences of Conviction" N.Y.L.J.(Dec.7, 1999)

[16] Ashley M. Steiner, Remission of Guilt or Removal of Punishment? The Effects of a Presidential Pardon, 46 Emory L.J.959(Spring 1997)

[17] *Carlesi v. People* 233 U.S. 57

[18] Finding of Committee on Government Reform, www.house.gov/reform/reports/final—faln-2pt2.htm

[19] Charles D. Berger, The Effects of Presidential Pardons on Disclosure of Information: Is our Cynicism Justified? 52 Okla. L. Rev. 163 (Summer 1999)

[20] Charles R. Babcock, "Among Bush's Final Acts! 12 Pardons and 2 Commutations," Wash. Post. Jan. 22, 1993.

[21] Of Pardons, Politics and Collar Buttons: Reflections on the President's Duty to Be Merciful- Margaret Colgate Love, Fordham Urban Law Journal *Vol. 27 @ 1491-2*

[22] *Id.*

[23] A. Craig Copetas, "Metal Man" (1986)

[24] *Id.*

[25] *Id.*

[26] Wall St. Journal "The Forgiven"

[27] A. Craig Copetas, "Metal Man" (1986)

[28] See Note #(3)

[29] N.Y. Times Sunday, Feb. 18, 2001 @ p. 13 "My Reasons for the Pardons"

[30] A. Craig Copetas, "Metal Man" (1986)

[31] 69 Texas L. Rev. 633-38 (Kobel)

NEW PROPOSED REGULATIONS ON INNOCENT SPOUSE RELIEF*

by

Martin H. Zern**

I. INTRODUCTION

Early this year, the Internal Revenue Service ("IRS") issued proposed regulations that provide guidance on how a spouse may obtain relief from the joint and several liability that arises from being a signatory to a joint return.[1] Public hearings regarding the proposed regulations are scheduled for May 30, 2001.

The filing of a joint return by a married couple is the rule rather than exception. Although filing jointly usually results in a lower overall tax liability than filing separate returns, the downside is the fact that both parties to the joint return are jointly and severally liable for the accuracy of the return, for the full tax liability, and for any interest or penalty relating to the return.[2] In addition to the tax reported on the return, joint and several liability extends to any tax that should have been but was not reported on the return. Consequently, each spouse signing a joint return should recognize, although many do not, that he or she is a guarantor for additional tax owed on account of income omissions, exaggerated deductions or erroneous credits or basis of the other spouse.

Because the joint and several liability rule was perceived as excessively unforgiving in certain circumstances, some time ago a provision was added to the Internal Revenue Code ("Code") under which a spouse could be relieved of liability if he or she qualified as an innocent spouse.[3] As it turned out, however, the conditions to obtain relief applied in very limited circumstances. Consequently many spouses who arguably deserved relief were denied it. Moreover, it was usually the wife (herein, including a former wife) who belatedly realized that filing a joint return, or at least not reviewing it carefully, was a blunder.[4] Although the husband (herein, including a former husband) is equally responsible for the tax liability, in many situations the

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wife is the easier mark for the IRS to attempt a tax recovery since the husband is deceased, financially destitute or not to be easily found.

In order to remedy the perceived unfairness in the rules for obtaining innocent spouse relief, which generally resulted in relief being obtained in only the most egregious situations, Congress enacted new innocent spouse rules and deleted the existing law. The new law, Code § 6015, became effective for any tax liability arising after July 22, 1998, and was part of the IRS Restructuring and Reform Act of 1998.[5] The Act was an outgrowth of a concern by Congress that the IRS needed a facelift with respect to its public image and that it should change its emphasis from revenue collection to customer service.[6]

The new law provided for the IRS to "prescribe such regulations as are necessary to carry out the provisions of this section."[7] Now, after about a year and half after enactment of the new law, the IRS has issued proposed regulations that give guidance to those who have filed joint returns and who seek relief from joint and several liability.

II. OVERVIEW OF NEW PROPOSED REGULATIONS

In general, the proposed regulations, consistent with the Code and Congressional intent, expand the relief available to spouses or former spouses who wish to be relieved from all or a portion of the joint and several liability arising from a joint individual Federal income tax return. The 1998 change to the Code made the requirements to obtain innocent spouse relief less restrictive, and two new relief provisions were added. In addition to now providing for three types of relief from joint and several liability, Code § 6015 contains may other relevant provisions. The proposed regulations provide detailed guidance on the three type of relief available under Code § 6015 as well as the other provisions contained in this section.

The proposed regulations are broken down into eight major subdivisions that will be discussed in detail hereafter:

1. Overview of relief from joint and several liability.[8]
2. Relief applicable to all qualifying joint filers ("full relief").[9] This is one the three types of relief of available.
3. Allocation of liability for individuals who are no longer married, are legally separated, or are not members of the same household ("allocated liability relief").[10] This is another of the three types of relief available.

4. Equitable relief.[11] This is the last of the three types of relief available.
5. Time and manner for requesting relief.[12]
6. Non-requesting spouse's notice and opportunity to be heard in administrative proceedings.[13]
7. Tax Court review.[14]
8. Applicable Liabilities.[15]

III. OVERVIEW OF RELIEF FROM JOINT AND SEVERAL LIABILITY

This portion of the proposed regulations contains some general provisions. To obtain innocent spouse relief, the requesting spouse must affirmatively elect the application of a relief provision. The proposed regulations provide that a requesting spouse may submit a single claim electing relief under any or all of the relief provisions. However, equitable relief is available only if and to the extent the taxpayer does not qualify for full relief or allocated liability relief. If the requesting spouse asks for both full and allocated liability relief, the IRS can determine whether relief is available under either provision, and if not whether equitable relief is available. The IRS will consider equitable relief even if not specifically requested to the extent it does not grant full relief or allocated liability relief. If the taxpayer seeks only equitable relief, however, the IRS can consider only this type of relief.

The proposed regulations also make it clear that relief is available only for income taxes and not for other taxes reported on the personal income tax return (such as, domestic service employment taxes).

It is also made clear that relief is not available if the spouse has entered into a prior closing agreement or offer in compromise with the IRS that disposed of the tax liability.[16]

A. RES JUDICATA AND COLLATERAL ESTOPPEL

Under the doctrine of resjudicata or collateral estoppel, a requesting spouse is not entitled to full or allocated liability relief if a court has rendered a final decision on her tax liability provided she materially participated in the proceeding.[17] A spouse will not be deemed to have materially participated in a proceeding to the extent she participated at a time when, due to its effective date, relief under Code § 6015 was not available in that proceeding. Nevertheless, she will be deemed to have participated in a prior proceeding with respect to issues relevant under Code § 6015. Accordingly, for example, since allocated liability relief was not available under the old law, material participation in a proceeding under the old law will not preclude a spouse from seeking allocated liability relief in a court proceeding under the new law, assuming that the IRS has denied such relief. However, if it was determined in the prior proceeding that the requesting spouse had actual knowledge of an erroneous item — a ground for denying allocated liability relief— the determination of the court in the prior proceeding apparently would be conclusive in a subsequent proceeding brought under any of the three relief provisions.

B. TRANSFEREE LIABILITY

The proposed regulations provide that relief under the new law does not negate liability arising under the operation of other laws. Therefore, a requesting spouse who is relieved of liability under any of the three innocent spouse relief provisions may nevertheless remain liable for the unpaid tax, including interest and penalties, to the extent provided by Federal or state transferee liability or property laws. In addition, the requesting spouse's property may be subject to collection under Federal or state property laws.[18] Consequently, the door is left ajar for the IRS to come after a requesting spouse's property pursuant to other laws despite being relieved of liability under the innocent spouse rules.

Example: Husband and Wife timely filed a joint return for the taxable year 1999 that omits income attributable to Husband. Husband dies in March of 2001, and the executor transfers all of the estate assets to Wife. The IRS assesses a deficiency for 1999. Wife is relieved of liability under Code § 6015, but Husband's estate remains liable for the deficiency. Here, the IRS may seek to collect the deficiency from Wife to the extent permitted under Federal or state transferee liability or property laws.

IV. RELIEF APPLICABLE TO ALL QUALIFYING JOINT FILERS ("FULL RELIEF")

A spouse may be relieved of liability for a tax understatement, including additions to tax, penalties and interest, if the spouse makes an election to be relieved and meets the following requirements:

1. A joint return was filed for the taxable year;
2. On the return, there is an understatement attributable to erroneous items of the non- requesting spouse.
3. The requesting spouse establishes that when she signed the return

she did not know and had no reason to know of the item giving rise to the understatement; and

4. It is inequitable to hold the requesting spouse liable for the deficiency attributable to the understatement.

A. DURESS

The proposed regulations amend the joint return regulations[19] to clarify that if a spouse establishes that the joint return was signed under duress, then the return will not be considered a joint return. Consequently, relief from joint and several liability is not necessary and Code § 6015 is inapplicable.

B. ERRONEOUS ITEM

An item is defined as that which is required to be separately listed on the tax return. However, investment income that is required to be separately reported but is from the same source (e.g., dividends and interest) are aggregated and treated as one item. Items include, but are not limited to, gross income, deductions, credits and basis. An erroneous item is any item resulting in an understatement of tax to the extent that such item is omitted from, or improperly reported on the tax return, including improperly characterized. An erroneous item is also an improperly reported item that affects tax liability on other returns (e.g., an improper net operating loss carried back or forward to another taxable year).

C. KNOWLEDGE OR REASON TO KNOW

The proposed regulations adopt a reasonable person in similar circumstances standard for determining whether the requesting spouse had reason to know of the item giving rise to the understatement. Of course, if the spouse had actual knowledge of the item, full relief is not available. All of the facts and circumstances are to be considered in determining whether a spouse had reason to know, including: (i) the nature of the item relative to other items, (ii) the couple's financial situation, (iii) the educational background and business experience of the requesting spouse, (iv) the requesting spouse's participation in the activity giving rise to the erroneous item, (v) failure to inquire at or before the time she signed the return about items that a reasonable person would question; and (vi) whether the erroneous item represented a departure form a recurring item in a prior year's return. Much of the language providing for full relief, including the language knew or had reason to know, is similar to the language under the old law. Consequently, the case law interpreting this language under the new law is to be applied in interpreting the new law.[20]

D. INEQUITY

Again, a general facts and circumstances standard is set forth for determining whether it would be inequitable to hold a spouse responsible for an understatement. An important factor that would result in denial of relief is that of sign jficant benefit from the understatement. A benefit is significant if it is in excess of normal support. Evidence of significant benefit may be gleaned from property transfers to the requesting spouse (including life insurance proceeds) subsequent to the year of understatement that are traceable to items omitted from gross income that are attributable to the non-requesting spouse. Other factors mentioned, favorable to the requesting spouse, include the fact that the non-requesting spouse has not fulfilled support obligations to the requesting spouse or the fact that the spouses have been divorced, legally separated or not been members of the same household for at least 12 months directly preceding the election. See below Part V.A. regarding whether the parties to the joint return are members of the same household and Part VI regarding whether it would be inequitable to hold a requesting spouse liable.

E. PARTIAL RELIEF

Aprovision that is new under the 1998 change in the law is the possibility of seeking partial relief If a requesting spouse had no knowledge or reason to know of only a portion of an erroneous item, she may be relieved of the liability attributable to that portion of the item, provided she meets all of the other requirements for full relief For example, assume a husband embezzles $2 million that is not reported on the couple's joint tax return. The wife had no knowledge or reason to know of the embezzlement and the $2 million is secreted from her. Over the course of the taxable year, however, husband transfers $100,000 to the couple's joint bank account and this is the only benefit she gets from the embezzled funds. Under these circumstances, the wife may be relieved of tax liability for the deficiency attributable to $1.9 million of the unreported income.

V. ALLOCATION OF LIABILITY

A major change in the innocent spouse rules permits a requesting spouse to allocate a deficiency if the requesting spouse is divorced, widowed, legally separated or estranged (specifically, has not been a member of the same household as the non-requesting spouse at any time during the 12-month period ending on the date an election for relief is filed). Under this new provision, a requesting spouse may be relieved of liability to the extent a deficiency is allocated to the non-requesting spouse. Allocation methods are provided and are discussed below. Of the three relief provisions, the allocation method comes closest to being a mechanical test since, unlike the other two relief provisions, it does not require a determination that it would be inequitable to hold the requesting spouse liable in order for her to obtain relief Interestingly, relief under this provision may be available to both spouses filing the joint return.

A. *SAME HOUSEHOLD?*

Obviously, whether spouses are estranged (i.e., not members of the same household) is a question of fact. Here, the proposed regulations provide some guidance, but myriad fact patterns could leave taxpayers quite uncertain in many cases. Specifically, spouses are considered members of the same household during either spouse's temporary absences if it is reasonable to assume that the absent spouse will return to the household, and the household or a substantially equivalent household is maintained in anticipation of such return. Examples given are temporary absences, incarceration, hospitalization, business travel, vacation travel, military service or education away from home. Furthermore, spouses who reside in the same dwelling are considered members of the same household. On the other hand, spouses who reside in two separate dwellings, whether or not part of the same structure, are not considered members of the same household. The problematical phrase is clearly reasonable to assume. A distraught spouse may believe that after the other spouse has left the household after a serious blowup, that he or she will return. Is this a reasonable assumption or just wishful thinking? As a matter of fact, the spouse that left may have no intention of returning and in fact does not return. Of course, people do change their minds and reconciliation could occur at some point. The point is that when the word reasonable is used in the tax law, uncertainty necessarily exists. Also, what is meant by the possibility of two separate dwellings being part of the same structure? Are a husband and wife living apart in separate bedrooms in a one-family home residing in two separate dwellings? Or should the term separate dwelling require all the amenities of a household, such as a separate entrance and kitchen?

B. *NO REFUNDS*

Allocated liability relief is available only for a tax deficiency — that is, where the IRS claims that additional taxes are owed.[21] Consequently, this relief provision is not available to obtain a refund. A refund is possible only where the taxpayer is claiming full relief Also, a refund is not possible under the equitable relief provisions since that provision applies only where there is a tax deficiency or an unpaid tax.[22]

C. ACTUAL KNOWLEDGE BARS ALLOCATION METHOD

An election to allocate a tax deficiency allocable to an erroneous item is invalid if the requesting spouse had actual knowledge of the item at the time the return was signed, and the requesting spouse remains liable for the portion of the deficiency attributable to that item. In determining whether a spouse had actual knowledge of an item, that spouse's knowledge of how such an item should be treated for tax purposes is not relevant in determining whether the spouse had actual knowledge of the item. For example, relief would be denied to a wife if she knew of the husband's interest income, but believed that not reporting it was proper assuming incorrectly that the interest was not taxable. This knowledge standard is consistent with the knowledge standard adopted by the United States Tax Court and other courts.[23] Moreover, knowing how an erroneous item was treated on a tax return, or whether it was treated at all, is not relevant in determining whether the spouse had actual knowledge of the item. For example, if the wife knew that the husband had taxable interest income, but failed to review the return and thus did not know of its omission, relief would not be available to her. If a requesting spouse had actual knowledge of only a portion of an erroneous item, relief is denied only for that portion of the item. For example, if the husband did not report $5,000 of dividend income, but the wife actually knew of only $1,000 omitted, relief would be denied her only for the portion of the deficiency attributable to the $1,000.

