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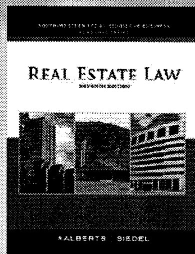

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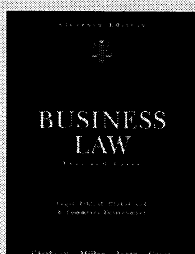

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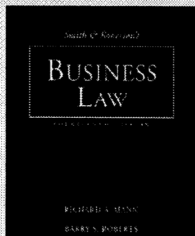

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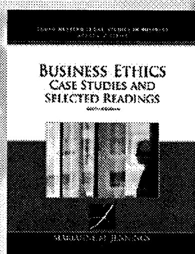

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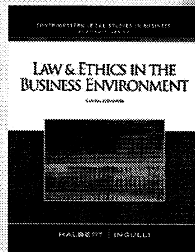

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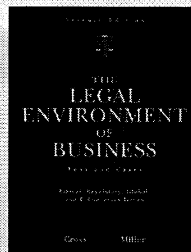

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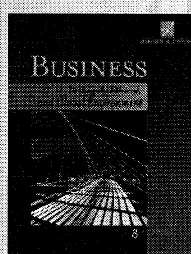

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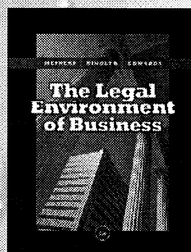

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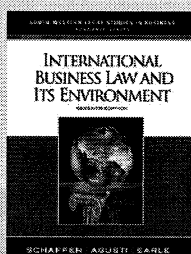

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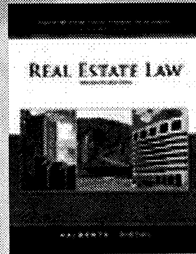

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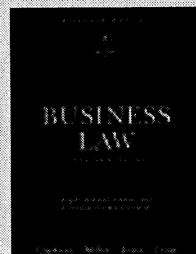

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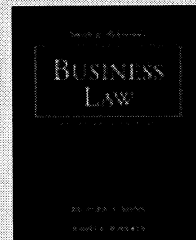

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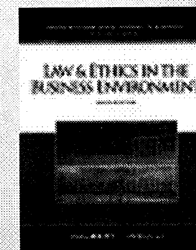

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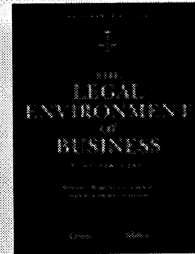

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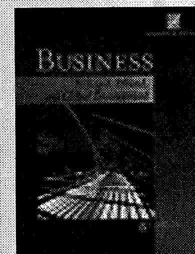

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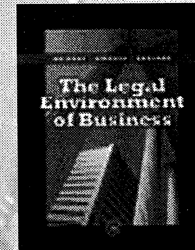

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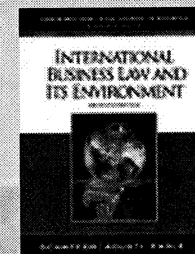

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THE IMPACT OF THE *STEIN* CASES ON THE PRACTICE OF DEPUTIZING THE CORPORATION

by
Regina M. Robson*

The use of prosecutorial discretion in charging decisions has been a potent tool for enlisting cooperation by organizational defendants facing charges of white collar crime. Federal policies have encouraged organizations to demonstrate their cooperation by becoming de facto members of the prosecutor's team and by pressuring employees to waive their constitutional rights. Recently, a series of rulings in the case of *United States v. Stein*,[1] has raised issues which may have a significant impact on the way in which federal prosecutors use organizational cooperation to assist them in conducting criminal investigations.

The *Stein* cases were the first to consider the impact of federal policies designed to encourage organizational cooperation on the constitutional rights of employees under criminal investigation. In attributing the actions of the corporate defendant to the government for Fifth Amendment purposes, the *Stein* court made the prosecutor liable for the actions of its corporate "deputy," and suggested possible limits on the utilization of information procured by organizational defendants anxious to avoid prosecution by demonstrating their own cooperation.

I. BACKGROUND: THE DIFFICULTY IN INVESTIGATING WHITE COLLAR CRIME AND THE ARTFUL USE OF PROSEUCTORIAL DISCRETION

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The term "white collar crime" is commonly used to refer to the non-violent actions of a person or business for the purpose of wrongfully obtaining property or an illegal advantage.[2] Since white collar crime typically occurs during the course of an otherwise legitimate business,[3] victims may be unaware that a crime has been committed at all, with little ability to identify the perpetrator. Moreover, organizational decision making may be so dispersed that no single individual within an organization may have actual knowledge of the entire range of illegitimate activities.[4] Consequently, the expertise and cooperation of insiders is critical if the prosecutor is to establish a case.[5]

One of the prosecutor's most potent tools in securing timely and meaningful cooperation by insiders is prosecutorial discretion: the prosecutor's right to determine whether to prosecute, whom to prosecute and what charges to bring.[6] Moreover, prosecutorial discretion is not subject to legal review.[7]

For business entities facing criminal charges,[8] there is an overwhelming incentive to convince the prosecutor to exercise discretion in favor of pre-trial diversion.[9] It was in recognition of the value of organizational cooperation in the investigational stage of a proceeding, that the government issued *Federal Prosecution of Corporations* in 1999 (hereinafter the "*Holder Memorandum*"), which identified a list of factors to be considered in evaluating corporate cooperation.[10]

The years after the adoption of the *Holder Memorandum* witnessed the prosecution of a number of well known corporations, and a crisis in confidence in the financial markets.[11] Acting on recommendations of the Corporate Fraud Task Force, in 2003, Assistant Attorney General Larry Thompson issued *Principles of Federal Prosecution of Business Organizations*, which became known as the

Thompson Memorandum. [12] Unlike the *Holder Memorandum* which functioned only as guidance to prosecutors, the *Thompson Memorandum* directed prosecutors to consider nine specific factors that evidenced the "authenticity" of an organization's cooperation with a criminal investigation.[13] The most controversial factors included:

> [T]he corporation's willingness to identify the culprits within the corporation...; to make witnesses available; [and] to disclose the complete results of its internal investigation;[14]
>
> ....
>
> ...[A] corporation's promise of support for culpable employees and agents, either through the advancing of attorneys fees, [or] through retaining the employees without sanction for their misconduct ....[15]

The impact of the *Thompson Memorandum* was to propel corporate "cooperation" from a passive, non-obstructionist attitude, to active participation in the government's investigation. In a speech shortly after the promulgation of the *Thompson Memorandum*, then Assistant Attorney General Christopher Wray succinctly advised business organizations seeking to avoid prosecution: "[*Y*]*ou have to get all the way on board and do your best to assist the Government.*"[16] The corporation had to become a "deputy" prosecutor; it had to "help the government catch the crooks."[17]

If the cooperation expected from business organizations was expansive, so too were the rewards. The years following the issuance of the *Thompson Memorandum* witnessed a significant increase in the number of pre-trial diversions of corporate defendants.[18] At the same time, prosecution of

individual defendants increased,[19] resulting in what Lisa Griffin has described as "inverted entity liability" with individual defendants more likely to be prosecuted than their corporate employers.[20]

Not surprisingly, the *Thompson Memorandum* sparked widespread criticism [21] with relatively few defenders.[22] The "cooperation" demanded by the *Thompson Memorandum* has been criticized as an impingement on corporate constitutional protections;[23] a trampling of individuals' constitutional rights;[24] a seismic shift from an accusatory system to an inquisitorial system of justice;[25] and an impetus to false and unreliable statements.[26] It is the application of these constitutionally sensitive provisions of the *Thompson Memorandum* which were at the center of the controversy adjudicated in the *Stein* cases, the first cases to consider the constitutional implications of such policies.[27]

II. ACTION AND REACTION: THE *STEIN* CASES AND THE *McNULTY MEMORANDUM*

The *Stein* cases grew out of a criminal investigation of the firm of KPMG LLP for tax fraud, based on its creation and marketing of certain tax shelters.[28] The hostile tone of the Congressional hearings on tax shelters convinced KPMG that it "intended to cooperate in order to save the firm."[29] After lengthy negotiation with the United States Attorney's Office ("USAO"), KPMG ultimately entered into a Deferred Prosecution Agreement ("DPA") on August 29, 2005.[30] KPMG employees did not fare so well and shortly thereafter the government filed its initial indictment against individual defendants.[31] The individual defendants, all present or former KPMG employees, were the claimants in the *Stein* cases.[32]

A prosecutor may elect to enter into a DPA if, in the opinion of the USAO, the corporation has demonstrated "cooperation."[33] What form that "cooperation" took, and its impact on the constitutional rights of the individual defendants was the subject of two separate actions, *Stein I* and *Stein II.*

In *Stein I*, the court held that KPMG's termination of advancement of attorneys' fees to the individual defendants violated their Fifth Amendment Due Process rights and Sixth Amendment right to counsel.[34] Although it declined to dismiss the indictments against the individual defendants, the court invited them to bring an action against KPMG for the recovery of their legal expenses.[35] While a detailed analysis of the Due Process and Sixth Amendment right to counsel claims are beyond the scope of this paper, recent cases suggest that with regard to these issues, *Stein I* may be limited to its somewhat convoluted facts.[36]

In *Stein II*, nine individual defendants claimed that certain statements made in response to KPMG's threats were the result of unlawful government coercion in violation of the defendants' Fifth Amendment right against self incrimination.[37] Observing that the Fifth Amendment restricts governmental and not private conduct,[38] the *Stein* court noted that economic pressure exerted by an employer could amount to unconstitutional coercion only if such action could be "fairly attributable" to the government.[39] The court relied on *United States ex rel Sanney v. Montanye*[40] to illustrate the connection between government action and economic leverage leveled by private actors. *Montanye* involved a private employer who conducted a polygraph of an employee who was suspected of murder.[41] The employer conducted the polygraph at the request of the police department, and transmitted information directly to it through the use of a hidden transmitter.[42] The employer threatened the employee with

termination if he refused to submit to the polygraph.[43] In attributing the action of the employer to the police, the *Montanye* court held that "[t]he state had involved itself in the use of a substantial economic threat to coerce a person into furnishing an incriminating statement."[44] Applying the *Montanye* standard, the *Stein* court held that KPMG's threats to cut off legal fees were attributable to the government.[45] By brandishing a big stick – the threat of indictment – and offering a tempting carrot – the possibility of a deferred prosecution agreement - the government made KPMG a part of its team.[46]

The court also distinguished two second circuit cases[47] which found that actions of stock exchanges in proceedings against member brokers could not be attributed to the SEC for Fifth Amendment purposes, despite the fact that the exchanges routinely communicated the results of their investigation to the SEC. The *Stein* court noted that while the stock exchanges had commenced an investigation as part of administering their own rules, independent of a government request, the actions of KPMG were not routine self-policing, but were initiated because of a government investigation, aimed squarely at KPMG itself.[48] Although the findings of investigations conducted by the exchanges were routinely reported to the SEC, the SEC had no prior knowledge of the investigations and had not pressured the exchanges to commence an inquiry.[49] In contrast, the *Stein* court found that the government had "quite deliberately coerced and in any case, significantly encouraged," KPMG to pressure its employees to cooperate.[50] The court found that *both* the investigatory policies of the government *and* the misconduct of the USAO[51] created a clear nexus such that KPMG's actions could be imputed to the government. [52]

Shortly after the decisions in the *Stein* cases, criticism of the *Thompson Memorandum* appeared to reach a tipping point and

on December 7, 2006, the Attorney-Client Privilege Protection Act was introduced in the Senate.[53] The Bill prohibited prosecutors from requesting waivers of attorney-client or work product privileges or considering the advancement of an employee's legal fees in any charging decision or cooperation credit.[54]

Less than five days after introduction of the Senate bill, Deputy Attorney General Paul McNulty reacted by issuing the *McNulty Memorandum*.[55] While leaving much of the language of the *Thompson Memorandum* undisturbed, the *McNulty Memorandum* made two significant changes with respect to the government's consideration of corporate cooperation: it required explicit approval for prosecutors seeking waivers of attorney client and work product protections;[56] and it prohibited prosecutors from considering a corporation's advancement of legal fees as a factor weighing against a finding of corporate cooperation,[57] except in "rare" circumstances approved by the Deputy Attorney General.[58]

While the *McNulty Memorandum* can be said to have increased the transparency of the government's requests for information, it in no way limited the actions which a business entity could "volunteer" to secure cooperation credit. Moreover, it left undisturbed the fundamental principle guiding the exercise of prosecutorial discretion in charging decisions: "authentic cooperation" requires an organization to help the prosecutor discover and prosecute wrongdoers. After almost five years of experience with the *Thompson Memorandum,* corporate counsel have a good idea of the type of cooperation that makes a prosecutor smile. If, after the *McNulty Memorandum,* prosecutors may no longer consider advancement of fees as a failure to cooperate, that does not mean that they cannot consider a voluntary corporate policy which terminates or denies advancement of fees to employees

who are targets of an investigation.[59] For the employees involved, the outcome is virtually indistinguishable.

III. THE IMPACT OF THE *STEIN* CASES ON THE PRACTICE OF "DEPUTIZING" THE CORPORATION

Given the limited impact of the *McNulty Memorandum* in circumscribing the scope of corporate cooperation, the question remains: will *Stein* have any impact on federal investigational techniques? Part III of this paper considers what impact *Stein* may have on the federal policy of deputizing business entities to assist in the investigation of white collar crime and the types of actions which signify corporate cooperation.

It is settled law that the Fifth Amendment right against self-incrimination does not apply to private actors, but only to state action.[60] Private employers are free to conduct internal investigations of actual or perceived wrongdoing, and may terminate employees who refuse to cooperate or make statements.

The question of whether a private action can be attributed to the government for state action purposes under the Fifth or Fourteenth Amendments generally arises when state and private actions are blurred, either because the state has delegated to a private actor an action which traditionally has been the prerogative of the state,[61] or because there is such a "close nexus" between a private action and the state as to make the decisions of the private party those of the state.[62] Moreover, the actions of the government do not escape the label of "state action" when the government acts in a quasi-private manner such as an employer[63] or purchaser.[64]

Defendants claiming state action based on the actions of private entities face a high hurdle. For example, courts have

refused to consider the actions of stock exchanges in investigating their members as state action, despite acknowledging the responsibility of the exchanges for self-policing, arguably a function traditionally reserved to the state.[65] Defendants claiming that pervasive government regulation of an industry is tantamount to state action, have fared no better.[66] The fact that a private entity is highly regulated is not sufficient, without more, to make its actions attributable to the government. [67] In those cases where the courts have attributed the acts of a private actor to the state, they have done so only where the private actor admitted to being an agent of the state,[68] or where there was government knowledge of or acquiescence to actions taken by the private entity.[69]

The question of imputing the actions of private entities to the government has become even more critical in light of federal policies which equate cooperation with helping to "catch the crooks." Deputizing corporations to assist in the investigation of white collar crime can have far ranging effects on employees, particularly in light of the trend toward prosecution of "secondary" offenses.[70] Federal statutes impose criminal liability on any person who influences, or obstructs a federal investigation,[71] or who lies to a federal agent, without regard to whether the statement is made under oath.[72] Perhaps the most aggressive instance of deputizing a private party involved an investigation of Computer Associates International, Inc. In that case, an executive pleaded guilty to a charge of obstruction because of false statements made to auditors and an outside law firm which he himself had hired to conduct an internal investigation.[73] Although the statements were not made under oath, the government took the position that the executive was liable because he knew that the results of the investigation were to be shared with the government in an effort by the company to demonstrate its cooperation.[74] In

effect, there was no distinction between lying to the prosecutor and lying to an agent of the corporation.