Knowledge by a spouse of the source of an item, however, is not sufficient to establish actual knowledge. For example, the wife may know that her husband has stock in X Corp., but may not know that the corporation paid him a dividend. Interestingly, the proposed regulations take the position that a spouse's actual knowledge cannot be inferred from the fact that a spouse had reason to know of an erroneous item. Thus, although a wife might have a reason to know that her husband might receive dividends due to stock investments of which she is aware, she would not by this fact alone be deemed to have actual knowledge of dividends received by him. On the other hand, it would seem that a wife should be deemed to have actual knowledge if she knew of her husband's specific stock investments and knew from an outside source, such as reading the newspaper, that dividends had in fact been paid on them.

Whether a spouse had actual knowledge of an erroneous item at the time the return was filed is to be gleaned from all the facts and circumstances. Here, it appears that the IRS is apparently concerned about a spouse proverbially putting his or her head in the sand. Accordingly, the proposed regulations take the position that a factor to be considered in determining whether a spouse had actual knowledge when the return was signed is whether the requesting spouse made a deliberate effort to avoid learning about the item in order to be shielded from liability. Apparently, the IRS is concerned about a spouse who states to the other spouse: "I don't want to know so don't tell me."

Another factor demonstrating actual knowledge of an erroneous item relates to property that the spouse's own jointly and from which the erroneous item arose. Thus, if there is a joint savings account, this factor would be important in demonstrating that the spouse had actual knowledge of interest paid with respect to the account.

D. DISQUALIFIED ASSET TRANSFERS

In order to prevent fraudulent transfers from one spouse to the other, the proposed regulations provide that the portion of the deficiency for which a requesting spouse is liable is increased, even up to the entire amount, by the fair market value (on the date of the transfer) of any disqualified asset that was transferred to the requesting spouse. A disqualified asset is any property transferred from the non-requesting spouse to the requesting spouse where the principal purpose of the transfer was tax avoidance. Clearly, no relief should be granted to a spouse, although otherwise innocent, to the extent she participates in a scheme under which the non-innocent spouse denudes himself of property to prevent collection from him by the IRS.

To assist the IRS in showing that the principal purpose of a transfer is tax avoidance, the proposed regulations provide for an evidentiary assumption that any property transferred to a requesting spouse during the 12-month period preceding the mailing date of the first letter of proposed deficiency (e.g. a 30-day letter, or if none, a notice of deficiency) is presumed to be a disqualified asset. The presumption continues for property transferred after the mailing date of the first letter of proposed deficiency. There is no presumption, however, if the property transfer is pursuant to a divorce decree or separate maintenance agreement. Since a presumption is only an evidentiary rule, the non-requesting spouse is given the opportunity to rebut the presumption by establishing that the principal purpose of the transfer was not tax avoidance or payment of the tax. The IRS has requested comments as to whether there should be a de minimis exception to the presumption, and if so the amount of such an exception.

E. ALLOCATION METHODOLOGY

In general, the requesting spouse's liability is limited to that portion of the tax deficiency allocated to her. In essence, this means that she can be held responsible for no more than the portion of the tax deficiency allocated to her. Complete relief from the deficiency is still possible, however, under either the full or equitable relief provisions.[24] As mentioned, all three types of relief may be elected. Thus, it is apparent that an election to allocate liability is a fallback option if a spouse does not qualify for full relief. It should be noted, however, that equitable relief is a final fallback option since it is available only if a spouse does not qualify for either full or allocated liability relief.[25] Only a requesting spouse may obtain allocated liability relief The spouse not requesting allocated liability relief remains liable for the full deficiency unless such spouse is relieved of liability under either the full or equitable relief provisions.[26] This language in the proposed regulations seems to be saying that one spouse can be held responsible only for an allocated portion of the deficiency while the other spouse could be relieved of liability altogether. Consequently, the full deficiency would not be collected. If this the intention, it would be useful if the IRS would clarify in the regulations the circumstances under which this would be possible.

The IRS recognizes that both spouse may make an election to allocate liability, and that as a result a portion of the deficiency may not be allocable to either party. If both spouses elect to allocate a tax deficiency and a portion of the deficiency is not allocable, both spouses remain jointly and severally liable for such portion.[27]

1. Separate Returns Concept

In allocating a tax deficiency, the proposed regulations provide that erroneous items are to be allocated as if separate returns were filed. Erroneous income items are generally allocated to the spouse who owned the income or who owned the investment or business producing the income. Four special rules are set forth:

a. An erroneous item that would be allocated to a non-requesting spouse is allocated to the requesting spouse to the extent she received a tax benefit from the item.
b. If fraud can be shown by one or both spouses, the proposed

regulations give the IRS the authority to allocate any item appropriately.

c. An erroneous item of income is allocated to the spouse who was the source of the income. If the source of the income is from jointly held property, the allocation is generally 50% to each spouse unless shown that it should be otherwise by clear and convincing evidence. The same is true for deductions attributable to jointly held property.

2. Burden of Proof

The spouse electing to allocate liability has the burden of proving that she meets all the qualification for making the election and that none of the limitations, such as the transfer of disqualified assets, is applicable. The IRS, however, has the burden of proving that the requesting spouse does not qualify to allocate liability because she has actual knowledge of the erroneous item.

3. Detailed Allocation Rules

The proposed regulations contain detailed allocation rules and numerous examples concerning allocation of a deficiency.[28] As a start, a portion of the deficiency is allocated under the proportionate allocation method (i.e., in proportion to each spouse's share of erroneous items). The regulations contain other detailed rules regarding allocation of other portions of the deficiency. First, any portion of a deficiency attributable to certain disallowed credits and taxes (other than income tax and alternative minimum tax) is allocated entirely to one spouse or the other. Second, any portion of deficiency attributable to the liability of a child of the parties is allocated under special rules. Third, any portion of the deficiency attributable to the alternative minimum tax is allocated to the spouses in proportion to their individual shares of the total alternative minimum taxable income. Fourth, any portion of the deficiency attributable to accuracy-related penalties[29] is allocated to the spouse to whom the item giving rise to the penalty is allocable.

One alternative method of allocation is provided and is to be used in place of the general proportional allocation method when there are erroneous items taxed at different rates. This method is provided to ensure that allocation of liability is not skewed, for example, when the items causing the deficiency consist of ordinary income and capital gains.

VI. EQUITABLE RELIEF

Also new under the 1998 change in the law is what may be categorized as a last chance possibility of seeking relief if relief is not otherwise possible. If a spouse does not qualify for full relief or allocated liability relief, a final possible way out of her predicament is to request equitable relief The IRS is given the discretion to grant equitable relief when based upon the particular circumstances it would be inequitable to hold the requesting spouse liable. As is the case with allocated liability relief, the proposed regulations make it clear that the equitable relief provision cannot be used to obtain a tax refund. Consequently, if the requesting spouse qualifies for allocated liability relief, where no refund is possible, a refund cannot be requested by virtue of the equitable relief provision. The proposed regulations state that the criteria to be used in determining whether equitable relief will be granted by the IRS will be set forth in revenue rulings, revenue procedures, or other published guidance. In January of 2000, the IRS issued a detailed revenue procedure providing guidance to taxpayers on seeking equitable relief.[30]

Importantly, equitable relief is the only relief method under which a taxpayer may be relieve for an unpaid tax obligation. Thus, if the joint tax return filed is correct, but the tax shown as due has not been paid, relief from liability for the unpaid tax obligation is possible under the right circumstances.

VII. TIME AND MANNER FOR REQUESTING RELIEF

In order to elect relief under any of the three relief provisions (i.e., full, allocated or equitable relief), the requesting spouse must file Form 8857, "Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)." Alternatively, the requesting spouse may submit a written statement containing the same information required on Form 8857, signed under the penalties of perjury.

A. TIME PERIOD FOR REQUESTING RELIEF

In order to elect relief under any or all of the three relief provisions, the requesting spouse must file Form 8857 or other similar statement with the IRS no later than two years from the date of the first collection activity taken by the IRS (after the effective date of the new law, July 22, 1998) against the requesting spouse with respect to the joint tax liability.

1. Collection Activity

The term collection activity is defined as an administrative levy or seizure[31] to obtain property of the requesting spouse; an offset of an overpayment of the requesting spouse against a tax liability;[32] the filing of a suit by the government against the requesting spouse for the collection of the joint tax liability; or the filing of a claim by the government in a court proceeding in which the requesting spouse is a party or which involves property in which the requesting spouse has an ownership interest (including jointly held property). However, a collection activity does not include a notice of intent to levy;[33] the filing of a Notice of Federal Tax Lien; or a demand for payment of tax. Consequently, the two-year filing requirement does not begin to run until the government does something more significant, such as an actual levy or seizure, than simply sending out a notice or filing a lien.

2. Date of Levy or Seizure

For purposes of determining when the two-year filing period begins where personal or real property is to be seized and sold, the date of levy or seizure is the date the notice of seizure is given.[34] If a levy is made on cash or intangible personal property that will not be sold (e.g., accounts receivable interdicted by the IRS), the date of levy or seizure is the date the notice of levy is made. If a notice of levy is served by mail, the date of levy or seizure is the date of delivery of the notice of levy to the person on whom the levy is made.[35]

3. Relief Request before Collection Activity

Aspouse does not have to wait until collection activity has commenced in order to request relief As an example, the proposed regulations state that a spouse may request relief in connection with an audit of the joint return, or pursuant to a pre-levy collection due process hearing.[36] However, no relief may be requested for a tax year prior to the receipt of a notification of an audit or a letter or notice from the IRS indicating that there may be an outstanding liability with regard to that year. This does not include notices or letters regarding partnership proceedings. In a divorce situation, a spouse may move and not become aware of IRS communications or a levy regarding a joint return. Consequently, many divorce lawyers started to file innocent spouse relief claims along with the filing of divorce papers as a means of protecting the client so that the two-year filing requirement was not unknowingly missed. The proposed regulations make it clear, however, that such protective claims are premature and will not be considered an election for relief.

4. Examples Regarding Time Period for Requesting Relief

The proposed regulations set forth a number of examples regarding the two-year time frame for requesting relief:

> Example 1: On January 11, 2000, a notice of intent to levy is mailed to the taxpayers regarding the taxable year 1997. An actual levy is made on the wife's salary on June 5, 2000, and on husband's salary on July 10, 2000. Wife must request relief by June 5, 2002, and husband by July 10, 2002.
>
> Example 2: The taxpayers do not remit full payment with their timely filed tax return for 1989. No collection activity is taken after July 22, 1998, until on July 1, 1999, the IRS files a suit against the taxpayers to reduce the tax assessment to judgment and to foreclose the tax lien on their jointly held residence. Wife elects relief on October 2, 2000, which is timely since made within two years of the IRS collection activity.
>
> Example 3: Wife files for Chapter 7 bankruptcy on July 10, 2000. On September 5, 2000, the IRS files a proof of claim regarding her joint 1998 income tax liability. Wife elects relief on August 20, 2002. The election is timely since it is made within two years of the date the IRS filed the claim in the bankruptcy case.

5. One Bite at the Apple

The proposed regulations provide that a requesting spouse is entitled to only one administrative determination of relief for a given assessment. Consequently, the statement that must be attached to the Form 8857 explaining why the spouse believes she qualifies for relief should be comprehensive. In this regard, it would appear advisable to retain a competent representative. If a spouse did not meet the requirements for allocated liability relief when the first election was filed, however, but met them subsequently, a second request for relief can be made. For example, if a spouse was not divorced, not legally separated or not estranged at the time of the filing of the first election for relief, she would not qualify for allocated liability relief If she met the requirements for allocated liability relief at a later time, however, a second election for relief under this provision could be filed.

VIII. NON-REQUESTING SPOUSE'S NOTICE AND OPPORTUNITY TO BE HEARD

When the IRS receives a request for relief under any of the three relief provisions, it is required to send a notice to the non-requesting spouse's last know address informing such spouse of the relief claim. The notice must provide the non-requesting spouse with an opportunity to submit any information relevant in making a determination as to whether relief should be granted, but may not require that information be submitted. The IRS is given discretion to share with each spouse the information given by the other. In the interests of privacy, the IRS is required to redact, if so requested, a spouse's new name, address, employer, telephone number, and any other information that would reasonably indicated the other spouse's location. After all is said and done, the IRS must notify the non-requesting spouse of its final determination as to whether relief has been granted. However, the non-requesting spouse is not entitled to appeal the IRS decision.

A. PARTICULAR INFORMATION

The IRS is to consider all of the information relevant to each relief provision that a non-requesting spouse submits in determining whether relief should be granted to the requesting spouse. In this respect, the proposed regulations particularize what is considered relevant:

a. The legal status of the marriage;
b. The extent of the requesting spouse's knowledge of the erroneous item or underpayment;
c. The extent of the requesting spouse's knowledge or participation in the family business or financial affairs;
d. The requesting spouse's education level;
e. The extent to which the requesting spouse benefited from the erroneous item;
f. Any asset transfers between the spouses;
g. Any indication of fraud on the part of either spouse;
h. Whether it would be inequitable to hold the requesting spouse liable;
i. The allocation or ownership of items giving rise to the deficiency; and
j. Any other relevant information.

If the requesting spouse is completely let off the hook, the non-requesting spouse then becomes responsible for the full deficiency. Accordingly, where warranted, the non- requesting spouse should submit any information that would defeat the requesting spouse's attempt to shift full blame to him. Of course, where there is marital strife or a divorce, a culpable spouse may wrongfully try to keep the innocent spouse liable.

B. *EFFECT OF OPPORTUNITY TO BE HEARD*

A non-requesting spouse's failure to submit information when given the opportunity to do so does not affect such spouse's ability to seek relief from joint and several liability for the same tax year. However, if the non-requesting spouse does submit information, it will be relevant in determining whether he will be granted relief if he submits an independent application for relief. Obviously, the IRS is not going to administratively let both parties off the hook if both file applications for relief, and it is highly unlikely that both parties would be relieved of liability even in separate court proceedings. As noted, if both parties submit applications for allocated relief, they remain jointly and severally liable for any portion of the deficiency that is not allocated to one or the other.

IX. TAX COURT REVIEW

If the requesting spouse does not obtain relief administratively, she may petition the Tax Court to review the denial of relief.