In its investigation of Computer Associates, the government "benefited" from the actions of its unofficial deputy by being able to bring obstruction charges based on the statements made to its deputy.[75] The S*tein* court expanded this reasoning to its logical conclusion, holding prosecutors responsible when corporate deputies use coercion to secure statements from employees in violation of their Fifth Amendment rights.[76]

The critical inquiry, the *Stein* court noted, is whether the government "commands or significantly encourages a private entity to take the specific action."[77] In *Stein,* the court found that the "encouragement" took two forms: prosecutorial misconduct *and* the federal policies embodied in the *Thompson Memorandum*.[78] By basing its decision, not only on the actions of the prosecutor but also on the policy itself, the court implied that deputizing private entities to assist in federal investigations may be constitutionally suspect – even without specific requests for cooperation by individual prosecutors.[79] The court reasoned that the policies embodied in the *Thompson Memorandum* were *intended* to exert enormous pressure on target organizations for the very purpose of encouraging them to coerce statements from employee defendants.[80]

Taken to its logical conclusion, the *Stein* court expanded the circumstances in which the actions of a private entity can be imputed to the government for Fifth Amendment purposes. Analogizing to the techniques used in investigating "street crimes," it is as if the prosecutor accepted "cooperation" from an accused bank robber, knowing full well that the robber will secure admissions from his accomplice by wielding a baseball bat over his head. *Stein* can be read as imposing a kind of prosecutorial "respondeat superior" wherein a prosecutor is

strictly liable for actions of a private party trying to demonstrate cooperation – without regard to any overt misconduct by the prosecutor or self-interest of the corporate deputy.

IV. CONCLUSION

The ultimate impact of the decision in *Stein* will depend on which strand of the court's holding proves dominant. If *Stein* is viewed as a prosecutorial misconduct case, the benefits for individual defendants asserting constitutional protections may be short lived. The *McNulty Memorandum*, while providing more transparency for prosecutors' requests for corporate cooperation, does little to discourage over-the-top corporate efforts to demonstrate cooperation. Hewlett-Packard Company's recent use of "pretexting" to track down leaks in its Boardroom suggests that corporations may have innovative techniques for conducting internal investigations – even without the overarching threat of a criminal indictment.[81] In the *Stein* case itself, KPMG demonstrated its creative approach to cooperation by requesting that the government identify those of its employees who were not being fully cooperative. In an effort to curry favor, it then boasted that it had done something "'never heard of before'– condition[ing] the payment of attorney's fees on full cooperation with the investigation."[82] Arguably, any policy of conditioning corporate leniency on investigational cooperation is an impetus for organizational actions which could be devastating to individual constitutional rights.

If, however, subsequent courts adopt the second rationale of *Stein* - the rejection of investigative policies which spur organizations to demonstrate their cooperation at the expense of their employees – individual subjects of criminal investigation may find that their constitutional rights are not

rendered moribund as soon as a corporate prosecution appears likely. *Stein* lays the groundwork for a ruling that would, at a minimum, suggest that there are some actions which a corporation cannot even "volunteer" and which cannot be considered by prosecutors, even if they have had no role in requesting or encouraging the action.

Unless the challenge laid down by the *Stein* court is followed by other courts in considering federal prosecutorial policies, then *Stein* risks being confined to its facts, an interesting, but ultimately minor addition, to the debate on the evolving role of the corporation as a deputy prosecutor in white collar criminal cases.

ENDNOTES

[1] United States. v. Stein, 435 F. Supp.2d 330 (S.D.N.Y. 2006) (hereinafter "*Stein I*"); United States v. Stein, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) (hereinafter "*Stein II*" and collectively with *Stein I,* the *"Stein* cases").

[2] James W. Coleman, *Toward an Integrated Theory of White Collar Crime,* 93 AM. J. SOC. 406, 407 (1987).

[3] *Id.*

[4] Under the collective knowledge doctrine, a corporation can be held liable for a crime even if no single person within the corporation had complete knowledge that a crime had been committed and even if no natural person could be prosecuted for the activity. United States v. Bank of New England, 821 F.2d 844, 856 (1st Cir. 1987).

[5] Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure,* 82 N.Y.U. L.REV. 311, 340-42 (2007); Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World; The Thompson Memorandum in Theory and Practice,* 43 AM. CRIM. L. REV. 1095, 1170-71 (2006).

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[6] See Leonard Orland, *Transformation of Corporate Criminal Law,* 1 BROOK. J. CORP. FIN. & COM. L. 45 (2006) for an excellent discussion of all of the options available to a prosecutor who has sufficient evidence to indict.

[7] Lance Cole, *Revoking Our Privileges: Federal Law Enforcement's Multi-Front Assault on the Attorney-Client Privilege (And Why It Is Misguided)*, 48 VILL. L. REV. 469, 552-53 (2003).

[8] Corporations have been labeled "eggshell defendants" whose vulnerability to adverse market reactions motivates them to avoid indictment at all costs. Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 72-74 (2007).

[9] Prior to 1993, pre-trial diversions were used primarily for street crime. Oreland, *supra* note 6, at 57. Pre-trial dispositions of cases accelerated after the promulgation of the *Thompson Memorandum*, (*see also infra* notes 18-20 and accompanying text) and the Sarbanes Oxley Act. Orland, *supra* note 6, at 49-52.

[10] Eric Holder, *Principles of Federal Prosecution of Business Organizations* http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html (1999) last visited 11/13/06. Prior to 1999, the exercise of prosecutorial discretion in charging decisions was essentially a departmental matter, loosely guided by the provisions of the U.S. Attorney's Manual. *See* Lawrence D. Finder & Ryan D. McConnell, *Devolution of Authority: The Department of Justice's Corporate Charging Policies,* 51 ST. LOUIS L. J. 1,7 (2006).

[11] Wray & Hur, *supra* note 5, at 1100-1101.

[12] Larry D. Thompson, *Principles of Federal Prosecution of Business Organizations* www.usdoj.gov/dag/cftf/corporate_guidelines.htm. (last visited Jan. 5, 2007).

[13]*Id.* In directing additional attention to a corporation's "authenticity" while ignoring the "authenticity" or sincerity of individual defendants, the *Thompson Memorandum* seems to depart from its own requirement that corporations should not be treated more harshly than individual criminal defendants. *Id.* at II (A). The "authenticity" of corporate cooperation

contained in the *Thompson Memorandum* appears to incorporate a standard similar to the "corporate ethos" standard of criminal liability. *See* Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability,* 75 MINN. L. REV. 1095 (1991).

[14] *Thompson Memorandum*, *supra* note 12, at VI (A).

[15] *Id.* at VI (B). (footnote omitted). An exception was made in those instances where advancement of attorneys' fees was required by law. *Id.*

[16] Christopher A. Wray, *Remarks to the Association of Certified Fraud Examiners Mid South Chapter*, (Sept. 2, 2004), http://www.usdoj/gov/criminal/press_room/speeches/2004.htm. (emphasis added).

[17] Interview with United States Attorney James B. Comey Regarding Department of Justice's Policy on Requesting Corporations Under Criminal Investigations to Waive the Attorney Client Privilege and Work Product Protections, U. S. ATTY'S BULL. 1 (Nov. 2003).

[18] Griffin, *supra* note 5, at 321-36. Griffin suggests that the emphasis on individual liability was in part a response to the public outcry over the investigation of Arthur Andersen which resulted in significant collateral damage to corporate stakeholders, despite the fact that the firm was cleared of wrongdoing. *Id* at 331-32.

[19] Since 2003, the Department of Justice obtained convictions of 160 executives in 1000 corporate fraud cases. *The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations: Hearing Before S. Judiciary Comm.,* 109th Cong. (2006) (Statement of Paul J. McNulty, Deputy Attorney General, United States Department of Justice) http://www.usdoj.gov/dag/testimony/2006/091206dagmcnulty_testimony_thompson_memo.htm.

[20] Griffin, *supra* note 5, a*t* 332-33. The *Thompson Memorandum* included language which suggests that individual defendants would still be prosecuted even if the corporate entity pled guilty. *Thompson Memorandum, supra* note 12, at I (B).

[21] *See* John Hasnas, *Ethics and the Problem of White Collar Crime,* 54 AM. U. L.REV. 579, 602-19 (2005); Bruce A. Green & David C. Clifton, *Feeling*

a Chill: Changing Government Policies Are Pressuring Corporations And Attorneys to Disclose Protected Information, 91 A.B.A. J. 60 (2005).

[22] Although recognizing its shortcomings, the *Thompson Memorandum* has been defended by prosecutors, most recently by Deputy Attorney General Paul J. McNulty who noted: "The [Thompson] Memo promotes specific aspects of good corporate governance and presents a rational plan of action to a corporation facing criminal charges....The Thompson Memo is transparent, simple and relies on the common sense prosecutors have been using for years." Paul J. McNulty, Deputy Attorney General, *Let's Make A Deal: The Question of Privilege, Prepared Remarks before the National Association of Securities Dealers* (Sept. 13, 2006) at http://www.usdoj.gov/dag/speech/2006/dag_speech_060913.htm (last visited 2/22/07).

[23] *See Conference Report on the ABA Annual Meeting*, 74 U.S. LAW WEEK 2091, 2092 (2005).

[24] Earl J. Silbert & Demme Doufekias Joannou, *Under Pressure to Catch the Crooks: The Impact of Corporate Privilege Waivers on the Adversarial System,* 43 AM. CRIM. L. REV.1225, 1225-26 (2006).

[25] George Ellard, *Making the Silent Speak and the Informed Wary: False Statements to Impede Government Investigations,* 42 AM. CRIM. L. REV. 985, 990 (2005) (The *Thompson Memorandum* is moving the criminal justice system from an accusatorial to an inquisitorial system).

[26] Griffin, *supra* note 5, at 334-47. *See also* Mary Beth Buchanan, *Effective Cooperation by Business Organizations and the Impact of Privilege Waivers,* 39 WAKE FOREST L. REV. 587 (2004).

[27] In response to the criticism sparked by the *Thompson Memorandum*, and perhaps in anticipation of the court's rulings in the *Stein* cases themselves, Acting Deputy Attorney General, Robert McCallum, Jr. issued a directive (the "*McCallum Memorandum*") requiring each district to formulate a written policy designed to make the process or requesting a waiver more transparent. *See, ABA 2006 Legislative Priorities* http://www.abanet.org.poladv/ priorities/priviledgewaiver.html (last visited January 13, 2008. The *McCallum Memorandum* was superceded by the *McNulty Memorandum* on December 12, 2006. *See infra* note 55 and accompanying text.

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[28] 435 F.Supp. 2d at 362.The action had been commenced by the IRS. United States v. KPMG LLP, 316 F. Supp. 2d 30 (D.D.C. 2004). Congressional hearings soon followed. *See U.S. Tax Shelter Industry: The Role of Accountants, Lawyers and Financial Professionals, Hearing Before the Permanent Subcomm. On Investigation of the S. Comm. on Governmental Affairs,* 108th Cong. 2 (2003).

[29] 440 F. Supp. 2d at 320.

[30] 435 F. Supp. 2d at 349. Among other things, the DPA also required KPMG to continue to cooperate with the government or risk that the government would reinstate prosecution. *Id.*at 349-50.

[31] *Id.* at 350.

[32] Seventeen individual defendants were moving parties in *Stein I,* claiming violation of due process and the Sixth Amendment right to counsel; nine of the seventeen defendants were also moving parties in *Stein II,* claiming violation of the Fifth Amendment right against self incrimination.

[33] *Thompson Memorandum, supra* note 12, at II (A) (4) and II (A) (6).

[34] 435 F. Supp. 2d at 380-82.

[35] Because KPMG was not a party to the action, the issue of whether KPMG had a legal obligation to advance attorneys' fees was not technically before the court. The defendants subsequently brought a claim against KPMG to adjudicate its legal and contractual obligations. United States v. Stein, 452 F. Supp. 2d 281 (S.D. N.Y. 2006). The Second Circuit Court of Appeals subsequently dismissed the case, holding that the district court's assertion of ancillary jurisdiction over the state law claims was improper. United States v. Stein, 486 F.3d 753 (2d Cir. 2007).

[36] As of this writing, two other cases have considered *Stein I* and dealt, in some measure with the *Thompson Memorandum*, claiming violations of substantive Due Process under the Fifth Amendment and the right to counsel under the Sixth Amendment. United States v. Rosen, 487 F. Supp.2d 721 (E.D. Va. 2007), distinguished *Stein I* by finding no presumption of prejudice in a corporation's termination of attorney fees to accused employees since case was less complex than *Stein* and attorneys

continued to represent clients without advancement of fees; United States v. Galante, No. 3:06 CR 161 (EBB), 2006 WL 3826701 at 81 (D. Conn. Nov. 28, 2006) found *Stein I* was inapplicable where termination of fees was the result of post indictment freeze on corporate assets. In a third case, a Texas jury did award a former Dynegy, Inc. employee legal fees which had been terminated by his employer in an effort to show cooperation in accordance with the *Thompson Memorandum*. Paul Davies & David Reilly, *In KPMG Case, The Thorny Issue of Legal Fees*, WALL. ST. J. June 12, 2007 at C5. None of these cases involved an allegation of a violation of the Fifth Amendment right against self-incrimination.

[37] 440 F. Supp. 2d at 319. The claimants in *Stein II* had received a letter from KPMG capping the advancement of legal fees at $400,000, and conditioning its advancement of fees on the individual's cooperation with the government. *Id.* at 321. Two claimants alleged that they were threatened with termination of employment if they did not cooperate. *Id.* Each of the claimants ultimately made a statement to the government; however, the court found that all but two of the defendants had failed to establish that they had felt subjectively coerced into making a statement because of KPMG's threats to terminate advancement of legal fees. *Id.* at 338.

[38] *Id.* at 333-34 *citing* D.L. Cromwell Invest. Inc., v. NASD Regulation, Inc., 279 F.3d 155 (2d Cir. 2002).