A. *TIME PERIOD FOR PETITIONING*

The requesting spouse has 90 days in which to petition the Tax Court to review the denial of relief beginning on the date the final determination letter is mailed. If the IRS does not mail the spouse a final determination letter within 6 months of the date the spouse files an election for full or allocated liability relief, she may petition the Tax Court at any time after the expiration of the 6-month period, and before the expiration of the 90- day period starting with the date the determination letter is mailed. The Tax Court may also review a claim for innocent spouse relief if it has acquired jurisdiction pursuant to a general petition for relief appilicable to the taxable year concerned,[37] or pursuant to a Tax Court hearing before a levy.[38]

B. *RESTRICTIONS ON COLLECTION*

Unless the IRS determines that collection will be jeopardized by delay, no levy or proceeding by the government in court for tax collection may be prosecuted against a spouse requesting full or allocable relief until the expiration of the 90-day period in which to file a Tax Court petition, or if a petition is filed, until the decision of the Tax Court become final. If the requesting spouse appeals an adverse Tax Court decision, the IRS can commence collection unless the requesting spouse files an appeal bond. A court proceeding for this purpose does not include participation in suits not filed by the government, such as Tax Court cases, refund suits and bankruptcy cases.

C. *SUSPENSION OF STATUTE OF LIMITATIONS*

The statute of limitations on collection against a spouse electing full or allocated liability relief is suspended during the time the IRS is barred from collecting by levy or a court proceeding and for 60 days thereafter. If a spouse is only seeking equitable relief, however, the restrictions on collection do not apply. In such case, the request for relief will not suspend the statute of limitations.

X. APPLICABLE LIABILITIES

The three relief provisions are applicable to tax liabilities that arose after the effective date of the new law, July 22, 1998, and to tax liabilities that arose prior but were not paid on or before the effective date.[39] With respect to taxes paid on or before July 22, 1998, relief is available only under the tougher prior law.

XI. CONCLUSION

The proposed regulations are on track in giving guidance to a spouse seeking innocent spouse relief. Of course, the regulations are only in proposed form and there will no doubt be significant clarifications and additions. Comments on the proposed regulations and requests to speak at a public hearing scheduled for May 30, 2001, must be received by April 27, 2001. The details for sending submissions are set forth in the proposed regulations. Hopefully, the IRS will not drag this project out interminably and will issue final regulations within a short period of time after the scheduled public hearing.

Clearly, the rules for obtaining innocent spouse relief are highly technical. Moreover, whether relief will be granted depends to a large extent upon the particular facts and circumstances. Consequently, it would behoove a spouse seeking innocent spouse relief to retain competent tax counsel to represent her administratively and, of course, in any court proceeding. The possibility of seeking innocent spouse seems to be of interest to many taxpayers since it has been reported that the IRS has been inundated with innocent spouse claims.[40] Hopefully, IRS collection personnel, not especially noted for being overly compassionate, will be reasonable in applying the new rules.

ENDNOTES

[1] REG-106446-98. 66 Fed. Reg. 3888 (01/17/0 1).

[2] I.R.C. § 6013(d)(3) (2001). All references to "I.R.C." are to the Internal Revenue Code of 1986, as amended.

[3] I.R.C. § 6013(e) (1998). This section was enacted in 1971 (Pub. L. No. 91-679, 84 Stat. 2063).

[4] According to testimony presented before Congress, innocent spouse relief was only "theoretically" available because it was extremely difficult for the standards for such relief to be met. "In fact there are some 50,000 women, generally ex-spouses, who are caught up in this 100-percent liability for a tax return.' Senate Floor Debate for Amendment No. 2369 (144 CONG. REC. 56, S4473 (1998)). Additionally, the New York Times noted that 90% of the parties seeking relief as an innocent spouse were women (David Cay Johnson, With Law Changes, Innocent Spouse Claims Flood IRS, New York Times, 12-29-99, p.1.). This percentage is consistent with the writer's review of the litigated cases in this area.

[5] I.R.C. § 6015 (2001). Added by the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. 105-206, 112 Stat. 742) ("Act"). The Act removed the prior Code section dealing with innocent spouse relief, I.R.C. § 60 13(e).

[6] See Act Sec. 1002, IRS Mission, H.R. CONF. REP. No. 105-199: "The Committee believes that a key reason for taxpayer frustration with the IRS is the lack of appropriate attention to taxpayer needs." "The Committee believes that taxpayer service is of such importance that . . . a key part of the IRS mission must be taxpayer service.

[7] I.R.C. § 60 15(g) (2001).

[8] Prop. Reg. § 1.60 15-1 (2001). All references to "Prop. Reg." are to the Proposed Treasury Department Regulations interpreting § 6015 of the Internal Revenue Code of 1986, as amended. All references to "Reg." are to Treasury Department Regulations interpreting the Internal Revenue Code of 1986, as amended.

[9] Prop. Reg. § 1.60 15-2 (2001).

[10] Prop. Reg. § 1.60 1 5-3 (2001).

[11] Prop. Reg. § 1.60 15-4 (2001).

[12] Prop. Reg. § 1.60 15-5 (2001).

[13] Prop. Reg. § 1.60 15-6 (2001).

[14] Prop. Reg. § 1.6015-7(2001).

[15] Prop. Reg. § 1.60 15-8 (2001).

[16] See I.R.C. § 7121 (2001) regarding closing agreements and I.R.C. § 7122 (2001) regarding offers in compromise, and the regulations under said sections.

[17] To avoid awkward references, the female gender will be used from time-to-time in this article as a pronoun to refer to the spouse requesting innocent spouse relief since it is predominantly the wife (or ex—wife as the case may be) who is seeking relief, and the male gender will be used for the non-requesting spouse.

[18] See I.R.C. §§ 6901 through 6904 (2001) and the regulations thereunder for the Federal rules regarding transferee liability.

[19] Reg. § 1.6013-4 (1971).

[20] For a detailed analysis of the prior rules, see Martin H. Zern, The Innocent Spouse: Appeals Courts Endorse Pro-Taxpayer Standard, Journal of Legal Studies in Business, Volume 5, Number 2 (1997).

[21] I.R.C. § 6015(c)(1).

[22] I.R.C. § 6015(f)(1) (2001).

[23] See, for example, *Cheshire v. Comm'r*, 115 T.C. No. 15 (2000) (knowledge requirement under section 6015(c) does not require requesting spouse to possess knowledge of the tax consequences arising from the erroneous item or that the item reported on the return is incorrect; rather the statute requires only a showing that the requesting spouse actually knew of the erroneous item); *Wiksell v. Comm'r*, 215 F.3d 1335 (9th Cir. 2000) (knowledge inquiry in section 60 15(c) focuses on whether the taxpayer had knowledge of the erroneous item, not the tax consequences of that item).

[24] Prop. Reg. § 1.60 1 5-3(d)(1)(i) (2001).

[25] I.R.C. § 6015(f)(2) (2001); Prop. Reg. § 1.6015-4(a) (2001).

[26] Prop. Reg. § 1.60 15-3(d)(1)(ii) (2001).

[27] Id.

[28] Prop. Reg. § 1.6015-5(d) (2001).

[29] I.R.C. §§ 6662 and 6663 (2001).

[30] Rev. Proc. 2000-15, 2000-5 I.R.B. 447, 2000 IRB LEXIS 17 (2000). This revenue procedure was effective on January 18, 2000, and superceded Notice 98-61, 1998-51 I.R.B. 13 (1998). For a detailed analysis of the circumstances under which equitable relief may be sought pursuant to the new revenue procedure, and further aspects of the new innocent spouse provisions, see Martin H. Zern, Innocence in the Eyes of the Internal Revenue Service, North East Journal of Legal Studies, Volume 8, Number 1 (2001).

[31] I.R.C. § 6331 (2001).

[32] I.R.C. § 6402 (2001).

[33] I.R.C. §§ 6330 and 633 1(d) (2001).

[34] The proposed regulations refer to I.R.C. § 6502(b) (2001) and the regulations thereunder for details concerning the notice of seizure.

[35] Reference is made to Reg. § 301.6331-1(c) (1994) for details.

[36] See I.R.C. §§ 6320 (2001) and 6330 (2001); Reg. §§ 301 .6320-1T(e)(1) and (2) (1999) and 301.6330-1T(e)(1) and (2) (1999).

[37] I.R.C. § 62 13(a) (2001).

[38] I.R.C. § 6330(d) (2001).

[39] Prop. Reg. § 1.6015-8 (2001).

[40] The New York Times reported that the IRS expected to receive 3,000 claims for relief after enactment of the new law, but instead has received over 45,000 claims, with hundreds more being received each week. Because it has been inundated with so many claims, the IRS reportedly has assigned 500 auditors to deal with the situation, which is more than 3% of its auditing force (David Cay Johnson, With Law Changes, Innocent Spouse Claims Flood IRS, New York Times, 12-29-99, p.1.).

COMMUNITY COURTS: JUSTICE FOR NEIGHBORHOODS?

by

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As the population swelled and crime rates soared in the 1960s, 1970s, and 1980s, the emphasis in law enforcement was on controlling violent crime and protecting the citizenry from the harm that accompanies such crime. It is well documented that during this period the courts were generally overburdened with case load and the courts and the prison system were overcrowded and often near the point of boiling over. In many cases, the courts and prisons were also understaffed. The decline in living conditions in many cities and a whole host of modem day problems, especially in cities, also seemed to add to the rising crime rate.

Centralization of court systems in some cases made courts somewhat remote from neighborhoods and neighborhood problems in bigger cities. Overcrowded prisons and jails contributed to brutality among incarcerated prisoners and the belief that the harsh conditions faced during incarceration often made the guilty worse. Understandably there was a reluctance to confine those accused of lesser crimes.

"VICTIMLESS" CRIMES

In time, a theory took root that certain crimes were "victimless." These were the so-called quality of life crimes. Quality of life crimes include but are not limited to public urination or defecation, graffiti, prostitution, possession of small amounts of drugs, fare-beating, vandalism, violation of open container laws, and shop lifting. These matters were often dealt with by the courts in ways that did not deter further similar violations. Crimes of this type, generally of the misdemeanor variety, were frequently disposed of in a manner which sometimes made them seem like an afterthought or distraction to the criminal justice system. Defendants found guilty of crimes of this nature were often sentenced to time served waiting trial or small fines. Some found guilty were given adjoumments contemplating dismissal in which the matter was adjourned to a certain date and dismissed at that time provided the defendant was not found guilty of a similar offense during the period of the adjournment. In essence, society through the courts seemed to be saying that there was little

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that society could do to deal meaningfully with quality of life offenses. The stated or unstated rationale (or rationalization?) was that at least they were victimless crimes. Society seemed to be saying that certain crimes had to be tolerated.

The above analysis concerning victimless crimes missed several essential points. Communities and community residents are the victims of these crimes and are damaged by them. The heartbeat and life of the affected neighborhood are diminished as crimes of these types go uncorrected. Community morale erodes, community residents are demoralized, and their quality of life is diminished as quality of life crimes are ineffectively dealt with. It is difficult for people to feel content in their neighborhoods while witnessing and being exposed to the effects of graffiti, public urination, vandalism, prostitution, drug possession, etc. "It is important not to overlook the historical context. Courts in the 1960s and 1 970s labored under a different understanding of crime and social order. It has been only recently — James Q. Wilson and George Kelling wrote their landmark essay, 'Broken Windows: The Police and Neighborhood Safety' in 1982 — that we have begun to understand the impact of low-level crime on the social fabric of communities. According to Kelling and his supporters, low-level crime — if left unaddressed — erodes communal order, leads to disinvestment and decay, and creates an atmosphere where more serious crime can flourish (See Wilson, J.Q., and Kelling, G.L. 1982. 'Broken Windows: The Police and Neighborhood Safety,' Atlantic Monthly, March, pp. 29-38)."[1]

To address concerns of this type, so-called Community Courts have begun to be funded and established. Some of the locations include New York City, Austin, Texas, Madison, Wisconsin, Maricopa County, Arizona, Jersey City, New Jersey, and Vermont. Funded in part by the U.S. Department of Justice and active in many cities, community courts are not exactly the same in each location, but there are certain characteristics common to them. The fundamental principle on which community courts are founded is that neighborhoods and the stakeholders in those communities are the true victims of so- called victimless crimes. Just as the theory of criminal law is that the people of the state are the victims of all crimes, the basic theory of community courts is that the particular community in which low level crime is committed is also the victim of these crimes. Accordingly, convicted offenders should therefore compensate neighborhoods and try to make them whole for the offenses committed. This restorative justice may take many forms, but its root goal is to add value to the community that has been damaged by the crime.

To help restore the community, community courts often sentence quality of life offenders to work projects in an attempt to pay back the community for the wrongs done to it. Among the popular work projects are graffiti removal, cleaning subway and bus stations, caring for trees, recycling cans and bottles, and cleaning garbage from lots. The offenders are sometimes garbed in a manner which identifies them as persons doing community work as ordered by the court. Since the work is performed in the damaged community, community stakeholders are able to observe the process and formulate an opinion as to the appropriateness and restorative quality of the punishment. "A community court puts offenders to work in places where neighbors can see what they are doing, outfitting them in ways that identify them as offenders performing community service. It also publicizes its social service and treatment accomplishments. Success stories give community residents and organizations tangible evidence that the criminal justice system is accountable to the community."[2] Additionally, offenders are often sentenced to perform their community service immediately after pleading or being found guilty, thus giving a sense of immediacy or prompt justice to the proceedings. Interested community members thereby feel a sense of connectedness to the court for the relatively prompt administration of justice.

Another principle of the community courts is that there should be community justice and that the aggrieved community should have a voice in the formulation of that justice. "What is community justice? It can take many forms, but at its core, community justice is about partnership and problem-solving. It's about creating new relationships, both within the justice system and with outside stakeholders like residents, merchants, churches and schools. And it's about testing new and aggressive approaches to public safety."[3] In a survey taken in Vermont regarding the proper course to pursue with low- level criminals, there was strong support for community involvement with sentencing. "The Vermont surveyors also found widespread acceptance of the proposal for the Reparative Probation Program, which called for the creation of community boards to determine how low-risk offenders would repay their victims and the community at large. Planners were astonished by the results: more than 90 percent of respondents favored this type of community involvement."[4] The survey also found that the survey respondents were, in general, strongly interested in alternative sentencing that added value to the community, e.g., some form of public service project.

Community courts will often involve the creation of a community advisory board whose members in cooperation with the judge and other community stakeholders will attempt to formulate meaningful community service projects. Members of community advisory boards may include representatives of religious organizations, victims of crimes, representatives of tenants groups, businesspersons, members of civic associations, homeowners, social workers, and other interested community residents.