[39] *Id.* at 334 *quoting* Blum v. Yaretsky, 457 U.S. 991 (1982) (further citations omitted).

[40] 500 F.2d 411 (2d Cir. 1974).

[41] 500 F.2d at 414.

[42] *Id.*

[43] *Id.*

[44] *Id* at 415. Although the *Montanye* court did find that the employer's actions amounted to state action, it found no violation of the defendant's constitutional rights, reasoning that the defendant failed to establish that he subjectively felt coerced by the employer's threats.

[45] 440 F. Supp.2d at 334.

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[46] *Id.* at 337-38.

[47] United States v. Solomon, 509 F.2d 863 (2d Cir. 1975); D.L. Cromwell Invest., Inc. v. NASD Regulation, Inc., 279 F.3d 155 (2d Cir. 2002).

[48] 440 F. Supp.2d at 336-37.

[49] 279 F.3d at 163.

[50] 440 F. Supp. 2d at 337.

[51] The "misconduct" cited by the court included reminding KPMG that the USAO would view payment of legal fees "under a microscope" and acceding to KPMG's request that it identify uncooperative employees. *Id.* at 336-37.

[52] *Id.* at 337 (citations omitted).

[53] Attorney-Client Privilege Protection Act, S. 186, 110th Cong. (2007).

[54] *Id.*§3(b)(1)-3(b)(2). As of this writing, the Senate bill has not been reported out of committee. A similar bill has been passed by the House. *See,* Attorney-Client Privilege Protection Act 2007, H.R. 3013, 110th Cong. (2007).

[55] Paul J. McNulty, *Principles of Federal Prosecution of Business Organizations,* http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf (hereinafter the "*McNulty Memorandum*").

[56] *Id.* at VII (B) (2). The *McNulty Memorandum* does not prohibit the government from asking for a waiver of the attorney client and work product protections. Rather it classifies the type of information being sought by the government into two categories and then provides detailed procedures for prosecutors who wish to request waivers. A corporation's response to a request for Category I information ("purely factual information") may be considered in evaluating corporate cooperation while a negative response to a request for Category II information (legal advice or attorney work product) may not be considered in evaluating cooperation. *Id.* at VII(B)(2) – VII(B)(3). Moreover, a corporation's voluntary waiver of protection may be favorably considered. *Id.* at VII(B)(3).

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[57] *Id.* at VII (B) (3).

[58] *Id.* at VII (B) (3). The *McNulty Memorandum* suggests that advancement would have to be part of a larger scheme to impede the investigation. *Id.*

[59] Prosecutors may also consider a corporation's participation in joint defense agreements as indicating a lack of cooperation. *McNulty Memorandum, supra* note 55, at IV (B) (4).

[60] Shelley v. Kraemer, 334 U.S. 1, 13 (1948).

[61] Blum v. Yaretsky, 457 U.S. 991,1004 (1982).

[62]Jackson v. Metropolitan Edison Co., 419 U.S. 345, 350 (1974) (certificate of public convenience and significant regulation by the state insufficient to impute action of a utility in terminating service to the government).

[63]Garrity v. New Jersey, 385 U.S. 493 (1967) (statute requiring termination of police officers if they failed to make a statement violated their Fifth Amendment right against self-incrimination).

[64] Lefkowitz v. Turley, 414 U.S. 70 (1973) (statute barring an individual from bidding on state contracts unless he waived Fifth Amendment right against self-incrimination held unconstitutional).

[65] 509 F.2d at 868-69.

[66] 419 U.S. at 351 (fact that Medicaid program licensed facilities and subsidized the medical expenses of over ninety percent of nursing home patients insufficient to constitute state action).

[67] *Id. See also* Desiderio v. National Ass'n of Securities Dealers, Inc. 191 F.3rd 198, 206 (2d Cir.1999), *cert. denied,* 531 U.S. 1069 (2001).

[68] 500 F.2d at 414.

[69] United States v. Walther, 652 F.2d 788, 793 (9th Cir. 1981) (citations omitted) (government knowledge and acquiescence in search by private party constituted state action). *But see* Blum v. Yaretsky, 457 U.S. at 1004-

05 ("Mere approval of or acquiescence in the initiatives of a private party is not sufficient to justify holding the State responsible ....").

[70] Hasnas, *supra* note 21, at 602-19.

[71] 18 U.S.C.§§1503,1505,1510,1512,1519-1520 (2006).

[72] 18 U.S.C. §1001(2006). The language of this statute is so broad that even an "exculpatory no" in response to a question has been held to be a false statement. Brogan v. United States, 522 U.S. 398,401 (1998).

[73] *Wray* & Hur, *supra* note 5, at 1147-48.

[74] Indictment, §§51-59,75-79, United States v. Kumar, Cr. No. 04 Cr. 0846 (E. D. N.Y. filed Sept.20, 2004). *See also* Alex Berenson, *Software Chief Admits to Guilty in Fraud Case,* N.Y. TIMES, Apr. 24, 2006 at A1.

[75] *See* Griffin, *supra* note 5, at 373-374.

[76] 440 F. Supp.2d at 337 n. 114.

[77] *Id.* at 334 (citations omitted).

[78] *Id.* at 337-38.

[79] In *Stein I,* the court softened its finding of prosecutorial misconduct, noting that the USAO's actions were consistent with policy and occurred before any court consideration of such policies. 435 F. Supp.2d at 381.

[80] 440 F. Supp.2d at 337-38.

[81] Miguel Helft, *H.P. Read Instant Messages of Reporter*, N.Y. TIMES, Sept. 30, 2006, at C8. Other techniques included twenty-four hour surveillance, procurement of telephone records and background checks. *Id.*

[82] 435 F. Supp.2d at 349 (citation omitted).

TAX COURT REVERSES COURSE ON DEDUCTION FOR MBA COSTS

by
Martin H. Zern *

I. INTRODUCTION

Anyone considering obtaining a Master of Business Administration degree (MBA) is no doubt acutely aware that the cost of the degree is expensive and, if past is prologue, will continue to increase.[1] Additionally, for a full-time student, cash is needed for everyday expenses, such as, housing, food and utilities, which will have to be paid through borrowing or savings. Moreover, full-time students forego opportunities for advancement and the gaining of experience they could have by working and going to school part time. Obviously, those striving for an MBA anticipate that it will more than compensate for the cost and lost opportunities. Whether the anticipation is likely to become the reality has been questioned. For instance, a professor teaching in a top-tier business school, to the apparent dismay of his colleagues, has posited that MBA holders seemed no more successful than persistent business leaders without the degree.[2] Nevertheless, MBA programs are popular and likely to stay so.[3]

If the cost of the MBA can be taken as a tax deduction, however, the cost is to some extent subsidized by the government, the exact benefit correlated with one's tax bracket.

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As a result of some Tax Court decisions in 2002 and 2004, however, there was considerable concern among tax professionals that a deduction for the costs of an MBA was virtually foreclosed.[4] But in a significant decision in 2005, the Tax Court reversed course and found in favor of the taxpayer. Accordingly, there now appears to be a greater possibility that a tax deduction for the cost of an MBA will be allowed. Nonetheless, the cases illustrate the difficulty of generalizing in this area. Ineluctably, the result in each case will turn on the specific facts and circumstances.

II. BACKGROUND

While the Internal Revenue Code (IRC) nowhere deals directly with education expenditures, IRC §162(a) provides for the deduction of the ordinary and necessary expenses paid or incurred in carrying on a trade or business. The requirements that must be met in order to deduct educational expenses as a business expense are detailed in an IRS regulation.[5] In pertinent part, the regulation states that a deduction will be allowed if the education:

(1) Maintains or improves skills required by the individual in his employment or other trade or business, or

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of his employment, status or compensation, but only if such requirements were imposed for a bona fide business purpose of the employer.

With respect to expenditures to obtain an MBA, the first hurdle to vault is whether the education maintains or improves

skills that are required on the job or, alternatively, whether the education is to meet express requirements of an employer. A careful reading of these provisions reveals that a determination under either of the alternatives depends on the particular facts and circumstances.

Alternative (1) requires that an MBA should maintain or improve business skills. Whether there is any nexus, however, between what is learned in an MBA program and what is *required* in a particular employee's job is another matter.

Alternative (2) refers to employer requirements. But note that the employer requirements must be *express*. Obviously, there is a difference between a mere suggestion by an employer and a clear-cut demand, with a host of possibilities in between. Perhaps nothing less than a written policy or written demand would meet the language of the regulations that there must be an express requirement. Moreover, it would have to be demonstrated that the employer had a bona fide business purpose for imposing the requirement.

As may be apparent, the foregoing ambiguous language is fodder for controversy, often resulting in litigation. What makes a determination of deductibility even more uncertain and contentious, however, is that the regulations go on to say that *even if* you qualify under either of alternatives (1) or (2), the expenditures will be considered personal, and non-deductible,[6] if either:

(a) Made for education that is required of the individual in order to meet the minimum educational requirements for qualification in his/her employment or other trade or business, or

(b) Made for education that is part of a program of study being pursued by the individual that will lead to qualification in a new trade or business.

In the case of an employee, however, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment.

In summary, the first hurdle that must be vaulted is to qualify under either general rule (1) or (2). Even if that hurdle is cleared, however, it is necessary to vault the second hurdle by demonstrating that neither (a) nor (b) is applicable. Based on a number of court decisions, it seems that the second hurdle is the one that taxpayers frequently trip over.

It appears well settled that education leading to a license or certification qualifies a person for a new trade or business. For example, in one case, a deduction for education expenses was denied to a public accountant seeking to become a certified public accountant.[7] In another case, an education deduction was denied to an intern pharmacist studying to become a registered pharmacist.[8] Much of the litigation in this area involves the issue of whether a course of study qualifies a person for a new trade of business.[9] This paper will focus only on cases concerning the deductibility of MBA costs, first some earlier cases, then some more current ones, and finally the most recent case decided in 2005.

III. EARLIER CASES ON MBA DEDUCTION

In *Sherman,*[10] a 1977 Tax Court decision, the taxpayer had been a military officer. About a year after his discharge from active duty, he obtained employment in a civilian capacity with the Army and Air Force Exchange Service (AAFES) as Chief

of the Plans and Programs Office. Much of his duties were of a managerial type. Approximately two years later, he was accepted into the MBA program at Harvard and applied for a leave of absence from the AAFES. This was denied since his employment contract was shortly due to expire. Upon expiration of his contract with AAFES, the taxpayer entered the Harvard MBA program as a full-time student. During this time, he was not employed. While in the MBA program, however, he applied for re-employment with the Army. His application was denied due to a cutback in management personnel in AAFES. Upon graduation, the taxpayer obtained employment with a corporation as Director of Planning and Research. For the tax year at issue, he deducted the amount he expended for tuition and books. The Internal Revenue Service (IRS) denied the deduction on the grounds that at the time the taxpayer incurred the education expenses, he was not carrying on a trade or business.

Citing prior case law, the Court noted that a taxpayer who *temporarily* ceases active participation in a trade or business during a transition period between leaving one position and obtaining another may be carrying on a trade or business during the hiatus, and that a formal leave of absence is not essential to carry on a trade or business while attending school.[11] The Tax Court specifically rejected the IRS assertion that the taxpayer's unemployment was indefinite because it was longer than the IRS guideline of a year or less. The two years it took to finish the MBA was found not to be indefinite, and there was no "magic" in the IRS's arbitrary one-year rule. The Court observed that the length of a hiatus as temporary or indefinite depends on the particular facts and circumstances. Of significance, the Court found that the taxpayer was established in the trade or business of being a manager before he went to Harvard and continued in that trade or business after he completed the MBA. The degree did not equip him for a

different career, but rather to be a better manager than he had been, although not with the same employer. The deduction for tuition and books was allowed. Consequently, the fact that a taxpayer is enrolled in an MBA program full time, while unemployed during the course of study, is not necessarily in and of itself grounds for denying the deduction.

In *McIlvoy*,[12] a 1979 Tax Court decision, the taxpayer had a bachelor's degree and a graduate degree in geophysical engineering. For several years thereafter, he held a number of jobs that were essentially of a technical nature. After the termination of his last employment, the taxpayer began to pursue an MBA degree as a full-time student. After graduation, he was hired as an engineer/geologist by a different firm. The IRS determined that he was not allowed to deduct his education expenses.

The Court agreed with the IRS. It found that the MBA courses did not maintain or improve skills used by the taxpayer in his trade as a professional engineer. The major finding was that the taxpayer was a technician, not a manager. Since the Court found no relationship between the MBA courses and his technical duties or the skills he possessed as an engineer, it concluded that the MBA courses taught him new skills. As further pointed out hereafter, cases have held that education that teaches significantly new skills qualifies a person for a new trade or business. This case demonstrates that one must be in a managerial position in the first place in order to have a shot at deducting MBA costs. Furthermore, the course work must be related to what one's job entails.

In *Beatty*,[13] a 1980 Tax Court decision, the taxpayer held bachelor and master degrees in aeronautical engineering and was employed by McDonnell Douglas Corporation (McDonnell). Initially, the taxpayer worked on highly

sophisticated and technical projects. Later, his duties expanded and, among other things, he became responsible for software integration. In this capacity, he had to coordinate the activities of numerous other engineers, interact with individuals at various levels within and without McDonnell, and resolve conflicts among various individuals, groups, and subcontracting companies. To enhance his career objectives of engineering operations management, the taxpayer entered into a part-time program leading to a Master's of Science in Administration, and ultimately graduated. The IRS disallowed the taxpayer's education deduction asserting that the education lacked proximity to his trade or business, and that even if the education was sufficiently related to what he was doing, it qualified him for a new trade or business.

The Court disagreed with the IRS on the grounds that it could not "perceive any discrete line of demarcation between the engineering aspects of his employment and the administrative role he played in the software integration area." The skills that the taxpayer used were found to "transcend any strict and rigid definition of engineering." Accordingly, the Court concluded that the degree he obtained maintained and improved his employment skills. The Court also found that the degree did not qualify the taxpayer for a new trade or business. In this regard, it said that it was necessary to compare the type of tasks the taxpayer was qualified to perform before and after obtaining the degree. The Court found that the taxpayer's activities before entering the master's program were components of administration and management. The education corresponded at most with a change of duties. The Court pointed out that under IRS regulations, a change of duties does not constitute a new trade or business.[14] A final point made by the Court was that the courses the taxpayer took were not a prerequisite to professional certification for any particular profession or trade or business.

In *Blair*,[15] a 1980 Tax Court decision, the taxpayer had a bachelor of arts in English. She was hired as a personnel representative. Subsequently, she began a two-year program of evening instruction leading to an MBA degree. About half way through the program, she was promoted to personnel manager. Her duties became primarily supervisory and she received a substantial pay increase. As a manager, she made hiring decisions and was responsible for her department budget. About a year after her promotion, she graduated. The IRS disallowed the taxpayer's deduction for the cost of the MBA on the basis that a personnel manager was a new trade of business insofar as the taxpayer was concerned. There was no contention by the IRS that the taxpayer's job had a minimum educational requirement.

The Court disagreed with the IRS position. The Court referred to the IRS's own regulations that provide: "In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment."[16] It determined this regulation to be relevant since it found that there was a substantial overlap between a personnel representative and a personnel manager. The only significant difference found by the Court was that the former made only recommendations while the latter made decisions. The fact that the taxpayer acquired a new title did not constitute a new trade or business.[17] As a final point, the Court observed that even if a "personnel manager" in this situation were deemed to be a new trade or business, the educational expenses did not *qualify* the taxpayer to be a personnel manager.

What is particularly noteworthy about *Blair* is that the Court analyzed each course that the taxpayer took in the MBA

program to see how it related to the taxpayer's duties on her job. It found a relationship for each course other than a course in Marketing Information Systems for which it disallowed a deduction. Consequently, the IRS, with apparent court sanction, can divide the MBA degree into its component courses and require the taxpayer to show a relationship between each course and specific duties required in the taxpayer's job.

In *Link*,[18] a 1988 Tax Court decision, the taxpayer earned a bachelor's degree in operations research. Following graduation, he obtained employment where his job was to develop market research procedures, a position that did not require an MBA. He remained in this position roughly three months over the summer. He could have continued with this employment but decided to pursue an MBA full time. Upon graduation, he obtained employment with another company as an operations research analyst. This employment likewise did not require an MBA. For the taxable year at issue, the IRS disallowed the taxpayer's deduction for education expenses. The Court sustained the disallowance. It observed that implicit in I.R.C. §162 and the regulations is that the taxpayer must be established in trade or business in order for any expenses to be deductible. Here, the taxpayer's first employment seemed to be a "hiatus" in his academic endeavors. Since he worked only three months, the Court considered his employment as at best only a summer job. Although the Court declined to set a minimum period of time over which one must be employed to be considered engaged in a trade or business, it noted that a very short employment is relevant evidence in making a determination.

In *Schneider*,[19] a 1983 Tax Court decision, the taxpayer graduated with a bachelor of science degree from the United States Military Academy at West Point. He pursued a general

engineering curriculum with an elective concentration in national security and public affairs. Upon graduation he served on active duty in the Army for five years as an infantry officer. While in the Army, the taxpayer held numerous positions among which were: vehicle maintenance officer, platoon leader, company commander, personnel officer, base supply officer, and executive officer in Special Forces. These positions involved supervision of those under his command, including civilians. At the time of his discharge from active duty, the taxpayer had achieved the rank of Captain.

Following his discharge, the taxpayer entered a full-time MBA program, graduating in two years. While in the program, he did not engage in any employment. After completing the MBA, the taxpayer continued his schooling for another year earning a master's degree in public administration. Thereafter, he began working as a business consultant. He deducted the cost of his MBA on his tax returns for the two years that he was in this program. The IRS disallowed the deductions contending: (1) that as an Army officer, the taxpayer could not be considered engaged in a trade or business of being a manager, (2) that the MBA qualified the taxpayer for a new trade or business, and (3) that the taxpayer's cessation of employment while in the MBA program was indefinite rather than temporary. The taxpayer, of course argued to the contrary.

The Tax Court agreed with the IRS contentions. First, it found that while in the MBA program, the taxpayer was not engaged in any trade or business. He resigned his commission and had no plans to return to active duty. The Court distinguished the taxpayer's situation from those cases where a taxpayer was found to be on a temporary leave of absence from an established trade or business while pursuing the degree.[20] In this case, the Court determined that in no sense of the word

was the taxpayer's leave of absence from the military temporary. Rather, it was indefinite since his resumption of employment was to begin at "some future time."

Second, the Court found that the taxpayer's "education was designed to, and did, prepare him for a new trade or business...."[21] It determined that the taxpayer had never been in the business world. Despite the fact that as an Army officer he served in a variety of leadership and administrative positions, the Court stated that he had not shown any substantial relationship between such positions and the course of study he pursued in the MBA program. The taxpayer's comparison of his managerial responsibilities in the Army to those of business executives was deemed insufficient to negate that the MBA studies were not preparing him for a new trade of business.

Essentially, the taxpayer argued that whether someone is a manager should not be determined by whether the person wears a uniform or a business suit. The Court did not specifically disagree, but observed that the business of being a "manager" is too amorphous to come to any definitive conclusions. It noted, as an example, that a chef "manages" a kitchen and a teacher "manages" a classroom. What the Court deemed most important in analyzing a particular situation is the differences that exist in the *tasks and activities* required in a particular trade or business vis-à-vis another trade or business. In sum, the Court found that the taxpayer's duties as an Army officer constituted a different trade or business than the consulting business for which the MBA prepared him.[22]

IV. RECENT CASES ON MBA DEDUCTION

Two fairly recent cases involving the deductibility of the costs of an MBA, one decided in 2002 and the other in 2004, illustrate the restrictive interpretation of the regulations taken

by the IRS, with which the Tax Court in these cases agreed. The cases were decided in the small claims part of the Tax Court, at the taxpayer's election, since the amounts in controversy did not exceed $50,000. Consequently, the decisions could not be appealed and should not be cited as authority.[23] Nevertheless, after the cases were decided, tax practitioners were concerned that the pro-government reasoning in them would be followed in a regular Tax Court controversy.[24]

In *Lewis,*[25] decided in 2002, the taxpayer attended the University of California at Los Angeles, graduating in June 1998 with an MBA. Prior to his enrollment in the MBA program, the taxpayer was employed in the telecommunications industry. Since he was increasingly called upon to negotiate contracts with a wide variety of clients, he noted in a written statement submitted into evidence that, "I needed additional accounting, financial and general business administration skills." At trial, the taxpayer testified that the MBA degree qualified him for "a wider variety of positions," although he did not pursue such positions.

The Court first reviewed the regulations dealing with the deductibility of education expenses, focusing on the provision that denies a deduction for education that is part of a study program being pursued leading to qualification in a new trade or business. The Court correctly observed that even if the studies are required by an employer, and the taxpayer does not intend to enter a new field of endeavor, or even though the taxpayer's duties are not significantly different after the education from what they had been before, the expenditures are not deductible if the course of study would *qualify* the taxpayer for a new trade or business.[26]

As the Court saw it, there was no doubt that the MBA improved the taxpayer's skills in his employment. But the seminal question, it pointed out, was whether the MBA qualified the taxpayer for a new trade or business. In this regard, the Court referred to what is called the *commonsense approach*.[27] Under this standard, if the education qualifies the individual to perform significantly different tasks and activities than previously, the education qualifies the individual for a new trade or business.[28]

Based on the record, the Court concluded, from what it perceived as a commonsense standpoint, that the MBA did qualify the taxpayer to perform significantly different tasks and activities. Accordingly, even though there was no indication that the taxpayer was given significantly new tasks and activities after obtaining the MBA, and no indication that he intended or desired to move into another position with significantly different tasks and activities, the point was that the Court believed that the MBA label *qualified* him to do significantly new things and to move on to a significantly new job. Thus, no deduction was allowed.

In *McEuen*, [29] decided in 2004, the taxpayer, Tracy McEuen, began working at Merrill Lynch (M-L) in 1992 as a "financial analyst." The next step up was "associate," which required an MBA degree. The taxpayer left M-L in 1995 to work for Raymond James Financial, Inc. (James) in its corporate finance department. Her position there was also "financial analyst" and, similar to M-L, she needed an MBA to become an "associate." In the investment banking industry during the relevant time, an MBA generally was required to advance to "associate."

Analysts at James were evaluated using three criteria: (a) mastery of analytics; (b) attention to detail; (c) teamwork and positive attitude; and (d) communication and leadership skills.

Associates at James were evaluated according to performance criteria grouped under five categories: (a) general performance expectations; (b) recruiting and team building; (c) management and supervision of banking analysts; (d) execution of business; and (e) business generation. The management and supervision category stated that associates were responsible for supervising and training analysts, and were responsible for the quality of work they produced.

While working at James, the taxpayer was accepted at the Kellogg School of Management at Northwestern University (Kellogg) to pursue an MBA degree. The taxpayer resigned her position at James in 1996 in order to attend school full time, realizing that it would be impractical to undertake the MBA while working at James due to the long hours required on the job. The taxpayer majored in marketing, organizational behavior, and finance and received a master of management degree (equivalent to an MBA) in 1998. Shortly after graduating, the taxpayer was hired by Spring Industries (Spring), a manufacturer of home furnishings, into its "General Management Program" (program). Only persons with an MBA were hired into the program. The program was described as a "proving ground for future top executives" and "prepares associates for careers in marketing, finance or operations management." When the taxpayer completed the program, she became an "associate brand manager." On her joint return with her husband for 1998, the taxpayer took an itemized deduction (Schedule A) in the amount of $20,317 for her MBA costs.[30]

The taxpayer's argument was that she was employed as an "investment banker" with the M-L and James firms and had not

abandoned this trade or business by attending Kellogg for two years.[31] She further alleged that the expenses of her degree were incurred to maintain and improve her skills. Alternatively, she argued that the education was required as a condition to the retention of an existing employment relationship status or rate of compensation.

The Court first reviewed the applicable regulations referring to the general rule that educational expenses are deductible if incurred to maintain or improve skills required in one's employment or trade of business. The Court then focused in on the disallowance rules. As noted previously, these rules provide that educational expenses incurred to meet minimum educational requirements for qualification for an employment, or that will qualify the taxpayer for a new trade or business, are not deductible.

In advancing her argument, the taxpayer asserted that the duties of an analyst and associate at the M-L and James firms was similar, both falling within the general category of investment banking positions. The Court noted that the fact that an individual is already performing services in an employment situation does not mean that the person has met the minimum educational requirements for qualification in that employment.[32] Such a determination must be made by consideration of such factors as the requirements of the employer, applicable law and regulations, standards of the profession and trade or business involved.

Considering all the facts and circumstances, the Court remarked that although there was some overlapping of duties of an analyst and an associate at both M-L and James, the analyst position was a subordinate temporary position lasting for a maximum of three years. At both companies, the associate position was a prerequisite to further advancement.

The Court concluded that analysts had not achieved the status of "investment banker" although, in a broader sense, they were in the investment banking business. Consequently, the expenses incurred by the taxpayer in obtaining an MBA were held to be for the purpose of meeting the minimum educational requirements for qualification in her trade or business, as set by her employers and the industry in which she was working.

More significantly, the Court observed that even if not to meet minimum educational requirements, the expenditures nevertheless were not deductible since they qualified the taxpayer for a new trade or business.[33] Moreover, it stated that this rule is applicable even though the education is required by an employer or applicable law, the taxpayer does not intend to enter a new field of endeavor, or the taxpayer's duties are not significantly different after the education from before.[34] In this regard, the Court referred to precedent holding that if the education qualifies the taxpayer to perform *significantly new tasks and activities*, the education qualifies the taxpayer for a new trade or business.[35] Accordingly, if the MBA obtained by the taxpayer qualified her to perform significantly different tasks compared to what she was doing before the MBA, the degree qualified her for a new trade or business.

After obtaining her MBA, the taxpayer did not go back to work for an investment banking firm. Rather, she was hired into a management-training program with Spring with the potential, though not assured, of moving into upper management. Although the Court agreed that the MBA did not automatically qualify her for a new trade or business, it noted that it could lead to such qualification, and that is all that is necessary under the regulations to bar a deduction.[36] From the record before it, the Court found that the MBA degree would lead to qualifying the taxpayer to perform significantly different tasks and activities than she performed before

obtaining the degree. Accordingly, the Court concluded that the MBA qualified the taxpayer for a new trade or business, which was just icing on the cake since it had also held that the MBA was to meet minimum education requirements as set by her employer and the industry in which she was working.

It is clear from the foregoing cases that the IRS has been challenging a deduction for the cost of an MBA degree for many years with mixed success. Of particular concern to tax practitioners as a result of the *McEuen* decision, however, was the Tax Court's reasoning that even if the education does not automatically qualify one for a new trade or business, the cost is nevertheless not deductible if the education will lead to such qualification. Once again, the Court equated the ability to perform significantly different tasks and activities with a new trade or business.

Since an MBA should result in the ability to perform significantly different tasks and activities, under this line of reasoning, very few persons, if any, would be able to deduct the cost of an MBA. This is what had tax practitioners particularly concerned. As a result of a new decision by the Tax Court, however, taxpayers pursuing an MBA degree should have at least some assurance that a deduction for its cost has not been completely foreclosed.

V. THE LATEST WORD

In *Allemeier*,[37] a 2005 Tax Court decision, the taxpayer was a successful and valued salesperson. About three years into his employment, he decided to pursue a part-time MBA. His employer had told him that an MBA would enhance his business skills and speed his advancement in the company. The employer, however, did not require him to get an MBA and had a strict policy of not reimbursing employees for

education costs. Shortly after he enrolled in the MBA program, the taxpayer was promoted to several new managerial positions. Consequently, his duties significantly expanded. He became responsible for analyzing financial reports, designing sales plans, and evaluating marketing campaigns. He performed these functions while in the MBA program, from which he ultimately graduated.

The IRS disallowed the deduction taken for his tuition and other related expenses, raising two arguments. First, the IRS contended that the MBA was necessary for the taxpayer to get his promotion, and, therefore, the education was to meet minimum education requirements of his employer. Secondly, it argued that, in any event, the MBA qualified the taxpayer for a new trade or business regardless of his intent to enter a new trade or business and regardless of whether his duties changed significantly after he obtained the MBA.