HISTORY OF THE COMMUNITY COURTS

The community court movement began in New York City in midtown Manhattan in 1993. Considered extremely successful, there are now approximately twenty community courts throughout the country. The number is growing and many more are in the planning stage. The other community courts are modeled after New York's but do not attempt to be exact duplicates because each community has its own particular problems. As set forth in "Community Courts An Evolving Model," each court in essence attempts to address these fundamental background questions:

a. Can courts assume a problem-solving role in the life of a community, bringing people together and helping to craft solutions to problems that communities face?
b. How can courts address the impact that chronic offending has on a community?
c. Can courts improve the quality of life in a community?
d. Can local voices-residents, merchants, community groups engage in the administration ofjustice?[5]

The Midtown Community Court, the prototype to which other community courts look as a reference, located the court in the neighborhood it was serving. This did a great deal to overcome the estrangement between the community and the court system it felt had become remote from it. As previously mentioned, sentencing of low level offenders emphasized the compensation of the community through community service sentencing. Many of the offenders, however, are individuals in need of help who will repeat these or similar crimes unless accessible help is made available to them, so the court sentenced offenders to complete social services programs to help the offenders and indirectly the affected community. Sentencing offenders to participate in social service programs, e.g., drug and alcoholic counseling is not in itself unique, but the Midtown Court made space available to social agencies in the court itself and social service staff was provided to deal with offenders. This approach shifted the emphasis somewhat from simply punishing wrongdoers and disposing of cases to one which additionally stressed true problem solving. Drug treatment, medical services, counseling, and educational programs became incorporated in sentencing and prompt reference to professionals located at the court and able to help the offender and therefore the community as well, became common.

Locating the court in the community it is designed to serve and establishing a community advisory board obviously help to involve community stakeholders in the process, but the Midtown Court introduced another innovation as a sanction, Community Impact Panels. "The Community Impact Panels have roots in two related national trends. The first is the victims movement, which over the past generation has worked to increase the criminal justice system's acknowledgment of, and respect for, victims of crime. The second is the community justice movement, a relatively new phenomenon that seeks to bring criminal justice agencies together to develop collaborative approaches to neighborhood problems. In Impact Panels, offenders don't meet with an individual victim, but with a panel of community representatives."[6] Interaction and participation with the Impact Panel is made part of the sentence generally for first time offenders. The idea behind the panels is to bring offenders and community members into a face-to-face situation which hopefully is a meaningful sanction for the offender and a restorative experience for the community in that the offender gains a sense of the thinking of the community. Impact Panels were introduced in 1999 and have been used effectively with those guilty of vandalism and public urination. They have also been used extensively with "Johns" found guilty of having sex in public with prostitutes.

Impact Panels are part of the evolution of the Community Court, and they are usually composed of volunteer community representatives, the offenders, and a facilitator. The latter is a trained mediator who is stationed at the Court. The newcomers to the procedure, the offenders and the community representatives, receive a one-hour training and orientation. The Court makes the determination as to whether an Impact Panel is an appropriate part of sentencing and generally particular community representatives are not used more than once or twice in a year. The idea is not necessarily to shame or humiliate the offenders, but to inform them of the effect these actions have on the community and to make them understand how community people feel injured by their conduct. "Overt apologies from the offenders are not a required result of the program. The Panels' primary goal is to inform the offenders of the impact of their behavior on others so that their heightened awareness will guide their future behavior. Nevertheless, it is not uncommon for offenders to express remorse for what they have done."[7] Although the process has been in place for a relatively short time, feedback is generally positive with offenders indicating that they previously had not been aware of the effect of their behavior. "Each Community Impact Panel is unique. Different types of offenses and different types of personalities yield dramatically different conversations. The Court is continuously exploring ways of improving the program's effectiveness, which is monitored by research questionnaires given to offenders and community volunteers before and after each session."[8] At a minimum, it is clear that these panels help eliminate turnstile justice where an offender simply receives a meaningless sentence, e.g., paying a small fine and leaving the courthouse essentially untouched by the procedures.

AVAILABLE COURT MANDATED SOCIAL SERVICES

A distinguishing feature of community courts is that the court attempts to take a more active role in solving community problems by requiring offenders to make use of social services, e.g., drug programs or counseling for drug users and health counseling for prostitutes. Mandating enrollment in a social services program as part of a sentence is not in itself unique, but the community courts seek to have greater involvement with the social services agencies and monitor closely the progress of the enrolled. In some cases, the social workers or representatives of social agencies are housed in the courts, and the court may employ a resource coordinator to aid the interaction among court, offender, and social agency. The Downtown Community Court of Austin, Texas, learned that 56 percent of those committing quality of life offenses reported suffering from chemical dependency.[9] Other estimates put the percentage of those committing these crimes who are dependent on drugs as high as 80 percent. "Community court planners sought to do something different: use community service as a sanction for low-level offenses, respond to repeat offenses with graduated sanctions, and use social services sanctions to address underlying problems such as drug addiction... The judge can craft a sentence using a variety of tools... Also, working with the resource coordinator, she can craft rehabilitative plans that include a range of social services such as acupuncture detoxification, peer counseling, day and residential treatment for substance abuse, and mental health counseling. The community court helps offenders reenter the work force in collaboration with partnering agencies. Social services are coordinated by court-based social workers."[10]

In attempting to solve problems and assuming an activist role in that capacity, the community courts illustrate a change in philosophy. The court no longer simply fulfills the role of punishing wrongdoers, but sees itself in a role more related to resolution of problems and improvement of quality of life. "As the first criminal court in the country to locate health care, education and drug treatment within the court building itself, the Midtown Community Court is actively rethinking the nature of a court's business. In the past, criminal justice, social service, education and health care organizations have often let bureaucratic divisions hamper or delay access to services. But the

Community Court has forged new coalitions by bringing everyone — the Department of Health, the Board of Education, the Department of Homeless Services, the Human Resources Administration, drug treatment providers, nurse practitioners and others — together under one roof. It makes sense: a court is the one place that has physical custody of large numbers of at-risk offenders on a daily basis."[11]

CONCLUSION

The results of the community court experiment have so far been encouraging. The time between arrest and arraignment in the Midtown Court has been reduced to 19 hours from the city-wide average of 30 hours, and 16 percent of offenders sentenced to social services programs returned to court voluntarily to follow up after completion of their sentence. Other evidence of effectiveness is the fact that prostitution arrest rate fell 63 percent in the Court's first two years.[12] Rather than rely on statistics alone, since quality of life is an intangible, it may be well to note that the Midtown Court received the 1994 Justice Achievement Award from the National Association for Court Management. In 1996, the Court was cited as improving the quality of life by the Municipal Art Society. Perhaps the greatest testimony to the success of community courts, is the proliferation of them referred to earlier. With more than 20 in service and many more in the planning stages, there is ample proof that communities feel they are helpful.

The most serious challenge to community courts would seem to be their short term cost. Housing the various social services agencies in one courthouse and employing additional personnel, e.g., the resource coordinator, have short term consequences. Similarly, the costs of running impact panels and maintaining community councils cannot be denied. The question for communities to answer may ultimately be: how much is quality of life worth?

ENDNOTES

[1] JOHN FEINBLATT, GREG BERMAN, and MICHAEL SVIRIDOFF, U.S. Department of Justice, NEIGHBORHOOD JUSTICE (1998).

[2] JOHN FEINBLATT, GREG BERMAN, Center for Court Innovation, COMMUNITY COURT PRINCIPLES A GUIDE FOR PLANNERS (1998).

[3] Id. at 1.

[4] ROBIN CAMPBELL, Center for Court Innovation, THERE ARE NO VICTIMLESS 4 (2000).

[5] ERIC LEE, U.S. Department of Justice, COMMUNITY COURT AN EVOLVING MODEL 1 (2000).

[6] Campbell, supra at 4.

[7] Campbell, supra at 6.

[8] Campbell, supra at 7.

[9] Lee, supra at 15.

[10] Lee, supra at 16.

[11] Fund for the City of New York, THE MIDTOWN COMMUNITY COURT EXPERIMENT A PROGRESS REPORT 8 (2000).

[12] Id.at 12.

NEW YORK STATE BROADENS PROTECTIONS FOR ACCOUNTANTS FROM THIRD-PARTY NEGLIGENCE CLAIMS: *PARROTT v. COOPERS & LYBRAND, L. L. P.*

by

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I. BACKGROUND

In a case decided December 14, 2000, *Parrott v. Coopers*, the New York Court of Appeals continued its long tradition of insulating accountants from negligence liability claims from third parties. In this article, after briefly describing the development of New York's near- privity rules governing accounting negligence actions, focusing on several of the leading cases,[1] we discuss the Parrott decision and our views regarding the effects of New York's rules on both the practice of accounting and the rights of third party investors and creditors.

In the first quarter of the 20th century, the Court of Appeals loosened strict privity rules in negligence actions that had obtained earlier in cases involving a contract to provide services. In the leading English case, *Winterbottom v. Wright*,[2] decided in 1841, the court held that an injured coach passenger lacked standing to sue a wheelwright for negligent repairs of the coach, because no direct contractual relationship existed between the passenger and the wheelwright. The court was concerned that, if a duty of care was owed to persons not in contract with the service provider, the wheelwright's potential liability would be indeterminate and conceivably so large as to make contracting uneconomical. The Wright case's reasoning was widely cited by courts in the U. S. and England. It established a requirement in negligence cases for a plaintiff to demonstrate a direct contractual relationship or privity of contract with the defendant.

In 1916, in *MacPherson v. Buick Motor Co.*[3], the New York Court of Appeals relaxed this rule, and held — as a matter of tort law — that a negligent manufacturer of a chattel whose intended use creates an unreasonable risk of serious bodily harm may be liable for negligence even though privity is lacking between the manufacturer and the user.

The Court of Appeals was, however, more reluctant to relax privity requirements for claims of negligent misrepresentations as opposed to negligent production of physical products. While a negligently produced product can, as a general rule, cause harm only to a limited number of people, the potential damage that a negligent misrepresentation might inflict cannot be readily foreseen. Thus, in *Courteen Seed Co. v. Hong Kong & Shanghai Banking Corp.*,[4] the Court of Appeals noted that negligent words "are not actionable unless they are uttered directly, with knowledge or notice that they will be acted on, to one to whom the speaker is bound by some relation of duty, arising out of public calling, contract, or otherwise, to act with care if he acts at all." Again, the court's concern was to circumscribe what might otherwise be indeterminate liability if negligent misrepresentation claims could be pursued where privity was lacking.

The Court of Appeals did relax the privity standard for negligent misrepresentations when the scope of those who might be directly harmed by the misrepresentation could be readily foreseen. The 1922 case of *Glanzer v. Shepard*[5] involved a buyer of a shipment of beans. The buyer had agreed with the seller that the sales price would depend on the shipment's weight, as determined by an independent professional weigher. The seller, not the buyer, hired the weigher.

The weight certificate was negligently prepared, and the buyer consequently overpaid. When these facts came to light, the buyer sued the weigher for negligence. The Court of Appeals, in an opinion by Justice Cardozo, found that the buyer had standing to assert a negligence claim, even though he was not in strict privity of contract with the weigher, because the buyer's use of the certificate was "the end and aim" of the weigher's contract with the seller. Under the facts in Glanzer, the relaxation of a strict privity standard did not create the risk of indeterminate liability for the weigher.

The leading case relating to accountants' liability for negligence is *Ultramares v. Touche*,[6] decided by the Court of Appeals in 1931. In that case the Court denied a third party lender the right to sue a borrower's auditors for a negligent audit of financial statements relied on by the lender in agreeing to extend credit. Again, the Court's concern was that the creation of a large and indefinable liability would make the practice of auditing uneconomical. In Justice Cardozo's words

"If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."[7]

The Ultramares decision held that third party users of financial statements lacked standing to assert negligence claims unless the third party could establish that it had a relationship with the accountants approaching that of privity of contract.[8]

In 1985, in *Credit Alliance Corp. v. Andersen & Co.*,[9] the Court of Appeals revisited Ultramares and its case law progeny. The Court clarified the requirements that a third party must meet to establish standing under the near privity standard. The requirements were described as a tripartite test. For near privity to be found:

(1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes;
(2) in the furtherance of which a known party or parties were intended to rely; and
(3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance.[10]

The court emphasized that these requirements represented a clarification, not a change, in law. As a practical matter, the third prong of the test precludes accountants' liability for negligence based upon actions of other parties. The accountants themselves must engage in conduct which links them to the plaintiffs.

In several subsequent cases, other New York courts have attempted to apply the prongs of the near privity analysis; in doing so they have tried to define terms such as "known party or parties", "linking" conduct, and exactly what "evinces the accountants' understanding" of another parties' reliance. In *White v. Guarente*,[11] the Court of Appeals found that limited partners could be a narrow enough class to be a "known party or parties" in a case involving the negligent preparation of partnership tax return data. The Court noted that "Although an accountant need not respond in negligence to those in the extensive and indeterminable investing public-at-large, the services of the defendant were not extended to a faceless or unresolved class of persons, but rather to a known group possessed of vested rights, marked by a definable limit and made up of certain components which did not involve prospective limited partners, unknown at the time and who might be induced to join."[12]

The "linking conduct" prong has been contested frequently. A Federal court, applying New York law, has held that, to meet this requirement, direct contact between the third party and the auditors is not required "but rather some link of the defendant to plaintiff which evinces defendant's understanding of plaintiffs reliance."[13] At one extreme, when auditors issue "no- default letters" to their clients, actually naming the lenders and referring to the loans, the third prong of the Credit Alliance criteria is satisfied.[14] Another Federal court, also construing New York law, held that "personal meetings between the parties, prior to the closing date" of a loan, involving oral statements about the audit client's solvency, could satisfy the Credit Alliance test.[15]

Nonetheless, cases like *White v. Guarente* and others finding that a plaintiff has met the Credit Alliance standard have been the exception rather than the rule. Indeed, New York courts have been quite reluctant to find the requisite "linking conduct." For example, in a leading case decided by the Court of Appeals in 1992, *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.*,[16] the plaintiff, a lender, made a telephone call to the auditor to discuss the audit report before extending credit, but was found to lack standing. The Court of Appeals held that the plaintiff failed to prove that the audit had been in some way "shaped" to the plaintiffs needs (thus failing the "particular purpose" prong), and had failed to show that the defendants' participation in the call "evinced" the auditors' understanding of plaintiffs intended reliance (thus failing the "linking conduct" prong). In dissent, Justice Hancock noted that how these terms are interpreted is unclear.[17] As a rationale for its decision, the Court of Appeals approvingly quoted the decision of the lower court, which also held for the defendants, which stated that

> If a lender can secure possible loan recourse against a borrower's auditor by the simple act of calling the auditor before advancing a loan and announcing reliance on the auditor's opinion, then every lender's due diligence list will in the future mandate such a telephone call. For the small price of a phone call, the bank would in effect acquire additional loan protection placing the auditor in the role of an insurer or guarantor of loans extended to client.[18]

In *CMNY Capital, L. P. v. Deloitte & Touche*[19] a federal court applying New York law held that a phone call from the client's president to the auditors was insufficient to establish near privity for a third party lender. Apparently, under New York law, an auditor can be directly informed by either the lender or the company president that a lender intends to rely on the audit, and still have a successful privity defense, so long as there are not other indicia of linking conduct.[20]

II. *PARROTT V. COOPERS*

In *Parrott,* defendant Coopers & Lybrand provided twice-yearly valuations to Pasadena Capital Corp. of company stock held in the company's ESOP plan, in accordance with a continuing letter of engagement dated December 20, 1993.[21] Pasadena was not a public company, so there was no market price for the stock. The company was fairly small, with less than 100 employees. The arrangement between the company and Coopers included a provision that the company would promptly inform Coopers of any significant changes in its management. The December 20, 1993 continuing engagement letter, as well as a 1996 transmittal letter (discussed below), indicated the valuations were being done on a minority shareholder basis, which means that the value would be reduced due to a lack of a controlling interest. Coopers also provided other accounting services to the company.