The Tax Court disagreed and allowed the deduction. The Court found factually that the taxpayer's promotion was not contingent on obtaining an MBA. His employer may have encouraged him to get an MBA and may have told him that he might advance faster, but this did not constitute a requirement that he get the MBA. Apparently, the Court felt that his promotion at the same time he entered the MBA program was coincidental. Citing numerous cases, the Court observed that whether education qualifies a taxpayer for a new trade or business depends on comparing the tasks the taxpayer was qualified to perform before and after getting the MBA.[38] The IRS, of course, argued that when the taxpayer began the MBA program, he advanced to managerial, marketing, and financial duties, all of which were different than what he had been doing prior to beginning the MBA program. The taxpayer on the other hand argued that the MBA merely capitalized on duties that he already had been doing, giving him a better

understanding. After reviewing the record, the Court concluded that the taxpayer performed the same tasks before and after obtaining the MBA, although on a more complex level afterwards. The Court, referring to the commonsense approach, observed that acquiring new titles or abilities does not necessarily constitute entry into a new trade or business.[39] In this case, it found that the taxpayer performed the same activities after entering the MBA program as he had been doing previously. The MBA simply improved preexisting skills.[40]

The taxpayer, apparently feeling that the IRS challenge to his MBA deduction was unwarranted, subsequently sought to recover his administrative and legal fees asserting that he had substantially prevailed in the litigation.[41] The Tax Court denied any award holding that the IRS position denying a deduction for the MBA was substantially justified even though it lost.[42]

VI. CONCLUSION

As noted, *Lewis* and *McEuen* were decided in the small claims part of the Tax Court. As a regular Tax Court decision, *Allemeier* is therefore more authoritative. One can read the *Lewis* case as denying any deduction for an MBA on the grounds that from a commonsense approach an MBA will always qualify a taxpayer to perform significantly new tasks and activities. In *McEuen*, the Court was even more restrictive, emphasizing that if education *will lead to* qualifying the taxpayer to performing significantly different tasks and activities, although not automatically, the education qualifies the taxpayer for a new trade or business.[43]

Anyone spending the time and incurring the expense to pursue an MBA no doubt believes, or at least hopes, that the degree will qualify him or her to perform significantly new

tasks and activities, or at least that it will lead in that direction. Although it may be hard to quantify, it would seem from a commonsense approach that most people with an MBA actually do move on to performing significantly new tasks. Retrospectively, it can thus be argued that the MBA led in that direction. In *Allemeier*, however, The Tax Court did not focus on the whether the MBA qualified the taxpayer to perform significantly new tasks or would lead in that direction, but rather emphasized the relationship between what tasks the taxpayer was performing before and after the MBA. In this regard, the Court apparently found an insufficient distinction between what he was doing before and after entering the MBA program. Fortunately for the taxpayer, the Court neither prophesized about what the MBA might lead to in the future, nor considered what other tasks the degree qualified him for.

Accordingly, it appears that a deduction for an MBA has not been virtually foreclosed as was feared after the *McEuen* decision. One would hope that the Tax Court will continue to follow the approach in *Allemeier*, evaluating what a person is doing before and after the MBA and not speculating about whether the degree might lead to qualification for a new trade or business in the future (i.e., performing new tasks and activities). Of course, as previously pointed out, if the education qualifies a person for a license or certification, the law is clear that no deduction is allowed.

From the standpoint of tax policy, one may contend that the IRS position on deducting the cost of an MBA is overly restrictive. In today's highly competitive global economic environment, it generally has been recognized that an important factor in the long-term economic success of a country is the educational level of its population. Recognizing this, many developing countries (e.g., India and China) are turning out record numbers of college graduates. In this

country, education is clearly a highly valued commodity as evidenced by the numerous provisions in the IRC favoring education.[44] Accordingly, denying a deduction for the cost of an MBA for someone working in the business community seemingly contradicts the overall policy of using the tax laws to foster education. Fortunately, *Allemeier* seems to sanction a more flexible approach. In any event, it is clear that the result for any taxpayer attempting to deduct the costs of an MBA will depend on the specific facts and circumstances.

ENDNOTES

[1] In 2005, the annual cost of an MBA in top-tier schools approached $40,000, with an average cost of about $34,000. For those pursuing the degree full time, an additional cost to consider is lost earnings. The average salary of a pre-MBA student was noted to be $67,000 (Jennifer Merritt, *MBA Applicants Are MIA*, BUSINESS WEEK, April 18, 2005, at 28). One estimate, considering only tuition and lost salary, stated that the overall cost of an MBA often tops $175,000 (Jennifer Merritt, *What's an MBA Really Worth,* BUSINESS WEEK, September 22, 2003, at 90). Of, course, these amounts have only increased.

[2] Statement by Stanford University Graduate School of Business Professor Jeffrey Pfeffer contained in article *What's an MBA Really Worth* (cited in Endnote 1, *supra*).

[3] In 2002, the latest year for which statistics are available, there were over 120,000 MBA degrees granted in the U.S. It is the second most popular graduate degree after a degree in education (According to National Center of Education Statistics). Recently, however, there has been a significant decline in applications for admission to MBA programs, including applications to the top-tier schools. There is speculation that the reasons for the decline are the high cost of obtaining the degree and some uncertainty as to its value (Endnote 1, *supra*, and *also see* Louis Lavelle, *Is the MBA Overrated*, BUSINESS WEEK, March 20, 2006, at 76). For many, if not most people, the financing of an MBA is met through loans, which are often

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piled onto amounts borrowed for an undergraduate degree (*see* Susan Berfield, *Thirty and Broke*, BUSINESS WEEK, November 14, 2005, at 76).

[4] *For example*, see statement by Robert Willens (Lehman Brothers) on Tax Prof Blog.

[5] Treas. Reg. §1.162-5 (as amended in 1967).

[6] As set forth in I.R.C. §262, no deduction is allowed for personal, living, and family expenses.

[7] Glen v. Commissioner, 62 T.C. 270 (1974).

[8] Antzoulatis v. Commissioner, T.C. Memo. 1975-327.

[9] As further examples: No deduction for attending law school (Weiszmann v. Commissioner, 52 T.C. 1106 (1969) (patent trainee); Bodley v. Commissioner, 56 T.C. 1357 (1971) (school teacher); Taubman v. Commissioner, 60 T.C. 814 (1973) and Weiler v. Commissioner, 54 T.C. 398 (1970) (IRS agents); and Galligan v. Commissioner, T.C. Memo. 200-150 (law librarian). No deduction for licensed practical nurse studying to become a registered nurse (Robinson v. Commissioner, 78 T.C. 350 (1982)); nor for licensed practical nurse studying to become a physician's assistant (Reisinger v. Commissioner, 71 T.C. 568 (1979)). No deduction for graduate teaching assistant studying for graduate degree (Jungreis v. Commissioner, 55 T.C. 581 (1970)). No deduction for bookkeeper studying for an accounting degree (Browne v. Commissioner, 73 T.C. 723 (1980)). No deduction for clinical social worker pursuing Ph.D in social work to obtain faculty position (Davis v. Commissioner, 65 T.C. 1014 (1976)). No deduction for paraprofessional studying to get a teacher's license (Diaz v. Commissioner, 70 T.C. 1067 (1978)). On the other hand, the regulations treat teachers at all levels the same (Treas. Reg. § 1.162-5(b)(2)(ii) and (iii)). Thus, a person holding an undergraduate degree in education and sociology, and who was a discussion leader in a "Family Education Program," was allowed to deduct the cost of pursuing a Masters in Educational Psychology and Guidance (Schwerm v. Commissioner, T.C. Memo 1986-16).

[10] Sherman v. Commissioner, T.C. Memo. 1977-301.

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[11] *See* Haft v. Commissioner, 40 T.C. 2 (1963), Furner v. Commissioner, 393 F.2d 292 (1968), *rev'g*. 47 T.C. 165 (1966) and Ford v. Commissioner, 56 T.C. 1300 (1971), *aff'd.* per curiam 487 F.2d 1025 (9th Cir. 1973).

[12] McIlvoy v. Commissioner, T.C. Memo. 1979-248.

[13] Beatty v. Commissioner, T.C. Memo. 1980-196.

[14] Treas. Reg. §1.162-5(b)(3)(i) (as amended in 1967). *See also* Rev. Rul.60-97, 1960-1 CB 69, 73.

[15] Blair v. Commissioner, T.C. Memo. 1980-488.

[16] Treas. Reg. § 1.162-5(b)(3) (as amended in 1967).

[17] *See* Granger v. Commissioner, T.C. Memo. 1980-196, where there was deemed to be no change in trade or business where someone progressed from personnel assistant to assistant personnel director and finally to personnel director.

[18] Link v. Commissioner, 90 T.C. 460.

[19] Schneider v. Commissioner, T.C. Memo. 1983-753.

[20] *See* Furner v. Commissioner, 393 F.2d 352 (7th Cir. 1968), *rev'g*. 47 T.C. 165 (1966).

[21] *Referring to* Treas. Reg. §1.165-5(b)(3).

[22] The Court distinguished this case from another case where the taxpayer after leaving the Army was employed in a civilian management position for two years before entering the MBA program (*Sherman*, Endnote 10, *supra*). Thus, in that case, the taxpayer had established himself in the trade or business of business administration before entering the MBA program.

[23] I.R.C. §7463.

[24] It may be noted that in the Small Claims part, the cases are decided based upon the preponderance of the evidence regardless of the allocation of the burden of proof otherwise.

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[25] Lewis v. Commissioner, 2002 TNT 89-12 (2002).

[26] *Citing* Robinson v. Commissioner, 78 T.C 550, 556-557 (1982); Bodley v. Commissioner, 56 T.C. 1357, 1360 (1971); and Schwerm v. Commissioner, T.C. Memo. 1986-16.

[27] *Citing* Reisinger v. Commissioner, 71 T.C. 568, 574 (1979).

[28] *Citing* Browne v. Commissioner, 73 T.C. 723, 726 (1980) (*citing* Diaz v. Commissioner, 70 T.C. 1067, 1074 (1978), *affd.* without published opinion 607 F.2d 995 (2nd Cir. 1979)); and Glenn v. Commissioner, 62 T.C. 270, 275 (1974).

[29] McEuen v. Commisioner, 2004 TNT 150-9 (2004).

[30] The $20,317 was after the 2% of adjusted gross income reduction under I.R.C. §67.

[31] The Court did not find it necessary to address the contention of the IRS that the taxpayer was not engaged in a trade or business in 1998. However, the fact that someone is not currently working does not mean the person is not in a trade or business. For example, a leave of absence to attend school does not necessarily mean the person is not in a trade or business if the person was in the trade or business before the leave and went back to work in the same field after the leave. *See, for example*, Furner v. Commissioner, 393 F.2d 292 (7th Cir. 1968), *rev'g*. 47 T.C. 165 (1966). The IRS has ruled that an absence of one or more years from a job terminates the carrying on of a trade or business. Rev. Rul. 68-591, 1968-1 C.B. 73. This ruling apparently was in response to the *Furner* case where the leave of absence was for one year. Of course, the courts are not bound by the interpretation of the IRS, which is a bright line test to the exclusion of the facts and circumstances.

[32] *Citing* Treas. Reg. §1.162-5(b)(2)(i) (as amended in 1967).

[33] *Citing* Treas. Reg. §1.162-5(b)(3) (as amended in 1967).

[34] *Citing* Treas. Reg. §1.162-5(b)(1) (as amended in 1967).

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[35] Glen v. Commissioner, 62 T.C. 270, 275 (1974); Wiesmann v. Commissioner, 52 T.C. 1106, 1110 (1969), *aff'd. per curiam* 443 F.2d 29 (9th Cir. 1971).

[36] Treas. Reg. §1.162-5(b)(3)(i) (as amended in 1967).

[37] Allemeier v. Commisioner, T.C. Memo. 2005-207.

[38] *See* Glenn v. Commissioner, 62 T.C. 270 (1974) (other citations omitted).

[39] *See* Reisinger v. Commissioner, 71 T.C. 568 (1979) (other citations omitted).

[40] *See* Blair v. Commissioner, T.C. Memo. 1980-488 and Beatty v. Commissioner, T.C. Memo. 1980-196.

[41] The Internal Revenue Code provides for an award of administrative and litigation costs to a taxpayer that substantially prevails in an administrative or court proceeding. However, the Code provision goes on to deny an award if the government's position is substantially justified (I.R.C §7430).

[42] Allemeier v. Commissioner, T.C. Memo. 2006-28 (2/16/06). *Allemeier* is a Memorandum decision, which supposedly has somewhat less authority than a Regular Tax Court decision. Regular decisions are supposed to involve novel issues not previously resolved by the Court. However, the distinction is not always observed and some decisions that are Memorandum arguably should have been Regular and vice versa. In any event, both are Tax Court decisions and thus both have value as precedents.

[43] *See* Treas. Reg. § 1.162-5 (b)(3) for "will lead to" language.

[44] In broad overview, there are: (1) Two savings plans for future education costs: Coverdale Education IRAs and Section 529 plans administered by the states; (2) Two tax credits: Hope Scholarship Credit and Lifetime Learning Credit; (3) Various deductions: Tuition and Fees deduction, Educator Expense Deduction, Student Loan Interest deduction, and possibly a deduction for education to maintain or improve job skills, or that is required by an individual's employer; and (4) Two benefits that are excluded from gross income: Scholarships are tax free and, within limits, so is Educational Assistance by an employer.

POWER OF ATTORNEY—POWER TO ABUSE? THE NEED FOR REFORM

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I. INTRODUCTION

New York State's durable power of attorney is a commonly used legal device. It allows an individual, the "principal", to designate an "agent", also known as an "attorney-in-fact", to act on the principal's behalf. The General Obligations Law (GOL) sets forth the statutory short form power of attorney.[1] This form enumerates various broadly defined specific categories of authority that can be given to an agent. At the time of execution each broadly defined category that the principal intends to vest authority in the agent must be initialed by the principal. The power of attorney form is simple to execute and use, but these very features are what render it susceptible to abuse.[2]

II. AGENT'S DUTY TO PRINCIPAL

New York's power of attorney statute does not specifically state that the agent owes a fiduciary duty to the principal.[3] At first glance, this does not appear to be a problem.

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Logic dictates that the attorney-in-fact is a fiduciary, and is accountable to the principal under the general rules of agency law. In fact, numerous courts have reached this conclusion.[4] However only the gift-giving powers contained in GOL §5-1501 (1) (M) unambiguously impose a duty on the agent to exercise authority in the best interest of the principal.

GOL §5-1501 (1) (M) authorizes an agent to make gifts to the principal's "spouse, children and more remote descendants, and parents, not to exceed in the aggregate $10,000.00 to each of such persons in any year." GOL §5-1502M construes this gift-giving authority to mean that the principal authorizes the agent to make gifts "only for purposes which the agent reasonably deems to be in the best interest of the principal, specifically including minimization of income, estate, inheritance, generation-skipping transfer or gift taxes."[5] The statutory short form power of attorney may contain additional language, pursuant to GOL §5-1503, authorizing gifts in excess of $10,000.00 or gifts to other beneficiaries.[6] GOL §5-1503 does not include a "best interest" standard. Is the agent required to act in the principal's best interest when the agent's gift-giving authority is augmented by GOL §5-1503? This is the issue that the New York State Court of Appeals addressed *In the Matter of Ferrara*.[7]

In *Ferrara* the decedent, George Ferrara, a Florida resident, executed a will on June 10, 1999, leaving his entire estate to the Salvation Army. His will specifically made "no provision...for any family member...or any individual person" because it was his "intention to leave (his) entire residuary estate to charity."[8] Decedent was single and had no children. His closest relatives were his brother, John, a sister, and their respective children. On August 16, 1999, decedent executed a codicil naming his attorney as his executor, and "ratif(ied), confirm(ed) and republish(ed) (his) said Will of June 10,

1999."[9] Decedent was hospitalized in December 1999, and his brother's son, Dominick Ferrara, traveled from New York to Florida to visit him.[10]

According to Dominick Ferrara the decedent "told (him) he wanted to move to New York to be near his family."[11] On January 15, 2000, Dominick accompanied the decedent on a flight from Florida to New York, where decedent was immediately admitted to an assisted living facility. Ten days later, on January 25, decedent signed, and initialed where required, multiple originals of a New York statutory short form durable power of attorney. Decedent appointed John and Dominick Ferrara as his attorneys-in-fact, and allowed either of them to act separately.[12] Decedent not only authorized his agents to make gifts in accordance with GOL §5-1501(1)(M), but also initialed a typewritten addition to the form, stating that "this Power of Attorney shall enable the Attorneys in Fact to make gifts without limitation in amount to John Ferrara and/or Dominick Ferrara."[13]

Decedent was admitted to the hospital on January 29, 2000, and died on February 12, 2000, less than a month after moving to New York, and approximately three weeks after executing the durable power of attorney. During those three weeks, Dominick Ferrara transferred all of the decedent's assets, valued at approximately $820,000.00, to himself.[14] The Salvation Army subsequently commenced a discovery proceeding in the Surrogate's Court against Dominick Ferrara and others, requesting turnover of the decedent's assets.[15]

The Surrogate dismissed the petition, noting that while the law requires an agent to demonstrate that gifts of $10,000.00 or less to specified individuals were made in the principal's best interest, no such requirement exists for gifts in excess of $10,000.00 or for gifts made to other individuals.

The Court invited the Legislature to amend the law "to provide for the same (best interest) limitation when there is express language in the power of attorney for gifts to an agent in excess of $10,000.00 per year."[16] The Appellate Division affirmed, and the Court of Appeals granted the Salvation Army permission to appeal.[17]

The Court of Appeals reversed the order of the Appellate Division, and found that in all cases the attorney-in-fact must act in the principal's best interest when making gifts. This is true regardless of whether the gift-giving power is limited to the authority spelled out in GOL §5-1501 (1) (M), or whether it is augmented by additional language pursuant to GOL §5-1503.[18] Nothing in GOL §5-1502M indicates that the best interest requirement is waived when additional language increases the gift amount or expands the individuals to whom gifts can be made. The Legislature intended GOL §5-1503 to function as a means to customize the statutory short form power of attorney, not as an escape hatch from the statute's protections.[19] That so much effort was required to deliver such a common-sense verdict testifies to the potential for abuse of New York principals by their attorneys-in-fact.[20]

III. SELF DEALING

A separate issue addressed by the Surrogate's Court in *Ferrara* is whether a "presumption of impropriety" exists when an attorney-in-fact makes gifts to himself. The Surrogate noted that at one time there was "a presumption of impropriety due to the appearance of impropriety and self-dealing" when an attorney-in-fact made self-gifts.[21] The Surrogate held, however, that amendments to the General Obligations Law, enacted in 1996 and effective January 1, 1997, eliminated this presumption. "When a post-January 1, 1997 power of attorney specifically and expressly authorizes gifting by the agent to

himself, the presumption of impropriety no longer applies and the burden of proving the validity of the gift is no longer on the agent." Instead, the opposing party has the burden of proving the invalidity of the gift.[22]

Even though the Appellate Division affirmed the Surrogate Court's decision in the *Ferrara* case, it reached a different conclusion on this issue.

The Appellate Division clearly held that the presumption of impropriety still exists when an agent is involved in self-dealing. This presumption, however, can be rebutted and overcome. An agent can rebut the presumption by submitting evidence of a valid power of attorney in which the principal gives the agent express written authority to make gifts to himself.[23] Courts also allow extrinsic evidence to establish the donative intent of the principal to rebut the presumption.[24] The Court of Appeals did not disturb this ruling of the Appellate Division when reaching its determination in *Ferrara.*

IV. AGENT'S AUTHORITY SUBSEQUENT TO DISABILITY

Scrutiny of the agent's actions often intensifies following a disability that renders the principal incompetent to act on his own. Assuming that the durable statutory form provided for in GOL §5-1501 has been used, the agent has continuing authority to act. The agent is only relieved of that authority by an appointed committee or guardian under GOL §5-1505(2), or by death of the principal. The courts have had to reconcile the provisions of Mental Hygiene Law (MHL) article 81, which addresses the appointment of a guardian for an incapacitated person, with the principal's wishes and statutory right to have his appointed agent continue to act in his behalf following disability. The Appellate Division has ruled

on these issues in the *In re Nellie G.*[25] and in the *Matter of Daniel TT.*[26]

In the *Nellie G.*, the principal executed a springing durable power of attorney in favor of her daughter.[27] This power of attorney became effective when the principal became disabled and further provided that the designation of her daughter as attorney-in-fact would not become ineffective upon the principal's subsequent incapacity. When Nellie G. suffered a series of stokes, and became uncommunicative as a result, she was ultimately admitted to a nursing home.[28] The hospital commenced a proceeding under article 81 of the MHL to have an independent guardian appointed. At the conclusion of the hearing, the Supreme Court ruled that Nellie G. was incapacitated.[29] They also determined that her daughter had misused the power of attorney and that there were no available resources, such as powers of attorney, health care proxies and trusts, to act as alternatives to guardianship.[30] The court appointed an independent guardian and revoked the power of attorney given by Nellie G. to her daughter.[31]

Upon appeal the Appellate Division disagreed. The Supreme Court was concerned about the daughter's fitness to manage Nellie G's property due to certain real estate transactions she had entered into on her mother's behalf. The Appellate Division stated that these real estate transfers made by the daughter did not financially benefit her as agent, and as a result did not harm Nellie G.'s interests in any way.[32] They further stated that the appointment of an independent guardian should only be done as a last resort. The daughter's right to act as attorney-in-fact for her mother was reinstated.[33]

In the *Matter of Daniel TT.* [34], a case also dealing with an application under MHL article 81, the power-of-attorney's execution was challenged by the daughter of the principal. The

principal appointed his only other child, Diane, as his attorney-in-fact. It was specifically alleged that Diane exerted coercion upon her father, that he was under duress, and that he had diminished capacity due to Alzheimer's disease at the time he executed the power of attorney in question.[35] The father resided with Diane for some time prior to appointing her as his attorney-in-fact. At the time of the execution of the power of attorney he also established a trust, modified his will, and executed a health care proxy all in favor of Diane. The trust established an unequal distribution between the two siblings and utilized a different estate planning attorney than the attorney used by the principal over the past 30 years.[36] It was further alleged that Diane was violating her fiduciary duties post appointment and was not taking proper care of her father. At the hearing the appointed court evaluator indicated he had spoken to the principal, and that the principal was opposed to the petition; he wanted Diane to continue as his attorney-in-fact.[37] The Supreme Court dismissed the petition for appointment of a guardian, notwithstanding the request by the court evaluator for authorization to inspect the medical records of the principal under MHL §81.09 and request for retention of an expert to evaluate the principal's alleged diminished capacity.

Upon appeal the Appellate Division reversed and remitted the matter to the Supreme Court for further proceedings.[39] It was determined that MHL article 81 requires a two pronged analysis. First, it must be determined whether the appointment of a guardian is necessary to provide for the personal needs of the incapacitated person, including food, clothing, shelter, health care or safety, or management of financial affairs. Second, it must be determined whether the person agrees to the appointment, or in the alternative, is incapacitated.[40] With regard to the first prong the court must consider the report of the court evaluator as well as the

sufficiency and reliability of the individual's "available resources". Here the principal's available resources consisted of the power of attorney, health care proxy and trust, all of whose validity were in question.[41]

Upon review of the record the Appellate Division cited the affidavit of the principal's long term attorney and the affidavit of the court evaluator in creating a question of fact to overcome the presumptive validity of the principal's estate planning documents and raise a genuine question regarding the sufficiency and reliability of his available resources.[42] Prior to rendering its decision the court cautioned that a guardian is to be appointed only as a last resort, and if done, must be in a manner which is least restrictive.[43] It also noted that, when necessary, the court had previously utilized its authority to modify, amend, or revoke any previously executed estate planning documents by virtue of the provisions of MHL §81.29[d].[44]

In re Nellie G. and in the *Matter of Daniel TT.* highlight the additional difficulties that can occur when challenges to the use of a durable power of attorney are scrutinized by the courts once the principal is incapacitated or has diminished capacity.

V. PROPOSALS FOR REFORM

The New York State Law Revision Commission has made various proposals to modify the power of attorney statute. The Commission contends that the effectiveness of the power of attorney is often frustrated by the lack of sufficient statutory direction. Powers of attorney are broadly used in estate planning, and the absence of statutory guidance generates the potential for financial exploitation. A four year study conducted by the Commission found that the power of attorney is, without question, an effective tool for attorneys and

the public at large for estate planning and to avoid the expense of guardianship. This popularity, however, has led to its use for transactions far more complex than were originally contemplated by the law, particularly in the area of gift giving.

The Law Revision Commission in 2006 proposed extensive modifications to the General Obligations Law as it relates to powers of attorney.[45] The proposed changes are based upon input from various groups, including representatives from the Trusts and Estates and Elder Law sections of the New York State Bar and the banking community. The Commission believes that powers of attorney should remain flexible enough to allow agents to fulfill their principal's reasonable intentions, but expressed concern about the statute's silence and ambiguity regarding the agent's authority to transfer assets. The Commission has also recommended that the statute offer guidance to third parties asked to accept powers of attorney, as well as those asked to investigate financial exploitation. The objective of the Commission's proposal for modification is to provide clarity and direction and to deter and curb financial exploitation without unduly burdening the utility and simplicity of the power of attorney.

Specifically, the Commission's 2006 proposal adds definitions and general requirements to the statute. To clarify the statute's ambiguity of language on fiduciary duty, the proposal states that "(a)n agent acting under a power of attorney has a fiduciary relationship with the principal".[46] It also defines "best interest" to mean that an agent must act "solely for the principal's benefit".[47]

The Commission expressed concern that the General Obligations Law does not require agents to keep records of financial transactions or to produce existing records if

investigated for impropriety. The proposed statutory form will allow the principal the option to appoint a "monitor". A monitor is defined as "...a person appointed in the power of attorney who has the authority to request, receive, and compel the agent to provide a complete record of all receipts, disbursements, and transactions entered into by the agent on behalf of the principal."[48]

Perhaps the most significant proposed change is the addition of a "Statutory Major Gifts Rider". The purpose of this rider is similar to that of current GOL §5-1503: to augment the gift-giving authority of the agent. But that is where the similarity ends. The proposed statute clearly states that gifts authorized by the statutory major gifts rider may be made only for purposes which the agent reasonably deems to be in the best interests of the principal.[49] It also states that the agent may not transfer the principal's property to himself without specific authorization in the major gifts rider.[50] The rider must be signed at the end and dated by the principal in the presence of two witnesses who are not named as permissible recipients of gifts or other transfers.

In order to implement the above changes, the proposed statutory form contains a "Notice to the Agent" that describes the agent's responsibilities. This notice states, in part:

> You have a duty (called a "fiduciary duty") to the principal. Your fiduciary duty requires you to:
>
> (1) act solely in the best interest of the principal and avoid conflicts of interest between the principal and you or any other person;
>
> (2) keep the principal's property separate and distinct from any assets you own or control;

(3) keep a complete record of transactions entered into by you or your authorized delegate on the principal's behalf and make the record available......[51]

The Notice to the Agent also states "...you are not entitled to use the principal's assets to benefit yourself or to give gifts to yourself or anyone else unless this document specifically gives you that authority."[52] Finally, the statutory form notifies the agent that if he violates his duty, he may be liable for damages and subject to criminal prosecution.[53]

These proposed modifications are currently in the hands of the Senate Judiciary Committee for further review. Several disagreements exist over the exact language, and concerns that the bill may initiate more frustrations due to its complexity are hindering the ratification of the bill. Some concern has been expressed that the proposed modifications encourage the use of a lawyer to prepare the power of attorney form. Some also argue that a specific provision should be added regarding advanced planning and Medicaid eligibility, although the Law Revision Commission believes that no specific provision is needed.

As the population ages, the use of the power of attorney is likely to become more widespread. The Legislature has begun to recognize the problem of financial exploitation of elderly citizens. Amendment of the power of attorney statute will bring additional accountability into the monitoring system and help to lessen the potential for abuse. On the other hand, durable powers of attorney may lose their appeal if they become too complex in form and execution. The goal is to achieve a balance between the simplicity of the current power of attorney law and the need for adequate protection of the unaware or incompetent principal from an unscrupulous agent.

The vast majority of agents holding power of attorney discharge their duties honestly and competently. Yet problems can arise, even when agents act in what they believe to be the principal's best interest. The proposed changes to the General Obligations Law seek to clarify and simplify the present law, thereby ending the confusion that currently exists.

ENDNOTES

[1] N.Y. General Obligations Law §5-1501(1) (McKinney 2001).

[2] Hilliard, Thomas. *Power Failures*, Schuyler Center for Analysis and Advocacy (December, 2006).

[3] See N.Y. General Obligations Law §5-1501 (McKinney 2001).

[4] *Mantella v. Mantella*, 268 A.D.2d 852 (3d Dept 2000), 701 N.Y.S. 2d 715; *Ferrentino v. Dime Sav. Bank*, 159 Misc.2d. 690 (1993), 606 N.Y.S.2d. 554, stating that the attorney-in-fact is merely a special kind of agent, whose authority differs little, if at all, from other agents; *Moglia v. Moglia*, 144 A.D.2d 347 (2d Dept 1988), 533 N.Y.S.2d 959, stating that the power of attorney proffered by the principal is given with the intent that the attorney-in-fact will utilize the power for the benefit of the principal.

[5] N.Y. General Obligations Law §5-1502M(1) (McKinney 2001).

[6] *Id.*

[7] *In re Estate of Ferrara*, 7 N.Y.3d 244 (2006), 819 N.Y.S.2d 215, 852 N.E.2d 138, 2006.

[8] *Id.* at 248.

[9] *Id.*

[10] *Id.*

[11] *Id.* at 249.

[12] *Id.*

[13] *Id.* at 250.

[14] *Id.*

[15] *Id.* at 251.

[16] *Id.* at 252.

[17] *Id.*

[18] *Id.* at 253.

[19] *Id.* at 254.

[20] Hilliard, Thomas. *Power Failures*, Schuyler Center for Analysis and Advocacy (December, 2006).

[21] *In the Matter of the Salvation Army v. Ferrara*, 3 Misc.3d 944 (2004), 775 N.Y.S.2d 470, affirmed 22 A.D.3d 578 (2d Dept 2005), 802 N.Y.S.2d 471, 2005, leave to appeal granted 6 N.Y.3d 704 (2006), 811 N.Y.S.2d 337, 844 N.E.2d 792 (Sur Ct, Rockland County 2004).