In 1992, the plaintiff Parrott began employment with Pasadena as a member of the senior management team. He bought 40,000 shares of company stock, under a stock purchase agreement which stipulated that, when his employment terminated, the company would buy back the shares at fair market value, which would be determined by an independent appraisal conducted in connection with the company's ESOP plan. The company had the right to select the appraiser.

In May 1996, Parrott's employment was terminated. The company subsequently informed him that it would repurchase his stock for $78.21 per share, based upon the June, 1996 valuation provided by Coopers. The accountants' June 1996 valuation "was transmitted to Pasadena in an October 2, 1996 letter which stated that the valuation was conducted 'to determine the fair market value of 100% of the common stock of Pasadena, on a closely-held minority basis, for stock transactions involving employees of the company.'"[22] There was no evidence cited that Coopers knew specifically that Parrott's stock was being repurchased by the company, or that its valuation was being used for this purpose.

Parrott challenged the stock repurchase and sought a preliminary injunction in Federal court. After application for an injunction was denied, Parrott and Pasadena entered into a stipulation providing for a $3.9 million repurchase price, without prejudice to Parrott's right to seek a higher price through litigation. The Federal District Court directed that the dispute be submitted to arbitration, in accordance with the stock purchase agreement. The arbitrator rej ected C&L's June 30, 1996 valuation of $ 78.21 per share ($3,128,000) and awarded Parrott a higher amount, based upon an independent calculation of $122.50 per share, or about $4.9 million. Pasadena paid Parrott the nearly $2.5 million difference.[23] During 1997, Pasadena was sold for $172.70 per share. At that value, Parrott's 40,000 shares would have been worth $6.9 million.[24]

Parrott sued Coopers for, among other causes of action, professional negligence and negligent misrepresentation. Coopers moved for summary judgment, seeking dismissal of the negligence claims on the basis that Parrott lacked standing, i. e. that "near privity" did not exist between Parrott and his ex-employer's advisors. While the trial court denied the motion, the intermediate court reversed and granted summary judgment. The Court of Appeals affirmed, dismissing the negligence claims on December 14, 2000.[25]

Both appellate courts held that the plaintiff failed to meet the tripartite Credit Alliance standard, and that the evidence was insufficient to establish that the auditors were specifically aware that their report would be used to value Parrott's stock, or that their conduct "evinced" a link to the defendant. They cited the lack of personal contact between Parrott and the auditors, and the lack of evidence that Coopers' conduct showed specific indications that it knew its valuations were being used by Parrott.

Justice Rosenberger' s dissenting opinion in the intermediate appellate court noted that, in his opinion, the plaintiff had alleged sufficient facts to satisfy the Credit Alliance standard and avoid dismissal. Although the 1996 transmittal letter sent by Coopers describing its valuation "did not specifically mention plaintiff or his recent termination", the dissent explained that "this language and the wording of the contract manifest defendant's awareness that the valuations were performed for this specific limited purpose."[26] Justice Rosenberger further argued that it was likely, given Parrott's senior position in a small company and the company's obligation to inform its auditors of changes in management, that Coopers was aware Parrott had been terminated and that their valuation would apply to his shares. According to the dissent, there was a question of fact — which should have precluded summary judgment -- as to whether Coopers had such awareness.[27]

The dissent made specific reference to factual parallels to the Glanzer v Shepard[28] case where near privity was found. In each, one party to a contract was contractually bound to accept a price based on an independent expert's valuation; in both cases the expert was hired by the other party to the contract. Justice Rosenberger found that while the plaintiff in Parrott may not have been specifically known to Coopers, he was a member of the small and identifiable class of shareholders. The Coopers' valuations were clearly designed to fit the needs of the company for dealing with the class of employee shareholders. Since the accountants performed twice-yearly valuations, the potential use of their reports was not indeterminate in nature, time, or class of user. Justice Rosenberger sought to distinguish between the application of the Credit Alliance standard to general-purpose reports and to special-purpose reports.

> The relationship between the prongs of the Credit Alliance test should be understood as follows. Where the reports themselves have a more general purpose, independent evidence of linking conduct is necessary. Conversely, where defendant, in making the report, manifested a conscious purpose to benefit the group to which plaintiff belonged, Credit Alliance should not be read to require wholly separate additional evidence of linkage. The 1993 letter agreement and the October 2, 1996 transmittal letter from Coopers & Lybrand to Pasadena satisfy both the first and third prongs of the Credit Alliance test, because they set forth the parties' intent that persons in plaintiffs position will rely on it and "evince the accountants' understanding of that part~7r or parties' reliance" (Credit Alliance Corp. v Arthur Andersen & Co., supra, 65 NY2d at 551).[29]

The majority in the Appellate Division, and the Court of Appeals, did not accept Rosenberger's arguments. In particular, the majority decision in the Appellate Division was unwilling to accept the letters as indicating the accountants had exhibited linking conduct. According to the majority opinion "the accountants' discharge of their routine responsibilities was completely unrelated to Pasadena's purchase of plaintiffs stock under the stock purchase agreement."[30] Both courts expressed continued concern that expanding accountants' liability for negligence to include such third parties would make the practice of accounting uneconomical.

III. DO COURTS UNDERSTAND WHAT ACCOUNTANTS ACTUALLY SAY IN THEIR REPORTS?

The court decisions since Ultramares generally do not show an awareness of the major changes that have taken place in the work accountants do, and the reports they issue, since the a 1920's. In Justice Cardozo's day, which was prior to the enactment of the federal securities laws in the 1930's, accountants' reports were prepared mainly for clients' use, and were generally custom-tailored to those clients' specific needs. Any potential usefulness to parties other than the client was an after-thought. On the other hand, modem accountants' reports are generally prepared with an understanding that they will mainly be used to provide third parties with assurance about the representations of management, and that the financial statements are prepared in conformity with widely known accounting and audit standards, promulgated specifically with the interests of third parties in mind.

In his opinion in Ultramares, Justice Cardozo concluded auditors owed no duty to third parties under contract law, and no duty under other theories. He thereby distinguished the fact setting from Glanzer, where the provision of the weigher's report to the buyer was "the end and aim" of the weigher's contract with the seller. Cardozo considered the auditor's report to be "primarily for the benefit of the Stem company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom [the company and its managers] might exhibit it thereafter."[31] In his view, third parties, receiving audit reports that they had not contracted for, would not expect to be treated as if they were the intended recipients.

When one examines the auditor's "certificate" at issue in Ultramares, the basis for Cardozo's opinion becomes clear. That certificate read as follows:

> February 26, 1924
> Touche, Niven & Co.
> Public Accountants
> Eighty Maiden Lane,
> New York
>
> Certificate of Auditors
>
> We have examined the accounts of Fred Stern & Co., Inc. for the year ended December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that, subject to provision for federal taxes on income, the said statement in our opinion, presents a true and correct view of the financial condition of Fred Stem & Co. as at December 31, 1923.[32]

The "certificate" as written is meaningless without further explanations. In particular, the term "examined" means nothing without a reference to what the examination entailed. There was no way to know what the auditors meant by "a true and correct view," since at the time there was no body of "generally accepted accounting principles" to serve as a definition of "correct" accounting. Furthermore, there was no quantification of what seems to be a problem with the accounts with respect to federal taxes. The auditors never claim to be independent. Their letterhead proclaimed them to be "public accountants," rather than "certified public accountants." Both their qualifications and their relationship with the client remain unclear.

In the 1920's, the public accounting profession was in its infancy. Accounting principles, financial statements, and audit reports were often custom-designed for the needs of particular users. Kohler and Pettengill, in a widely used textbook of the period, noted variations on such matters as the scope of detail checking performed and whether receivables and payables were confirmed, inventory was counted, or the existence of fixed assets was verified.[33] Auditors legally could simply accept figures given to them by management "if there is no reason for doubting the honesty of such persons."[34] Indeed, Justice Cardozo's statement that audits were performed primarily for management echoes statements made in the auditing textbooks of the period. For example, Dicksee's Auditing: A Practical Manual for Auditors, listed the "advantages of an audit" as beginning with providing the proprietors of a business with "an accurate statement of their affairs," which "cannot fail to be of the greatest convenience" in a variety of circumstances.[35] At that time, the CPA's duty to the public was unclear. The SEC had not been created, and there were no stock exchange requirements for audited financial statements.

It is now widely recognized that the auditor's role has changed, to be a provider of assurance to third parties. One court said auditors had changed from "watchdog for management to an independent evaluator of financial statements issued by management to stockholders, creditors, and others."[36] The U. S. Supreme Court, in *United States v. Arthur Young & Co.*, stated that "In certifying the public reports that depict a corporation's financial status, the accountant performs a public responsibility transcending any employment relationship with the client, and owes allegiance to the corporation's creditors and stockholders, as well as to the investing public."[37]

While courts have expressed their awareness that users now have different expectations regarding the auditors' role, the courts have not taken cognizance of the effect of these expectations with respect to the actual work done by accountants. Accountants today are required to perform their professional tasks in conformity with the ethical, auditing, and accounting standards promulgated since the 1930's. The FASB and its predecessors have issued well over 200 accounting standards, and the AICPA has issued 94 auditing standards, as well as various industry-specific audit guides and a code of ethics. These standards were intentionally designed to meet the needs of third party investors and creditors.[38] Modern auditors' reports, unlike the report at issue in Ultramares, refer to the auditors' independence, to generally accepted auditing standards, and to generally accepted accounting principles.

Because of the existence of codified professional standards, auditors and clients have far less ability and need to "shape" an audit of financial statements to the needs of a particular third party than in Justice Cardozo's day. The Credit Alliance test, which calls for third parties to demonstrate explicit "linking" conduct of the auditor "shaping" the audit to the needs of third parties, takes no cognizance of the fact that GAAS and GAAP are themselves designed to meet the needs of third parties.

Similarly, the courts deciding Parrott seemed oblivious of the purpose of Cooper's services to Pasadena. The Appellate Division~ s majority opinion noted that:

> There were no written or verbal communications between plaintiff and the accountants on the subject matter of the stock values prior to the report being issued. At best, the accountants acted pursuant to an ongoing engagement with their client--the employer--to simply appraise the stock twice yearly for employee stock ownership plan purposes generally, and this is an insufficient basis upon which to ground a relationship approaching privity with this plaintiff.
>
> Plaintiff concededly never read nor even received the accountants' report, and none had been provided to him. The accountants did not prepare the June 1996 report with any regard to plaintiffs termination. Nor did the accountants have a copy, or even knowledge of, any stock purchase agreement between plaintiff and the company. In sum, the accountants' discharge of their routine responsibilities was completely unrelated to Pasadena's purchase of plaintiffs stock under the stock purchase agreement.[39]

The Appellate Division does not seem to understand the "routine responsibilities" of an appraiser for an ESOP, and therefore, the "end and aim" of Coopers~ semiannual reports. The court stated that "In the present case, the 'end and aim' of the service was to provide an annual accounting for employee pension plan purposes. A potentially different use, such as that herein, was too remote to be foreseeable."[40] The court missed the point that ESOP's are only required to report annually (on Form 5500), so only the valuations Coopers prepared as of the plan's year-end were needed for this routine annual filing. The semiannual reports, valuing the stock as of June, were not needed for routine annual filing purposes and therefore must have had some other purpose.

What could that purpose have been? The purposes for which ESOP's need independent appraisals of company stock, as summarized by Research Institute of America's Federal Tax Coordinator, include "the contribution of employer securities to an ESOP"; "the purchase of employer securities by an ESOP"; "distributions to participants": "the offer of employer securities to the employer by a participant under a right of first refusal"; "the exercise of a put option"; "the allocation of assets to participants' accounts"; and "a participant's diversification election."[41] In each case, the appraisal directly affects the amount of money due between the employer and some third party. The valuation of the securities contributed to the ESOP affects the employer's tax deduction, and hence the IRS and state taxing authorities. The other purposes listed for valuations directly affect the value of participants' interests. Thus, the Appellate Division's statement that the use of the valuations for determining the repurchase price of Parrott's stock was "too remote to be foreseeable" is either disingenuous or badly informed.

On appeal, the Court of Appeals did not discuss the fact that the "end and aim" of a semiannual valuation of company stock in an ESOP had to relate to transactions with plan participants. In this case, Parrott was not a participant in the plan. The court stated

> Finally, no conduct directly linked Parrott and C&L that would evince an understanding by C&L of any reliance on Parrott's part. Parrott relies on a single phrase appearing in a transmittal letter submitted by C&L in connection with the June 30, 1996 valuation which noted that the valuation was performed "for stock transactions involving employees of the Company." However, as previously outlined, there is no indication that C&L knew of Parrott's separate stock purchase agreement or that its valuations would be used to determine the repurchase price of shares pursuant to the termination provision of that agreement. Although Parrott may have been part of a limited and defined class of employees in this small closely held corporation, there is no evidence that C&L was informed that its valuation would be used for the purpose here (cf., White v Guarente, 43 NY2d 356 [the nature and purpose of the accountant's contract with the limited partnership made it clear that the accountant's services were specifically obtained to benefit the members of the partnership who were necessarily dependent upon the defendant accounting firm's

audit to prepare their own tax returns]).[42]

None of the courts in Parrott addressed what procedures the accountants would have performed differently if they had known that their reports were to be used as a benchmark for stock repurchases, and thus what would have "evinced" their acceptance of this use of their report. Since the same valuation methods are used for all ESOP purposes, it is doubtful the courts could have elucidated what such different procedures would have been. Justice Rosenberger' s dissent alluded to this issue when he suggested that reports prepared for a special purpose should be considered to meet the third prong of the Credit Alliance standard.

IV. Discussion

The case law in New York on the duty owed by accountants to non-clients has consistently limited third parties' rights to sue auditors for negligence. The courts began creating this body of law at a time when accountants' work primarily served management's needs for information, and an accountant's engagement was custom-tailored for each client's purposes. In the 70 years since Cardozo's Ultramares opinion, cases interpreting New York law have consistently assumed that third party usage of accountants' reports is generally an incidental by—product of the accountant's contract with the client. Thus, to meet the Credit Alliance standard, a third party must show that the general rule does not apply, and that an audit has been "shaped" to meet the third party's needs.

In the field of accounting, as in so many others, practice has changed dramatically since Cardozo's day. Auditors' reports are now prepared according to well-known standards, for the purpose of providing assurance to third party investors and creditors, and indeed the public at large. So, for example, the ESOP valuation reports at issue in Parrott were prepared in accordance with IRS regulations, and were required to be prepared to support the handling of certain transactions. The courts have generally not recognized that, in a world where accountants' reports must meet external standards, special "shaping" by third parties is no longer necessary for the reports to be useful to third parties. Justice Rosenberger's dissent in Parrott, referred to above, was a rare attempt to deal with this issue.