[22] *Id.*

[23] *In re Estate of Ferrara*, 7 N.Y.3d 244 (2006), 819 N.Y.S.2d 215, 852 N.E.2d 138, 2006. It should be noted that the Court of Appeals did not address this issue in the *Ferrara* case.

[24] *In the Matter of Estate of Maikowski*, 24 A.D.3d 258 (1st Dept 2005), 808 N.Y.S.2d 174.

[25] *In re Nellie G.*, 38 A.D.3d 547 (2d Dept 2007), 831 N.Y.S.2d 473.

[26] *Matter of Daniel TT.*, 39 A.D. 3d 94 (3d Dept 2007), 830 N.Y.S.2d 827.

[27] *In re Nellie G.*, 38 A.D.3d 547 (2d Dept 2007), 831 N.Y.S.2d 473.

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Matter of Daniel TT.*, 39 A.D. 3d 94 (3d Dept 2007), 830 N.Y.S.2d 827.

[35] *Id.* at 95.

[36] *Id.*

[37] *Id.*

[38] *Id.* at 96.

[39] *Id.* at 99.

[40] *Id.* at 97.

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] 2006 NYS Law Revision Commission, *Report on Proposed Revisions to the General Obligations Law in Relation to Powers of Attorney* (Revised June, 2006).

[46] *Id.* at 1.

[47] *Id.*

[48] *Id.*

[49] *Id.* at 8.

[50] *Id.*

[51] *Id.* at 19.

[52] *Id.*

[53] *Id.*

AN UNSETTLED QUESTION: THE EMERGENCE OF SEXUAL ORIENTATION DISCRIMINATION UNDER TITLE VII

by
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I. INTRODUCTION

Within the last few years, harassment based on gender identity (sometimes referred to as sexual orientation or sexual preference) has been accepted by some courts as a form of sexual discrimination. This is a new development in the law and clearly favors those in the transgender community who wish to describe themselves as members of the opposite sex. The basic issue presented in this paper is whether sexual orientation discrimination is included within the boundaries of sexual discrimination under Title VII. Title VII of the 1964 Civil Rights Act states that it is illegal for any employer "to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of . . . sex."[1]

Serious problems exist since discrimination against transgendered individuals appears to be widespread. Mara Keisling, the executive director for the National Center for Transgender Equality in Washington, D.C. stated, " 'We get calls virtually every day from somebody who has been fired from his or her job' "[2] for having a different sexual orientation

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than their natural anatomical body. "Each month a transgendered person is murdered simply for being themselves,"[3] and most "will be the target of a hate crime."[4] Another problem is that "birth-assigned sex requires a host of medical experts to list all of the ways in which the transgender person is gender conforming."[5] Emotional difficulties abound when a transgendered individual discloses his or her status.

This paper describes the terms used in sexual orientation discrimination claims (Gender Identity Disorder, gender, sex, and transgender), the case law prior to the acceptance of gender identity discrimination, and the more recent case law which allows for a claim of sexual discrimination as well as upholds the traditional view.

II. TERMOLOGY

Those who have been discriminated against based on sexual orientation are sometimes classified as having a mental condition defined by psychologists as Gender Identity Disorder (GID). This is best described as "persistent feelings of gender discomfort and inappropriateness of anatomic sex."[6] The American Psychiatric Association's handbook, *The Diagnostic and Statistical Manual of Mental Disorders* (DSM), states that "there are two components of Gender Identity Disorder."[7] The first component is that the person must show "strong and persistent cross-gender identification."[8] This usually means that the person desires to live and dress as a person of the opposite sex. The second component is that "there must also be evidence of persistent discomfort about one's assigned sex or a sense of inappropriateness in the gender role of that sex."[9] This has been defined as having a "preoccupation with getting rid of primary and secondary sex characteristics."[10] In other words, there is a strong desire to seek sexual reassignment

surgery in order to become the other sex. "The exact cause of this disorder is unknown."[11]

"The term *transgender* generally refers to a person whose 'gender identity or gender presentation falls outside of stereotypical gender norms.' "[12] It should be noted that this is a very general definition. Opinion exists that there are "many different ways in which one can be transgender."[13]

Even "gender" and "sex" are terms in dispute. Gender has been described as "social behavior or norm"[14] and thought of as a cultural dimension. Sex is generally thought of as a person's physical trait. This is an anatomic versus psychological bifurcation. The courts, however, have not been coherent in applying these terms, and exact definitions have been elusive. Even the question of distinguishing between gender and sex is open to debate.

III.SETTING THE STAGE

Prior to 2001, gender identity sexual harassment claims based on Title VII were clearly not accepted by the courts. Examples are *Ulane v. Eastern Airlines, Inc.*[15] and *Hamner v. St. Vincent Hospital and Health Care Center, Inc.*[16] The traditional view of sexual discrimination dominated jurisprudence thinking. Title VII was read from a narrow viewpoint and conformed to the traditional male-female division of sex. Discrimination on any other basis, such as gender identity, was allowed.

Price Waterhouse,[17] however has been a cause of action for sexual orientation discrimination. Although this case has nothing to do with gender or sexual orientation discrimination, it does concentrate on sexual discrimination in the traditional

sense. The court set the stage for an expansion of the view of sexual discrimination when it stated that

> "We are beyond the day when an employer could evaluate employees by assuming or insisting that they matched the stereotype associated with their group, for in forbidding employers to discriminate against individuals because of their sex, Congress intended to strike at the entire spectrum of disparate treatment of men and women resulting from sex stereotypes."[18]

After this statement, all federal courts have held that sexual stereotyping falls under the umbrella of Title VII. In this case the plaintiff, Ann Hopkins, was denied promotion to partner due to her non-feminine appearance, behavior, and mannerisms. She had preformed very well for the employer but was considered " 'overly aggressive, unduly harsh, difficult to work with and impatient with staff' "[19] by the district court judge. She filed a Title VII claim against her employer. The court stated that "the central point is [that] . . . an employer may not take gender into account in making an employment decision."[20] An exception to this general rule occurs when gender is a bona fide occupational qualification (BFOQ). The court also stated that sexual stereotyping in and of itself is not gender discrimination. "The plaintiff must prove that the employer actually relied on her gender in making its decision."[21] For a cause of action to be upheld, it appears that some sort of harm must happen to the plaintiff based on sexual stereotyping. Sexual stereotyping could be defined as fitting one into a preconceived category. An example is "requiring that a woman wear heels and make-up."[22] The *Price Waterhouse* decision appears to open the door to the idea that there are a large number of mannerisms that are acceptable.

IV. THE EMERGENCE

Transgender rights under Title VII emerged as an evolutionary process starting with reliance on the *Price Waterhouse* decision. The following cases all base their opinions favoring transgender rights on this case.

Nichols v. Azteca Restaurant Enterprises Inc. (256 F.3d 1131, 10th Cir. 2001) was a case that extended sexual harassment to males. In this case Antonio Sanchez acted in an effeminate manner and received ongoing abuse from co-workers and a supervisor. The harassment was persistent. After an argument with a manager, the plaintiff walked off the job and was fired. A Title VII claim was filed by the plaintiff against the employer, and the court stated that "sexual harassment is actionable under Title VII to the extent it occurs 'because of' the plaintiff's sex."[23] The court considered this action a form of discrimination based on stereotyping an individual and, relying on *Price Waterhouse*, found that stereotyping is illegal sexual discrimination. In *Price Waterhouse* the woman was thought to be too masculine, here a male was thought to be too feminine. Both cases are based upon the stereotypical image of an individual founded on their anatomical sex at birth. A restriction was put in place since not "all gender-based distinctions are actionable under Title VII."[24] An exception was carved out, and the court went on to identify dress and grooming codes, which are different for males and females, as being acceptable. Although the court declared harassment for acting differently came under Title VII, it did not state that sexual orientation was within Title VII.

In *Smith v. City of Salem*[25] the court stated that sexual orientation was discrimination based on sex, similar to sexual stereotyping. Smith, a firefighter, worked for the city of Salem, Ohio and was diagnosed with Gender Identity Disorder.

He was employed as a lieutenant and had 7 years of prior service without an incident before adopting a more feminine appearance and conduct. After an executive meeting, the city requested that Smith submit to three psychological evaluations from different physicians of the city's choosing. The city hoped that he would either resign or not comply, thus terminating his employment. The firefighter's attorney contacted the city regarding this matter. Smith then filed a complaint with the Equal Employment Opportunity Commission (EEOC) and received a "right to sue" letter in return. The city suspended Smith for breach of a City/Fire Department policy which was not in effect at the time. At a City Civil Service Commission hearing, the chairman refused to allow testimony from Smith and upheld the suspension. The Columbiana County Court of Common Pleas in Ohio reversed the suspension since the regulation was not in effect at the time of suspension. Smith then filed suit in federal district court on the grounds of sex discrimination and retaliation under Title VII and other state claims. District court found for the city saying that sexual orientation was not a basis for filing a sexual discrimination suit. Smith appealed.

When Smith appealed court applied the McDonnell-Douglas rule. This required that "(1) he is a member of a protected group, (2) he suffered an adverse employment action, (3) he was qualified for the position in question, and (4) he was treated differently from similarly situated individuals outside of his protected class."[26] The appeals court also stated that four elements were required to establish a prima facie case for retaliation under Title VII. These were as follows: "(1) he [plaintiff] engaged in an activity protected by Title VII; (2) the defendant knew he engaged in this protected activity; (3) thereafter, the defendant took an employment action adverse to him; and (4) there was a causal connection between the protected activity and the adverse employment action."[27] Only

the questions of whether Smith suffered an adverse employment action and whether sexual stereotyping includes sexual orientation were examined by the appeals court. All other elements for a prima facie case were found to be established.

The court stated that "sex stereotyping based on a person's gender non-conforming behavior is impermissible discrimination."[28] It was also stated that the cause of the behavior is immaterial and that labels of an individual are "not fatal to a sex discrimination claim."[29] Here the term "non-conforming behavior" is utilized to make any form of discrimination illegal as applied to sexual behavior. It was the opinion of the court that labeling someone as "transsexual" does not "legitimize discrimination based on plaintiff's gender."[30] The court stated that Title VII was never meant to apply only to the traditional notions of sexual behavior. Traditionally, the courts had separated claims under sex or biological features from claims under gender or social norm behavior. The former were granted protection under Title VII and later were not. The appeals court stated that *Price Waterhouse* never intended this type of separation, but that the intent of the U.S. Supreme Court in that case was to bar discrimination based on sex. The court stated that "employers who discriminate against men because they do wear dresses and makeup, or otherwise act femininely, are also engaging in sex discrimination, because the discrimination would not occur but for the victim's sex."[31]

This case has opened the door for discrimination claims on any potential sexual behavior which the employer criticizes as not proper for a male or female. The court did not restrict sexual stereotyping to females who act as males but extended the concept to all people acting in other than traditionally acceptable sexual behavior.

Another case from the same circuit that supported transsexual rights and followed the *Smith* decision is *Barnes v. City of Cincinnati.*[32] In this case a police officer was denied promotion to sergeant based on the fact that the officer was a pre-operative male-to-female transsexual. The officer was scrutinized more severely than other officers regarding the promotion and was the only person denied promotion during the probation period between 1993 and 2000. At one point, the officer was told "to stop wearing makeup and act more masculine."[33] The officer filed suit for sex discrimination, and the city of Cincinnati objected on the grounds that the officer was not a member of any protected class and that a similarly situated employee was not identified. Using the *quid pro quo* test for sexual discrimination, the court found that the officer was "a member of a protected class by alleging discrimination against the city for his failure to conform to sex stereotypes."[34] The court also found that the officer did not have to "demonstrate an exact correlation with the employee receiving more favorable treatment in order for the two to be considered 'similarly situated.'[35]

The officer was never identified as having gender identity disorder. Thus, it appears that a transgender person is protected without the need for a psychiatric examination, which may be an expansion of *Smith.*

Other courts disagree with the traditional view. In *Schroer v. Billngton,*[36] the plaintiff applied for a position with the Congressional Research Service (part of the Library of Congress). After an interview, the plaintiff was offered the job and accepted the position. The plaintiff decided to explain . . . that she was under a doctor's care for gender dysphoria [gender identity disorder] and would be presenting herself as a woman when she started work. The position offer was rescinded, and the plaintiff filed a sex discrimination claim under Title VII.

The court stated that "neither the logic nor the language of Price Waterhouse establishes a cause of action for sex discrimination in every case of sex stereotyping."[37] A Title VII cause of action is created under sexual stereotyping only when disparate treatment occurs. The primary concern by the court was the motivation of the defendant. If the plaintiff was chastised for not conforming to a male role when perceived to be a male or chastised for not conforming to a female role when perceived to be a female, then discrimination has occurred.

Traditional courts have held that a distinction exists between sexual stereotyping and sexual orientation. The later has been considered "a form of discrimination that remains outside the settled scope of federal sex discrimination laws."[38] In *Schroer*, the court felt that it was the time to revisit the decision in *Ulane*.

In the case of *Mitchell v. Axcan Scandipharm, Inc.*[39] the court relied upon *Smith*, *Barnes* and *Price Waterhouse* to conclude that a Title VII claim does arise where the plaintiff has suffered discrimination due to "plaintiff's appearance and gender-related behavior."[40] The court equated this to sexual stereotyping.

V. CONFUSION AT THE DISTRICT AND APPEALS COURT LEVELS

The traditional view of sexual discrimination is still being applied in both the federal district and appeals courts. Examples include *Kastl v. Maricopa County Community College District,*[41] *Etsitty v. Utah Transit Auth.*,[42] *Dawson v. Bumble and Bumble*[43] and *Vickers v. Fairfield Medical Center.*[44]

In *Kastl* the plaintiff was diagnosed with Gender Identity Disorder and at the time was a pre-operative transsexual but " 'functionally living as a female.' "[45] The court held that the "plaintiff has failed to meet her burden of establishing a prima facie case of discrimination because she has provided no evidence that she was a biological female and member of a protected class while she was employed."[46] The equation made by the court is that for sexual discrimination to be determined for a female there must be the finding of a biological female.

In *Etsitty* (2005) a pre-operative transsexual individual, who had been diagnosed having Gender Identity Disorder, filed suit due to termination based on possible liability by the employer as to what restroom the employee would use. The district court recognized that the 6th Circuit court decisions of *Smith* and *Barnes* existed but disagreed with them stating that Gender Identity Disorder is a "drastic action"[47] and not sexual stereotyping. The court relied on *Ulane*. It maintained that the *Ulane* decision meant that sexual discrimination should be given an "ordinary common meaning"[48] in "that it is unlawful to discriminate against women because they are women and against men because they are men."[49] The district court also cited the Congressional intent when it stated:

> From 1981 through 2001, thirty-one proposed bills were introduced in the United States Senate and the House of Representatives which attempted to amend Title VII to prohibit employment discrimination on the basis of affectional or sexual orientation. None of them passed. The rejection of these proposed amendments indicates that Congress intended the phrase in Title VII prohibiting

discrimination on the basis of sex to be narrowly interpreted.