The courts' attempts to maintain a standard under which accountants can maintain that third parties' reliance on accountants' reports was not anticipated by the accountants, in a world where the whole purpose of accountants' reports is to satisfy third parties' needs for assurance, has resulted, we submit, in an untenable, inequitable and ultimately unworkable body of law.

One unfair aspect of the current law is the evidentiary standard plaintiffs must meet. In various cases, the courts have ruled that a single piece of evidence "evincing" the auditors' "linking conduct" was insufficient. Thus, in Parrott, the Court of Appeals refused to accept as convincing the "single phrase" appearing in a transmittal letter submitted by C&L in connection with the June 30, 1996 valuation which noted that the valuation was performed "for stock transactions involving employees of the Company."[43] As noted above, in Security Pacaic a single telephone call between a lender and the auditors was held insufficient linking conduct, and in CMNY Capital a single telephone call from the client's president to the auditors was also insufficient to establish linking conduct. The rule that these cases suggest, but which the courts have not articulated as a requirement in the linking conduct analysis, is that only repeated contact between the auditors and the third party will allow standing to sue for negligence. Thus, in situations where lenders efficiently conduct business with auditors in a single meeting, or in a single letter, they will be unable to obtain redress for negligent actions, while lenders who insist upon redundant communications will have rights in court. The ability to sue for negligence turns, not upon the underlying reality of the relationship of the accountant, client, and third party, but upon the repetition and documentation of contacts.

The reality was that the accountants in Parrott had to know that the only reason that semiannual valuations of stock in an ESOP plan were needed was for setting values at which stock transactions would occur, and that the current shareholders were the only possible sellers of stock at that price. Thus, the accountants' ability to prevail on a near privity defense is supported by the skimpiness of their own documentation of that understanding.

Reconciling the Court of Appeals' reasoning in Parrott with Glanzer is difficult. Both cases involved a transaction in which one party had contractually agreed to accept a valuation prepared by an independent expert chosen by the other party. In Glanzer, the Court held that the injured party had the right to sue, even though not in contract, because the weigher had to realize that the "end and aim" of a weight certificate was to set a value for transactions. In Parrott, the courts did not recognize that all the possible "ends and aim" of semiannual ESOP stock valuations are to set prices for transactions.

Perversely, near privity jurisprudence creates an incentive for auditors to deviate from generally accepted auditing standards. The Credit Alliance standard effectively rewards auditors for maintaining a willful ignorance with regard to the intended use of their reports. However, to conduct an audit in accordance with GAAS, an auditor is required to understand the intended recipients of the reports, and to design audit procedures to meet those users' needs. For example, GAAS requires an auditor to consider standards of materiality in designing audit procedures, and what facts are material depends critically upon the needs of financial statement users. GAAS requires the maintenance of adequate working paper documentation of the audit. Other auditing standards call upon the auditor to obtain an understanding of the covenants governing the client's current and potential sources of financing, in order to adequately consider the possibility of fraudulent reporting and in order to properly assess the client's ability to continue in business as a going concern.[44] Such an understanding, where it involves designing and implementing procedures to assure a client's continuing compliance with loan covenants, could prove fatal to the auditor's protection from negligence actions under the Credit Alliance doctrine.

Other methods of protecting accountants from excessive liability have been employed in other venues. Under the U. S. Supreme Court's decision in *Ernst & Ernst v. Hochfelder et al.*,[45] auditors cannot be sued under the Securities Exchange Act of 1934 for ordinary negligence. As of 1999, seven states had statutorily limited accountants' duty of care to those parties specifically named in the audit arrangement letters.[46] According to Causey and Causey, in 1999 eight states had privity rules similar to, or stricter than, the Credit Alliance standard, while the majority of states followed the Restatement (Second) of Torts, which is somewhat more liberal to third parties.[47]

Buffington[48] has suggested an intriguing statutory solution to the issue of balancing third parties' rights to redress for negligent actions with the maintenance of the economic viability of accounting firms. He suggests linking the definition of the class with standing to sue to the requirements of auditing standards. In particular, he suggests that:

> The scope of the auditors' liability to third parties should consist of those users whose reliance upon the audit report are components of the auditor's non-negligent assessment of audit risk. Under normal circumstances this liability scope would include all users, since all classes of users should normally be foreseeable to the auditor and would be factored in as risks.[49]

While Buffington's approach would expand accountants' liability to third parties, it would not create the indeterminate expansion feared by Cardozo. The auditor's assessment of audit risk deals with current and anticipated conditions. It does not include unanticipated major expansion or restructuring of the company. Under this standard, the auditor is expected to consider the levels of outstanding debt and equity when planning the audit. So long as these levels do not change materially, the business's creditors and investors would have standing to sue. Whether they can prevail is another matter. They still must establish that negligent acts by the auditors caused their losses, and their claims may also have to withstand the affirmative defense of contributory negligence.

ENDNOTES

[1] For a national perspective on the issue of third parties' rights to bring suit against accountants under state laws, see Christopher Allegaert and Daniel Tinkelman, "Reconsidering the 'Lack of Duty'" Defense to State Auditor Negligence Claims," 25 The Journal of Corporation Law 489 (Spring 2000), Denzil Y. Causey, Jr. and Sandra A. Causey, Duties and Liabilities of Public Accountants (6 Ed. 1999); and Roger Buffington, "A Proposed Standard of Common Law Liability for the Public Accounting Profession, 5 S. Cal Interdisc. L. J. 485 (1997).

[2] 152 Eng. Rep. 402 (Ex. 1842)

[3] 217 N.Y. 382 (N.Y. 1916)

[4] 245 N. E. 377 (N.Y. 1927)

[5] 135 N. E. 275 (N. Y. 1922)

[6] 174 N.E. 441 (N.Y. Appl. 1931)

[7] Id. at 444

[8] This was relaxed in cases alleging gross negligence or fraud.

[9] 483 N.E. 2d 110 (N. Y. 1985)

[10] Id. at 118.

[11] 372 N.E. 2d 315, 320 (N.Y. 1977)

[12] Id.

[13] *Huang v. Sentinel Gov 't Sec.*, 709 F. Supp 1290, 1298 (S.D. N.Y. 1989) (applying New York Law)

[14] *AUSA Life v. Ernst & Young* 991 F. Supp. 234, 253 (S.D. N.Y. 1997) (applying New YorkLaw)

[15] *Cherry v. Joseph S. Herbert & Co.*, 627 N. Y S. 2d 679 (1995).See also *European Am. Bank& Trust Co. v. Strauhs & Kaye*, 65 N.Y. 2d 536 (1985).

[16] 597 N. E. 2d 1080 (N. Y. 1992)

[17] Id. at 1087-95.

[18] Id at 1085-1086. It should also be noted that the court's statement that the auditors would become guarantors or insurers of the loans is misguided. Even if lenders have standing to sue for negligence, they must still prove negligence and establish a link between the negligence and their losses.

[19] 821 F. Supp. 152 (S. D. N. Y. 1993) (applying New York law)

[20] See *European American Bank and Trust Company v. Strauhs & Kaye*, 65 N.Y.2d 536 (1985) for a case where, due to numerous meetings between the lenders and the auditors, the lenders were granted standing.

[21] 702 N.Y.S.2d 40

[22] Id.

[23] 741 N.E.2d 506 at 507, 508

[24] 702 N.Y.S.2d 40

[25] 95 N.Y.2d 479

[26] Id

[27] Id

[28] Op. cit.

[29] Op. cit at 52, 53.

[30] 702 N.Y.S.2d 40

[31] Ultramares, op. cit., at 446.

[32] Ultramares, op. cit., at 442.

[33] Kohler, Eric L., and Paul W. Pettengill Princt~les ofAuditing. A. W. Shaw Company: Chicago (1924), p. 17.

[34] Briggs, L. L. "Accounting and the Courts" The Accounting Review Vol. VI, No. 3 pp. 184-191(Sept. 1931)

[35] Dicksee, Lawrence R. Auditing. A Practical Manual for Auditors, Authorized American Edition, edited by Robert H. Montgomery, (1905) as reprinted in 1976 by Arno Press: New York. The leading English text, Dicksee's Auditing, was edited for the American market by Robert Montgomery. See Causey, Denzil Y. Jr., and Causey, Sandra A., Duties and Liabilities of Public Accountants, Sixth Edition, Accountant's Press: Starkville, MS. (1999), p. 67.

[36] *Rosenblum v. Adler*, 461 A. 2d 138,149 (1983)

[37] 465 U. 5. 805 (1984) at 817-18

[38] See, for example, Statement of Accounting Concepts No. 1, "Objectives of Financial Reporting for Business Enterprises," (FASB, 1978), which derives the objectives of financial reporting "primarily from the informational needs of external users. . . ."

[39] Op. cit.

[40] Op. cit.

[41] Research Institute of America, Federal Tax Coordinator 2d, 1999. Section H-93 18, page 27,587.

[42] 95 N.Y.2d 479

[43] Op. cit.

[44] See, e.g., AJCPA Professional Standards (2000), AU 312 relating to the consideration of materiality in setting the audit plan, AU 341.07 relating to the going concern assumption, and AU 316 related to the consideration of fraud during a financial statement audit.

[45] 425 U. S. 185 (1976)

[46] Causey & Causey, 1999, op. cit., pp. 226-228. The states were Arkansas, Illinois, Kansas, Michigan, New Jersey, Utah, and Wyoming.

[47] Ibid, at 208 and 215. Courts in Connecticut, Idaho, Indiana, and Montana have adopted the Credit Alliance rule.

[48] Roger Buffington, A Proposed Standard of Common Law Liability for the Public Accounting Profession, 5 S. Cal. Interdisc. L. J. 485 (1997).

[49] Id. At 533

A GUIDE TO THE LEGAL AND BUSINESS ASPECTS OF FRANCHISING

by

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Franchising constitutes a huge and growing part of the economy of the United States. More than 300,000 franchised small businesses operating in the United States pump an estimated $1 trillion into the economy each year and provide jobs for some eight million Americans.[1] This phenomenon is not limited to the United States. An example is England where franchising is one of the fastest growing sectors of the economy. During the last year, the number of franchisees in England has risen by 17 percent to 35,200, with yearly turnover reaching 8.9 billion British pounds. Approximately 317,000 people are employed in franchising in England with 29.3 percent of all retail trade in being carried out by franchised businesses.[2] Franchising has entered the Internet era.[3] This shows that this method of doing business should be investigated by all businesses to ascertain if they can profit from selling their products and services using franchising.

REGULATION AND REGISTRATION OF FRANCHISES.

Franchising in the United States is governed by both federal law and state law. Federal law is administered by the Federal Trade Commission.[4] Filing of documents with the Federal Trade Commission is not required to franchise.[5] State laws affecting franchising include franchising laws, business opportunity laws and "Little FTC Acts."[6] In many cases, filing of documentation of approval by the state is required prior to offering a franchise for sale within a particular state. There are also statutes specific to certain industries in some states.[7] In the case of franchising, a state is permitted to enact and enforce laws relating to franchising which act in addition to the provisions of federal law.[8] In addition, franchising is increasingly being regulated by other

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countries.[9]

Unlike securities laws, franchise related laws are not designed to be "Blue Sky" laws, but to provide information to prospective franchisees to enable them to determine if they should purchase a particular franchise.[10] However, some states analyze a franchisor's financial statements and franchise agreements to make value judgments as to them. If these documents do not meet the requirements of some state agencies, "Risk Factor" notices[11] requirements,[12] bonding requirements[13] or even refusal to register an escrow franchise have been imposed.[14]

Originally, franchisors had to use documents drafted according to the requirements of the Federal Trade Commission Disclosure Rule.[15] This created a situation that required different versions of the franchise disclosure document to comply with different state disclosure requirements. To allow franchisors to use the same document on a nationwide basis a Uniform Franchise Offering Circular ("UFOC") was developed (and has been amended) by the Midwest Securities Commissioners Association, and it's successor the North American Securities Administrators Association ("NASAA"). The Federal Trade Commission issued a franchise disclosure rule in 1978 allowing franchisors the option of using the UFOC in lieu of it's document.[16] The UFOC is presently used by most franchisors for this reason. Although different states have different disclosure requirements, in some cases a franchisor can use one UFOC nationwide through the use of state specific language internally in the UFOC and addendums to the disclosure section and the franchise agreement. However, in some cases different states require contradictory disclosures that result in the necessity of having some state specific UFOCs.[17]

The UFOC is composed of several elements. There is generally a federal cover page, a state specific cover page (with different language depending on the state),[18] a Table of Contents (listing the 23 required Items[19] (sections of the UFOC), followed by a list of exhibits in the UFOC), the disclosures for the 23 required Items, financial statements (audited financial statements for the past three fiscal years, with unaudited financial statements that are within 90 days of the filing of the UFOC, if necessary),[20] copies of all agreements that the franchisee must execute and a Receipt page for the UFOC.[21]

To register a franchisor to sell in a state, additional documents must be filed. In New York, franchising is regulated by the office of the New York State Attorney General, Investor Protection and Securities Bureau which requires a facing page, application page, two copies of the UFOC, supplemental information sheet, verification of the application, salesman disclosure forms, consent to service of process, consent to use the franchisor's financial statements in the UFOC signed by the Certified Public Accountant who prepared them and possibly additional forms depending on specific circumstances.[22]

In certain circumstances, state registration is not necessary. Some states do not require registration if a franchisor has a federally registered trademark or service mark and provides a UFOC to prospective franchisees,[23] or if a franchisor has a certain specified amount of net worth,[24] or an offer is made to a maximum of two persons[25] or an offer is made to an existing franchisee.[26]

The Federal Trade Commission has defined what is a "franchise."[27] In addition, each state that requires registration has its own definition of what is a "franchise"[28] to determine if registration or regulation is required by that particular state.

To offer to sell a franchise in or from New York a franchisor must first be registered.[29] This includes the situation when an offer or sale of a franchise is made in New York when an offer to sell is made in New York, or an offer to buy is accepted in New York, or, if the franchisee is domiciled in New York, the franchised business is or will be operated in New York. An offer to sell is made in New York when the offer either originated from New York or is directed by the offeror to New York and received at the place to which it is directed. An offer to sell is accepted in New York when acceptance is communicated to the offeror from New York.[30] Effectively this means that if a franchisor is located in New York it must register in New York to sell franchises either within or without New York State.

ADDITIONAL LEGAL REQUIREMENTS AS TO THE SALE OF FRANCHISES.

If a franchisor wishes to advertise, in many states the advertisement must first be filed with the state.[31] Also, reports as to sales must be filed in various states.[32] A UFOC must be given at least five business days prior to the date agreements are to be executed according to the federal rule.[33] However, many states require that the UFOC be given to the franchisee earlier.[34]

A significant issue in franchising is the venue that litigation will be permitted in the event of a dispute between a franchisor and a franchisee. This issue is usually addressed in the franchise agreement that usually provides for exclusive venue at the franchisor's location. Obviously, if a franchisor is located in New York and a franchisee is located in Texas requiring a franchisee to litigate in New York not only gives the franchisor a huge advantage, but also might even stop a franchisee from commencing litigation in the first place.

When viewing the various state statutes as to franchise law it seems clear the intent of the legislature is to protect the franchisee. This is apparent as to the forum selection clause. Some states explicitly state that forum selection clauses may not be or are not enforceable for franchisees located in their states.[35] In a relatively recent case, a court in New York came to the opposite result and enforced a forum selection clause that required litigation in the franchisor's home state outside of New York.[36]

BUSINESS ASPECTS OF FRANCHISING

Franchising is an excellent way for a business to expand its operations and grow geographically. Unlike a chain system, the franchisor does not have to provide capital, management and employees for each location. This allows a franchisor to increase a company's profits, much more rapidly than if it expanded on its own,

As a franchisor, the company will have franchisees, people who own their own business, working for it. Therefore, the company's franchisees will have every possible incentive to work extremely hard to make their business a success. A person who owns his own business will have a far greater stake in the business and work much harder than a manager, even a manager who receives a percentage of the profits of the business.

The franchisor will also have the advantage that with each new location it will immediately make money in the form of the initial franchise fee. The franchisor typically receives $5,000 to $25,000 as an initial franchise fee. In addition, the franchisor will receive a continuing royalty, usually in the amount of 8% to 10% percent of the gross income of the company's franchisee.

One disadvantage of franchising is that after a franchisee has learned all there is to know about a business he resents paying a continuing royalty. In some cases he will try to find a way to terminate the franchise contract. In other cases he might try to cheat the franchisor since he believes in his mind that he is being cheated.

One other disadvantage to franchising is that the franchisor might be named in litigation involving the franchisee. Typically, this occurs when the franchisee is sued for injuries to its personnel or customers[37] or for various types of alleged discrimination. At this time, if the franchisor has not detailed how the franchisee has acted in this particular area, franchisors have usually been successful in defending these lawsuits.

CONCLUSION

Franchising is an excellent way for a business to expend. Due to the many federal and state requirements as to the various laws that affect franchisors, it is advisable that competent legal counsel who is thoroughly familiar with these laws be retained to avoid potentially devastating pitfalls.

Any questions relating to franchising can be directed to Mr. Kassoff at franatty@concentric. net.

ENDNOTES

[1] International Franchise Association.

[2] "Be Your Own Boss and Cut the Risks," Birmingham Post (09/27/00) P. 24, Philip Williams.

[3] "Electronic Franchise Agreement [Became] Reality October 1"; Franchising World (10/00) P. 21; Klein, Deven; Koch, David. With the deadline for the pending Electronic Signatures in Global and National Commerce Act (E-SIGN) passing it's Oct. 1 implementation date, businesses will now be allowed to complete their contracting process online. E-SIGN legislation makes electronic records and electronic signatures as legally binding as ink signatures.

[4] 16 CFR Part 436, effective October 21, 1979.

[5] Federal Trade Conimission Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Federal Register 49966 (August 24, 1979).

[6] Statues- Arkansas (Franchise Practices Act, Ark. Code of 1987, Title 4, Chap. 72, §4-72-207), California (Franchise Investment Law, Cal. Corporations Code, Div. 5, Parts 1 to 6, §§ 3 1000 to 31516 and Seller Assisted Marketing Plans, Cal. Civ. Code, Div. 3, Part 4, Title 2.7, §§ 1812.200 to 1812.22 1), Connecticut (Business Opportunity Investment Act, Conn. Gen'l Stat., Title 36b, Chap. 672c, §§ 36b-60 to 36b-80), Florida (Franchises and Distributorships, Ha. Stat,, 1995, Chap. 817, §817.416 and Sale of Business Opportunities Act, Ha. Stat., 1995, Chap. 817, §817.416), Georgia (Business Opportunity Sales, Code of Ga., Title 10, Chap. 1, Art. 5, Part 3, §§ 10-1410 to 10-1417), Hawaii (Franchise Investment Law, Haw. Rev. Stat., Title 26, Chap. 482E, §§ 482E-l to 482E5, 482E8, 482E9, 482E1 1 and 482E 12), Illinois (Franchise Disclosure Act of 1987, III Laws of 1987, Chap. 85-55 1 and Business Opportunity Sales Law of 1995, III Laws of 1995, Chap. 815, §§ 602/5-1 to 602/5-135), Indiana (hid. Code, Title 23, Art. 2, Chap. 2.5, §§ 1 to 51 and Business Opportunity Transactions, hid. Code, Title 24, Art.

5, Chap. 8, §§ 1 to 21), Iowa (Business Opportunity Promotions Law, Iowa Code, 1995, Title XX, Chap. 523B, §§ 523B. 1 to 523B. 13), Kentucky (Sale of Business Opportunities Law, Ky. Rev. Stat. and 1988 Supp., Title XXIX, Chap. 367, §§ 367.801 to 367.819 and 367,990), Louisiana (Lou. Rev. Stat. of 1950, Title 51, Chap. 21, §§ 51:1801 to 51:804), Maine (Sale of Business Opportunities Law, Maine Rev. Stat. and 1990 Cum. Pocket Part, Title 32, Chap. 69-B, §§ 4691 to 4700-B), Maryland (Franchise Registration and Disclosure Law, Code of Md., Title 14, §§ 14-201 to 14-233 and Business Opportunity Sales Act, Code of Mci, Title 14, §§ 14-101 to 14-129), Michigan (Franchise Investment Law, Mich. Comp. Laws, 1979, Chap 445, §§ 445. 1501 to 445.1545 and Business Opportunities, incorporated into the Consumer Protection Act, Mich. Comp. Laws, 1979, §§ 445.901 to 445.922), Minnesota (Franchises, Minn. Stat. 1996, Chap. 80C, §§ 80C.01 to 80C.22), Mississippi (lvliss. Code, Title 75, Chap. 24, §75-24-55), Nebraska, Seller-Assisted Marketing Plan Act, Rev. Stat. of Neb. 1943, Chap. 59, Art. 17, §§ 59-1701 to 59-1761), New Hampshire (Distributorship Disclosure Act, N.H. Rev. Stat., Title XXXI, Chap 339-C, §§ 33 9-C: 1 to 339-C:9), New York (General Business Law, Art. 33, §§ 680 to 695), North Carolina (Business Opportunity Sales Law, Gen. Stat. of N.C., Chap. 66, Art. 19, §§ 66-94 to 66-100), North Dakota (Franchise Investment Law, N.D. Century Code, Title 51, Chap. 51-19, §§ 51-19-01 to 51-19-17), Ohio (Business Opportunity Purchasers Protection Act, Ohio Code, Title 13, Chap. 1334, §§ 1334.01 to 1334.15 and 1334.99), Oklahoma (Business Opportunity Sales Act, Ok. Stat., 1991, Chap. 4, §§ 801 to 828), Oregon (Franchise Transaction, Or. Stat., Title 50, Chap 650, §§ 650.005 to 650.085), Rhode Island (Franchise Investment Act, Gen'l Laws of R.I., 1956, Title 19, Chap. 28.1, §§ 19-28.1-1 to 19-28.1-34), South Carolina (Business Opportunity Sales Act, Code of S.C. 1976, Title 39, Chap. 57, §§ 39-57-10 to 39-57-80), South Dakota (Franchises for Brand-Name Goods and Services, S.D. Cod. Laws and 1971 Pocket Supp., Title 37, Chap. 37-5A, §§ 37-5A-1 to 37-5A-87 and Business Opportunities, S.D. Cod. Laws and 1989 Pocket Supp., Chap. 37-25A, §§ 37-25A-l to 37-25A-54), Tennessee ("Little FTC Act," Tenn. Code, Title 47, Chap. 18, §§ 47-18-10l to 47-18-117), Texas (Business Opportunity Act, Tex. Business & Commerce Code, Title 4, Chap. 41, §§ 41.00l to 4 1.303), Utah ("Little FTC Act," Utah Code 1953, 1987 Supp., Title 13, Chap. 11, §§ 13-11-1 to 13-11-23 and Business Opportunity Disclosure Act, Utah Code 1953, 1989 Cum. Supp., Title 13, Chap. 15, §§ 13-15-1 to 13-15-6), Virginia (Retail Franchising Act, Va. Code of 1950, Title 13.1, Chap. 8, §§ 13.1-557 to 13.1-574 and "Little FTC Act," Va. Code of 1950, 1987 Replacement Vol., Title 59.1, Chap. 17, §§ 59.l-196 to 59. 1-207 and Business Opportunity Sales Act, Va. Code of 1950, Title 59.1, Chap. 21, §§ 59. 1-262 to 59.1-269), Washington (Franchise Investment Protection Act, 1989 Rev. Code of Wash., Title 19, Chap 19.100, §§ 19.100.010 to 19.100.940 and Business Opportunity Fraud Act, 1989 Rev. Code of Wash., Title 19, Chap 19.110, §§ 19.110.0l0 to 19.110.9340), Wisconsin (Franchise Investment Law, Wisc. Stat., 1993-94, Chap 553, §§ 553.0l to 553.78 and Wisc. Organized Crime Control Act, Wise. Stat., 1993-94, Chap 946, §§ 946.82) and Washington, D.C. ("Little FTC Act," D.C. Code, 1981, Title 28, Chap 39, §§ 28-3901 to 28-3908).

Regulations- California Administrative Code, Title 10, Chapter 3, Subchapter 2.6, §§ 3 10.000 to 310.505; Hawaii Department of Commerce and Consumer Affairs, Title III, Business Registration, Title 16, Chapter 37, Sections 16 to 37-1- 16-37-8; Illinois Administrative Code, Title 14, Subtitle A, Chapter II, Part 200, §§ 200. 100 to 200.901; Iowa Administrative Code, Insurance Division (191), Chapter 55, §§ 55.1 (523B) to 55.9 (523B); Maryland Code of Regulations, State Law Department, Division of Securities, Title 02, Subtitle 02, Chapter 8, §§ 02.02.08.0l to 02.02.08. 17; Minesota Rules, 1995, Department of Commerce, Chapter 2860, §§ 2860.0 100 to 2860.9930; New York Department of Law, Bureau of Investor Protection and Securities- Codes, Rules and Regulations of the State of New York, Title 13, Chapter VII, §§

200. 1 to 201.16; Oklahoma Business opportunity Regulations, Rules 660:25-1-ito 660:25-1-3, 660:25-3-1, 660:25-3-2, 660:25-Si and 660:25-7-1; Oregon Administrative Rules, Department of Consumer and Business Services, Division of Finance and Securities, Chapter 441, Division 325, §§ 441-325-010 to 441-325-055 and Division 13, §441-13-040; Texas Administrative Code, Title I, Part IV, Chapter 97, §§ 97.i to 97.42; Virginia Administrative Code, Title 21, Chapter 110, §§ 5-110-10 to 5-110-90; Washington Administrative Code, Department of Financial Institutions, Securitites Division, Chapter 460-80, §§ 460-80-100 to 460-80- 910 and Chapter 460-82, §460-82-200 and Wisconsin Administrative Code, Chapters SEC 31 to SEC 36, §§ SEC 31.01 to SEC 36.01.

[7] California (Real Estate Licenses, Cal. Business and Professions Code, Div. 4, Part 1, Chap 3, Art. 3, §10177(m)), Maryland (Gasohol and Gasoline Marketing, Code of Md., Title 11, §11-303), New York (Motor Fuels, General Business Law, Art. 11-B, §199-b and Cigarettes, N.Y. Tax Law, Art. 20-A, §§ 485 to 489), Tennessee (Motor Fuel, Tenn. Code, Title 47, Chap. 25, §§ 47-25-60i to 47-25-607), Vermont (Service Station Operators and oil companies, Vt. Stat., Title 9, Chap. 109, §4 103), Virginia (Motor Vehicles, Va. Code of 1950, Title 46.2, Chap. 15, Art. 7, §§ 46.2-1566 and 46.2-1567) and Washington, D.C. (Retail Service Stations, D.C. Code, 1981, Title 10, Chap 2, § 10-222).

[8] 44 Federal Register 49966 (August 24, 1979).

[9] Australia, Brazil, Canada (Alberta, Ontario and Quebec provinces), China, France, Indonesia, Italy, Korea, Malaysia, Mexico, Romania, Russia, Spain and the European Union.

[10] Federal Trade Commission Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Federal Register 49966 (August 24, 1979).

[11] e.g. New York- 13 N.Y.C.R.R. §200.4(i)(f.).

[12] e.g. N.Y. General Business Law, Art. 33, §685;13 N.Y.C.R.R. 200.6(a).

[13] e.g. N.Y. General Business Law, Art. 33, §685;13 N.Y.C.R.R 200.6(i).

[14] e.g. Minnesota and North Dakota.

[15] 16 C.F.R. Part 436.

[16] 16 C.F.R. Part 436.

[17] e.g. Indiana has required its agent to receive service of process to be listed in Item 1 of the UFOC and Minnesota has required that this information not be included in Item 1 of the IJFOC for any sales of franchises to be made in its state for the same franchisor.

[18] e.g. New York- 13 N.Y.C.R.R. §200.4(i)

[19] e.g. New York- 13 N.Y.C.R.R. §200.4(iii)- Franchisor, Its Predecessors and Affiliates; Business Experience; Litigation; Bankruptcy; Initial Franchise Fee; Other Fees; Initial Investment; Restrictions on Sources of Products and Services; Franchisee's Obligations;

Financing, Franchisor's Obligations; Temtory; Trademarks; Patents, Copyrights and Proprietary Information; Obligation to Participate In The Actual Operation of the Franchise Business; Restrictions on What the Franchisee May Sell; Renewal, Termination, Transfer and Dispute Resolution; Public Figures; Earnings Claims; List of Outlets; Financial Statements; Contracts and Receipt.

[20] e.g. New York- 13 N.Y.C.R.R. §200.4(iii).

[21] NASAA guidelines adopted on April 25, 1993.

[22] e.g. New York- 13 N.Y.C.R.R §200. 10.

[23] e.g. Connecticut (Business Opportunity Investment Act, Conn. Gen'l Stat., Title 36b, Chap. 672c, §§ 36b-6 1(6)) provided a copy of the trademark or service mark is tiled with the state prior to an offer or sale of the franchise in the state.

[24] e.g. New York- net worth of at least $5,000,000 (General Business Law, Art. 33, §684(2)) and an exemption form is filed with the Attorney General prior to offering a franchise for sale.

[25] e.g. New York (General Business Law, Art. 33, §684(3)(c) (with additional conditions).

[26] e.g. New York (General Business Law, Art. 33, §684(3)(d) (with additional conditions).

[27] 16 C.F.R. 436.2 Definitions.
As used in this part, the following definitions shall apply:

(a) The term "franchise" means any continuing commercial relationship created by any arrangement or arrangements whereby:

(1)(i)(A) a person (hereinafter "franchisee") offers, sells, or distributes to any person other than a "franchisor" (as hereinafter defined), goods, commodities, or services which are:

(1) Identified by a trademark; service mark; trade name, advertising or other commercial symbol designating another person (hereinafter "franchisor"); or

(2) Indirectly or directly required or advised to meet the quality standards prescribed by another person (hereinafter "franchisor") where the franchisee operates under a name using the trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor; and

(B) (1) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, marketing plan or business affairs; or

(2) The franchisor gives significant assistance to the franchisee in the latter's method of operation, including, but not limited to, the franchisees business organization, management, marketing plan, promotional activities, or business affairs; Provided, however, That assistance in the franchisee's promotional activities shall not, in the absence of assistance in other areas of the franchisee's method of operation, constitute significant assistance; or

(ii)(A) A person (hereinafter "franchisee") offers, sells, or distributes to any person other than a "franchisor" (as hereinafter defined), goods, commodities, or services which are:

(1) Supplied by another person (hereinafter "franchisor"), or

(2) Supplied by a third person (e.g., a supplier) with whom the franchisee is directly or indirectly required to do business by another person (hereinafter "franchisor"); or

(3) Supplied by a third person (e.g., a supplier) with whom the franchisee is directly or indirectly advised to cb business by another person (hereinafter "franchisor") where such third person is affiliated with the franchisor; and

(B) The franchisor:

(1) Secures for the franchisee retail outlets or accounts for said goods, commodities, or services; or

(2) Secures for the franchisee locations or sites for vending machines, rack displays, or any other product sales display used by the franchisee in the offering, sale, or distribution of said goods, commodities, or services; or

(3) Provides to the franchisee the services of a person able to secure the retail outlets, accounts, sites or locations referred to in paragraphs (a)(1)(ii)(B) (1) and (2) of this section; and

(2) The franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or a commitment to pay to the franchisor, or to a person affiliated with the franchisor.

(3) Exemptions. (not listed here).

(4) Exclusions. (not listed here).

[28] e.g. New York (General Business Law, Art. 33, §681.-
3. "Franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee, or

(b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchise fee. A franehise under this article shall not include any agreement, contract, or franchise subject to the provisions of article eleven-B of this chapter or section one hundred ninety-nine of this chapter, or any agreement or contract for the sale of motor fuel.

[29] New York (General Business Law, Art. 33, §683.1.

[30] New York (General Business Law, Art. 33, §681(12).

[31] e.g. New York (a minimum of seven days prior to use)- 13 N.Y.C.R.R. §200.09.

[32] e.g. New York (annually)- 13 N.Y.C.R.R. §200.08; Maryland (quarterly)- Code of Md. Regulations, Title 02, Subtitle 02, Chap. 8, §.02.02.08. 14.

[33] 16 C.F.R. §436.1(g).

[34]e.g. New York (the earlier of (a) the first personal meeting with the franchisee to discuss the franchise or (b) ten business days before the franchisee signs any binding agreements or pays any money)- 13 N.Y.C.R.R. §204(iii).

[35] California, Illinois, 1ndiana, Minnesota, North Dakota, Rhode Island, South Dakota and Washington.

[36] *B&R Management & Leasing Corporation v. Triarc Restaurant Group, Arby's Inc.*, 269 A.D.2d 804; 703 N.Y.S.2d 635 (App. Div. 4 Dept. February 16, 2000).

[37]*See Walters v. Ramada Franchise Systems, Inc.*, 2000 Tex. App. LEXIS 5673 (Court of Appeals of Texas, Fifth District, Dallas August 24, 2000) in which a franchisor was denied summary judgment because it retained some control over the franchisee's operations.

TEACHING THE TRUTH ABOUT BANK LOANS FOR SMALL OR START-UP BUSINESSES*

by

Peter M. Edelstein**

At Pace University we have a three course basic business law curriculum. Law 101 covers the introductory subjects including contract law. Law 312 covers sales, negotiable instruments and the UCC, among other areas. Law 313 examines the different business units from sole proprietorships, partnerships, and corporations to LLC's. Most of what we teach can be translated into immediately practical knowledge.

One area, however, where the material we teach and real life experiences substantially diverge is how to obtain bank financing especially if the borrower is a small or start-up business. This paper is intended to help our students understand how a lender views the loan process and evaluates a loan application, so he or she may then be able to anticipate and satisfy the lender's requirements.

Applying for a loan is typically viewed as a process involving a person in need of funds applying to an institution that has those finds but is reluctant to lend to the one in need. The borrower may commonly imagine that he or she practically has to beg for the loan. While that scenario may be true in some circumstances, it is not always the case. Lending is a business and lenders cannot make money if they do not lend. Typically, loan officers are motivated to lend because in many cases, the amount of their compensation or bonuses, or their promotions, are dependent on achieving lending goals. But lenders only want to make loans that they believe to be qualified in accordance with their institution's credit guidelines. By empathizing with the lender, and seeing the process from its point of view, the applicant can present and package the loan request so it is perceived by the loan officer as one worthy of consideration.

The issue of the principal's guaranty illustrates the value of viewing the proposed transaction through the lender's eyes. If the borrower is a corporation, LLC or other entity, which features limited liability, principals

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of the borrower tend to be cautious about, if not hostile to, the request to provide a guaranty of the entity's obligations. All the principal can imagine is the borrower's default followed by his or her liability on the guarantee. Yet, to the lender, the request for that guaranty is commonly the first and fundamental requirement for a small business loan. The lender has been taught to ask: . . . Why lend our money? . . . Why put our capital at risk?...when the principal has so little confidence in the venture, that he or she is unwilling to risk his or her own capital?" By inappropriately arguing this point, the loan applicant may not only demonstrate a lack of experience but may actually contribute to the denial of the loan request.

In most small business lending situations the personal guaranty is not, in fact, the actual source of repayment. It is considered a tertiary source, behind cash-flow and collateral. However, in the eyes of many lenders to small businesses, the unwillingness of the principal to risk his or her personal assets in the form of a guaranty, is a substantial negative to be considered in the loan evaluation process.

A successful loan transaction consists of two facets - first obtaining the loan and secondly closing the loan.

A. Obtaining the Loan.

The following points may help our students understand the loan process and contribute to a positive response to the loan application.

1. The Five "C's". Introduce your students to what in the lending community is known as the Five "C's" of credit analysis. They are: a) Character, b) Cash Flow, c) Collateral, d) Credit, e) Capital. These Five "C's" are in the nature of commandments handed down from the Mount Sinai National Bank. They represent a checklist of criteria against which loan applicants are analyzed. Lenders use each of the Five "C's" to inquire as to the following matters:

    a) character: Who are the principals? What are their backgrounds? What is their experience? How do they run the business? (Is there a history of honesty, integrity?) What is the quality of management? What is the depth of management? (Is there a structure in place or is it really only one person?) Is there a plan for succession of management? (Who will take over if the key person is not available?) What is the age of management? What is the lifestyle of the management? (On weekends do they go bird watching or do they race cars?) What is the condition of the health of management? Favorable responses make the lender more comfortable that the loan, if made, will be repaid. A banker recently commented, to emphasize the importance of the "Character" element, that in analyzing applications of small or start-up businesses, he considers the form of the borrowing entity to be irrelevant; that for purposes of this analysis he deems the loan to be made to the principals.

b) cash Flow: Will the borrower be able to pay back the loan from cash flow? What are the cash demands of the business? Can the cash flow be quantified? Is it consistent year-to-year? Is there a trend or is it unpredictable? (Is it seasonal? Is it vulnerable to changes in the economy?)

c) collateral: What will be used to repay the loan if cash flow is not sufficient? What property is available to secure the loan? (Unsecured loans are generally not made to high risk businesses and the lender will want to receive a security interest in everything and anything available). The lender may seek to encumber the particular asset being financed (equipment, accounts receivable, inventory, real estate), or all the business assets, and if that does not suffice, personal assets. What is the valuation of the collateral? Are there any problems associated with the collateral, such as environmental questions or lack of liquidity?

d) credit: What is the credit experience of the borrower and its principals? Has the borrower promptly and fully repaid previous lenders? Has the borrower been current with its trade payables? How have the principals repaid their personal obligations?

e) capital: What and how much do the principals have at risk in the venture? What is the ratio of owner's risk to others' risk? What is the debt to net worth ratio?

By being familiar with the Five "C's" of credit analysis our students can anticipate the lender's concerns and present the loan application and related documents in their most favorable light.

2. Preview the Credit History. If the applicant has a less-than-impeccable credit history, before applying for the loan, the applicant should obtain his or her own credit report. This will show the applicant what the lender may see and enable the applicant to correct any negative or erroneous

information, if possible, or to prepare appropriate explanations.

3. Research the Business and Borrowing Records. If the borrowing entity has been in business for some time, the applicant may wish to obtain a D & B report and UCC searches (Form UCC-1 1) before the lender does. The D & B will disclose general business information about the borrowers and the UCC search will disclose liens of record against its personal property. The applicant may then correct any errors or omissions in the D & B and may obtain any missing release-of-lien documents necessitated by the lien search.

4. In-House Clean Up. The applicant should work with his or her accountant, before submitting the loan application, to study and clean up the borrower's financial statements and to cure or explain any problems. This may avoid potential embarrassment or worse.

5. Be Realistic. It makes sense for the applicant to apply to sources of financing with real chances of success. Time spent with sources obviously unlikely to be responsive will probably be wasted. As a general rule, although there are exceptions, large money center banks are not anxious to lend to start-up or small businesses.

A large bank may feel that small business loans require a high degree of servicing, and relatively higher maintenance. In many cases small businesses cannot afford to maintain high balances on deposit which are a source of profits for institutional lenders. And small businesses and their principals may not buy many ancillary products from the bank such as payroll or investment services. Financing small businesses may be perceived as high risk and low reward.

Some banks, in an effort to reduce the cost of loan application processing and analysis, to reduce their risks, and to improve efficiency have adopted systems of credit scoring for small business loans. While credit scoring has been used for many years in the areas of credit card loans and automobile loans it is now being utilized in small business applications. By this system the completed loan application is graded by giving each response a numerical score. If the total score is over a certain number the loan may be offered, or offered subject to certain conditions, including credit checks or receipt of satisfactory appraisals. If the score falls below the cut off point the loan is rejected. With credit scoring it is more important than ever to attempt to apply to receptive institutions and to submit an impressive loan application package.

A new or small business may have a better chance at securing financing from a bank that has an SBA lender or department, or to a community or regional lender. Even with all the bank consolidations in the last few years, there are still many local banks that may be approachable.

It is often wise to communicate with the business's trade association or even speak to competitors to determine which lenders are already in the particular market and which are familiar with the particular trade or industry and its customs and risks.

6. Prepare a Business Plan. Preparation of a written business plan prior to submitting the loan application may be the single most valuable step in the process. There are many books available on the subject. The applicant's accountant is probably an expert. The plan should explain the business. How long the business has existed; who is involved. What is the nature of the trade or industry. Who or what is the competition. What the future holds. The business plan should include financials, a minimum of three years, if available. Describe the intended "use of proceeds" and the total cost of the project. Explain how the requested funds will help the business. Indicate how much the principals have invested; how much are they putting at risk now. Explain how loan will be paid back. Show how and what funds will be available to repay the lender.

The applicant should be forthright and strive to avoid having the lender discover any surprises. Any existing problems, any that are pending, or any that are anticipated to r arise in the future should be disclosed. It is not only bad form to place the loan officer in the position of announcing problems that the applicant should have recognized, but many lenders, by virtue of having handled other loan applications may be well trained to help in matters of problem solving.

Merely attaching financials to the application is not sufficient, nor does it impress a lender. The business plan should be used not only to explain but should act as a sales brochure. The loan officer may have to present the loan application to members of a committee and the information furnished in the business plan may provide answers to r their questions. The business plan should be reviewed and edited by the applicant's counsel and accountant to assure, to the extent possible, that it is accurate and not misleading.

7. Create and Maintain Banking Relationships. The applicant should work at cultivating banking relationships, if possible, sometime prior to the actual need for funds. He or she should meet the loan officers at the bank

that does or will provide the business checking or payroll accounts.

8. Consider Impressing the Lender. Weigh the potential value of impressing the bank by consolidating the applicant's balances in a single institution against the value of having more than one bank and establishing redundant banking relationships. Because the business world is such a fragile place and because there is no assurance that a particular loan officer will be at any particular institution for any given period of time, it may not be prudent for a borrower to put all its eggs in one basket.

9. Be Creative. The applicant should be creative when necessary. Some alternatives to small business loan products are credit card loans, home equity loans and refinancing of home mortgages.

B. Closing Quickly and Easily.

Once the lender has agreed to make the loan, the process leading up to the closing begins. By being prepared and anticipating the needs of the parties, the applicant can substantially contribute to making the transaction a success. The following suggestions are offered to make the process a smoother and more efficient experience.

1. Promptly Review the Commitment Letter. When the lending institution approves the applicant's loan application, a Commitment Letter is sent which sets forth the terms and conditions of the agreement to lend. The applicant should review the Commitment Letter with counsel before it is signed to confirm it accurately reflects his or her understanding of the transaction. Once the lender has decided to go ahead (probably after a lengthy decision-making process), now everyone is in a hurry. The applicant should not delay. There will probably be a lapse date in the Commitment Letter that should be noted.

2. Promptly Address the Loan Terms. After review of the Commitment Letter, list all points that are incorrect or unsatisfactory. Now is the time to raise business terms with the lender, and legal terms with lender's counsel. If the Commitment Letter (or revised Commitment Letter) is satisfactory, promptly sign and return it.

3. Request an Agenda and Designation of Responsible Parties. Sooner rather than later, the applicant should have his counsel request from the lender's counsel a written agenda or closing document list with "responsible parties" indicated. The applicant should determine what his or her

responsibilities are, and get started. For example: Where is the property insurance policy? Who has the survey? Where are the corporate records? Obtaining all the required documents or information may be complicated or difficult so make sure there is enough lead time.

4. Promptly Exchange Documents. When the applicant has received or prepared documents that are its responsibility, the documents should be promptly sent to counsel for the lender for blessing prior to closing, to avoid surprises and unexpected delays as the closing date approaches.

5. Review Costs and Expenses. The applicant should request all closing numbers prior to closing for review and obtain and bring the proper number and type of checks; e.g. bank or certified.

6. Attendance of Necessary Parties. Arrange to have all necessary parties present at closing for the entire duration of closing. It never fails, that if a party leaves early his or her signature is then required.

7. Powers of Attorney. If the applicant intends to use a Power of Attorney, the lender's advance approval, as to form and substance, should be obtained.

8. No New Issues at Closing. Attempt to have no new issues arise at the closing. The applicant should have raised and resolved all points prior to closing.

The transaction, in which a start-up or small business is the borrower, may involve questions and issues not found in transactions involving more established and creditworthy businesses. By properly preparing, the borrower may be able to obtain funds and close the transaction as expeditiously as possible.

By introducing our students to a little bit of borrowing reality they may be better prepared to apply their business law knowledge in the marketplace.

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