It is interesting to note that the district court went on to state that Title VII "should be liberally construed,"[50] that the issue of Title VII and transgender identity "is a complex one,"[51] and that "a great deal of tension [exists} . . . on the issue of whether Title VII applies to transsexuals."[52] These statements appear to be in conflict with the traditional view.

In *Dawson v. Bumble and Bumble*,[53] the appeals court stated that discrimination or harassment is not prohibited due to sexual orientation and that Title VII "does not recognize homosexuals as a protected class."[54] The court acknowledged the prior *Smith* decision but gave no analysis of that decision except to say that sexual orientation discrimination is clearly permissible behavior on the part of an employer because such an employee is not part of a protected class (the first requirement to show a prima facie case of sex discrimination). Both the district court and the appeals courts admitted that the distinction between being a woman or man, nonconformance to gender norms, and the status of being gay or lesbian are "somewhat interrelated protected classes"[55] and that "the borders [between these classes] are so imprecise."[56] Even though the appeals court stated that these behaviors would blur together, it still held to a clear distinction that sexual stereotyping was protected under Title VII and sexual orientation was not.

The *Vickers* case presents the most confusing opinion against sexual orientation discrimination. Vickers was a private police officer who filed suit against Fairfield Medical Center and others for a variety of claims including sexual orientation discrimination under Title VII. First, the district court held "that Title VII did not protect individuals from

discrimination based on sexual orientation."[57] Second, the court stated that the behavior upon which harassment was based was "the employee's perceived homosexuality, rather than based on gender non-conformity."[58] Vickers supplied the court with a complaint that had extensive details showing that he was harassed at work. The district court held that the "behavior which the employee claimed . . . was not behavior observed at work or affecting his job performance."[59] Vickers appealed and the 8th Circuit Court of Appeals affirmed in a terse opinion. The *Smith* decision was made after the district court made its opinion but before the appeals court affirmed the decision. The majority opinion in *Vickers* did not mention the *Smith* case. Only the dissent cited *Smith* claiming that sexual orientation was not covered under Title VII.

VI. ANALYSIS

The idea that discrimination is illegal due to sex has been long established by case law and by statutes. This has now been applied to sexual orientation and individuals with gender identity disorder. Perhaps an explanation for the traditional view is that the idea of adopting a different sex from one's anatomical birth sex is the belief that it is morally wrong. Even the American Psychiatric Association recognizes gender identity disorder in the DSM as a mental disorder or illness.[60] These attitudes have been criticized as regressive jurisprudence where the court holds a rigid vision of what sex and sexuality are. Until 2000, the courts used the doctrine of protected classes to "affirm and strengthen traditional sex and gender roles that fail to account for the wide spectrum of sexual difference[s]."[61] With *Smith, Barnes*, and *Schroer* the door has been opened to punish those who discriminate based on any form of sex.

The differentiation between sexual stereotyping and sexual orientation remains blurred. Some courts state that "gender identity and/or expression are distinct from sexual orientation."[62] The court in *Smith* found that using labels, such as transgender, to describe a person did not prohibit a claim of sex discrimination. The limits of the decision from *Smith* are in limbo as many questions remain unanswered. Will this decision allow a male to female (or female to male) preoperative transgender person from dressing and acting as a female (or male), going to work on a regular basis dressed as such, or using the women's (or men's) restrooms?

The basic question that must be answered is whether sexual orientation discrimination is truly discrimination? Title VII was created to eradicate sexual discrimination. Why is sexual orientation discrimination allowed at all? Why are transgender individuals punished for not conforming to traditional societal viewpoints regarding sex? Courts on both sides of the issue cite the intent of Congress. The traditional view points out that sexual orientation has never been accepted or enacted into law as a protected class. The modern view cites the opinion of *Price Waterhouse* since "Congress intended to strike at the entire spectrum of disparate treatment."[63] Courts with a traditional viewpoint, as in the *Etsitty* decision, acknowledged a legal problem concerning the usage of the narrow definition of sex discrimination.

Even with the concept that sexual orientation falls under Title VII, numerous questions still exist: What is the difference between physical sex and sexual orientation? Should there be a difference between the two? Should the transgendered individual be allowed insurance and medical coverage? What role, if any, does a psychological examination and determination of Gender Identity Disorder have to do with Title VII sexual orientation claims? Should GID be a standard

before sexual orientation discrimination is allowed? Although some courts have mentioned that the plaintiff has been diagnosed with GID, no court has held it to be a prerequisite for discrimination. How is record keeping handled concerning name, sexual classification, and social security? Should transgendered individuals be allowed to use the restroom, locker room, or the residence hall of their choice? What happens to the dress codes that require men to wear only suits and women to wear either skirts or dresses? Is this not sexual stereotyping? A standard of professional attire would appear more appropriate and be gender neutral.

VII. CONCLUSION

The federal courts are starting to recognize the fact that discrimination based on sex is illegal in all its forms. Also, "a growing number of states and localities have enacted laws prohibiting discrimination based on sexual orientation."[64] To simply state that discrimination is allowed because of a label (such as transsexual) placed on a person defies logic and the true intent of Title VII prohibition against sexual discrimination. The courts must interpret the law to prohibit discrimination no matter what its form or classification. "Many employers have also begun to address discrimination against transgender workers."[65] Perhaps the entire concept of sexual orientation discrimination is best stated as a warning: "No one will have their gender rights secure until the entire gender galaxy . . . have rights and protections."[66]

ENDNOTES

[1] 42 U.S.C. §2000e-2(a)(1)

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[2] Jost, Kenneth. *Transgender Issues: Should Gender-Identity Discrimination be Illegal?* 16 CQ Researcher, 391, n. 17 (May 5, 2006).

[3] Vade, Dylan. *Expanding Gender and Expanding the law: Toward a Social and Legal Conceptualization of Gender That is More Inclusive of Transgender People*. 11 Michigan Journal of Gender & Law 256, 2005, at 2.

[4] *Id.* at 257.

[5] *Id.* at 297.

[6] *Gender Identity Disorder*, Psychology Today, October 10, 2002, at http://www.keepmedia.com/Register.do?oliID=225.

[7] American Psychiatric Association, *The Diagnostic and Statistical Manual of Mental Disorders*, at 532.

[8] *Id.*

[9] *Id.* at 533.

[10] *Id.* at 538

[11] Zieman, Gayl. *Gender Identity Disorder*. Behavioral Health Advisor, August 15, 2005, at http://www.fairview.org/healthlibrary/content/bha_genderid_bha.htmon.

[12] Bazluke, F T. & Nolan J. J. *Topic: Gender Identity and Expression Issues at College and Universities Quoting Human Rights Campaign Foundation, Transgender Issues in the Workplace* 3 NACUANOTES June 2, 2005 n.3, 1, at http://www.nacuaorg/nacualert/memberversion/Gender.asp.

[13] Vade at 260.

[14] Ben-Asher, Noa. *The Necessity of Change: A struggle for Intersex and transex liberties.* 29 Harvard Journal of Law & Gender, 2006, at 52.

[15] *Ulane v. Eastern Airlines, Inc.*, 581 F.Sup. 821, 7th Cir. 1984.

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16 *Hamner v. St. Vincent Hospital and Health Care Center, Inc.,* 224 F.3d 701, 7th Cir. 2006.

[17] *Price Waterhouse v. Ann B. Hopkins*, 490 U.S. 228 (1989).

[18] *Id.* at 251.

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Nichols v. Azteca Restaurant Enterprises Inc,* 256 F.3d 1131, 9065 (10th Cir. 2001).

[24] *Nichols*, 9066 note 7.

[25] *Smith v. City of Salem*, 378 F.3d 566, 569 (6th Cir. 2005).

[26] *Id.*

[27] *Id.* at 570.
[28] *Id.* at 573.

[29] *Id.*

[30] *Id.* at 574.

[31] *Price Waterhouse* at 234.

[32] 401 F.3d 729, 731 (6th Cir., 2005).

[33] *Id.*

[34] *Id.* at 733.

[35] *Id* .

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[36] 424 F.Supp. 2d 203, 213 (D.C. Cir. 2006).

[37] *Id.*

[38] Bazluke at 2.

[39] 2006 U.S. Dist. LEXIS 6521 at 3.

[40] *Id.*

[41] 2006 U.S. Dist. LEXIS 60267 at 3, citing Defendant's Separate Statement of Undisputed Facts p 11-12, Ex. 6.

[42] 2005 U.S. Dist. LEXIS 12634 at 12.

[43] 398 F.3d 211, 2nd Cir. 2005.

[44] 453 F.3d 757 (8th Cir. 2006).
[45] *Kastl* at 3, citing Defendant's Separate Statement of Undisputed Facts p 11-12, Ex. 6.

[46] *Id.* at 20.

[47] *Estitty* at 12.

[48] *Id.* at. 5.

[49] *Ulane* at 1085.

[50] *Etsitty* at 8.

[51] *Id.* at 7.

[52] *Id* at 8.

[53] 398 F.3d 211, 218 (2nd Cir. 2005).

[54] *Id.*

[55] *Id.* at 217.

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[56] *Id.*

[57] *Vickers*, p. 1

[58] *Id.*

[59] *Id.*

[60] Jost at 390.

[61] Ling, Thomas. *Smith v. City of Salem: Title VII Protects Contra-Gender Behavior*, 40 Harvard Civil Rights-Civil Liberties Law Review, October 2, 2006 at 1, at http://www. law.harvard.edu/students/orgs/crcl/vol40_1/ling.php.

[62] Bazluke at.2.

[63] *Price Waterhouse* at 251.

[64] Sheehy, Catherine. *Transgender Issues in the Workplace 2004*, Human Rights Campaign Foundation at 4.

[65] *Id.*

[66] Vade at 315.

POST-SARBANES-OXLEY: INTERNATIONAL RESPONSES

by
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INTRODUCTION

The Enron, WorldCom, Adelphia, and other corporate scandals gave rise to the passage of the Sarbanes-Oxley Act (SOX) in 2002.[1] This legislation seeks to change corporate culture and significantly improve the reliability of financial reporting by corporate CEOs and CFOs. The Act, however, created a number of problems including the enormous costs of compliance with the Act, particularly with companies whose incomes were borderline or below profitability. Significant conflicts with the laws and regulations of other advanced countries also exist. Section 404 of the Act, for example, requires that the company document every internal and external process that affects corporate earnings.[2] Estimated costs for compliance exceed $4.6 million for companies with over $5 billion in revenues and medium-size companies are expected to incur approximately $2 million for compliance.[3] The EU adamantly stated that its regulations and the actions of member states protect shareholders and, therefore, SOX's extension of the Act to foreign companies is unwarranted.

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This article highlights US-European Union (EU) conflict and sets forth a possible resolution to the controversy.

SARBANES-OXLEY: KEY PROVISIONS AFFECTING NON-US PUBLIC ACCOUNTING FIRMS

Section 102(a) of SOX provides that: "…it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer." There is no exception for foreign audit firms. The statute requires foreign audit firms, whose reports are included in Securities and Exchange Commission (SEC) filings, to register with the newly created Public Company Accounting Oversight Board (PCAOB) by July 19, 2004. The application for registration with the PCAOB is quite extensive. The Board requires annual fees received for audit and non-audit services, quality control policy statements of the firm, a list of all accountants participating in audit reports, criminal or civil disciplinary proceedings against the firm or person associated with any audit, disputes between the audit firm and the issuer, and other information that the Board may determine is necessary.[4] A foreign firm registration does not relieve the auditor of responsibility for demonstrating its knowledge and experience in applying US GAAP, PCAOB standards, SEC financial reporting rules, and SEC independence requirements. A limited time grace period is allowed for the filing of quarterly reports by the foreign firm pending the review of its PCAOB registration application.[5]

Section 106(a) subjects "any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer" to the rules and regulations of SOX "in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States or

any State." Even if the foreign firm does not itself prepare the audit, its substantial role in the preparation of reports may subject it to Act requirements. SOX, furthermore, requires the firm to monitor internal controls as well as external controls. The US government desires to uncover not only offshore investments but also to prevent the export of forbidden end products. SOX, therefore, requires the maintenance of accurate records to reflect such transactions and their authorizations.

Section 106(b) that concerns the production of audit workpapers has produced widespread controversy.[6] A foreign public accounting firm that issues an opinion or provides material services to a registered public accounting firm is deemed to have consented to the production of its audit workpapers to the PCAOB or to the SEC. The firm is subject to the jurisdiction of US courts with respect to the enforcement of the provision. Domestic registered public accounting firms that rely on opinions by foreign public accounting firms are also deemed to have consented to provide the audit workpapers of the particular foreign public accounting firm.

Section 301 concerns the makeup of public company audit committees. The Act prohibits national securities exchanges and associations from listing any security of an issuer not in compliance with the Section's provisions. It includes the requirement that the audit committee of an issuer, acting as a committee of the board of directors, shall be responsible for the appointment and supervision of any registered public accounting firm with respect to the preparation or issuance of an audit report or related work.[7] The registered firm is to report directly to the audit committee. Each member of the audit committee shall be a member of the board of directors and shall be independent therein. The member of the audit committee may not accept any consulting, advisory, or other

fee from the issuer or be an affiliated person of the issuer or a subsidiary thereof.[8]

Section 302 describes the corporate responsibility for financial reports. The Section mandates that the principal executive officer(s) and principal financial officer(s) certify in each submitted annual or quarterly report that each of the said officers have reviewed the report; that, based on each officer's knowledge, the report does not state any untrue statement or material fact or omission; that the said report, based on each officer's knowledge, fairly represents in all material respects the financial condition of the issuer; that the said officers are responsible for establishing and maintaining internal controls designed to ensure that material information is made known to them and have reviewed the issuer's internal control within the prior 90 days prior to the report; and that the signing officers have disclosed to the issuer's auditors and audit committee all significant deficiencies in the internal controls and any fraud involving management or other employees having a role in the internal controls.[9] Note that an issuer that reincorporates or transfers offices to a foreign state shall remain subject to the Act.[10]

Section 401 concerns the disclosure in periodic reports. Section 13 of the Securities Exchange Act of 1934 was amended to provide for accuracy of each financial report filed with the SEC. with respect to the problem of Enron's off-balance sheet transactions, the Section states that "each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons that may have a material affect or future effect on the financial condition,

results of operations, liquidity, capital resources, or significant components of revenues or expenses."

Section 402 provides for conflict of interest provisions. With minor exceptions, personal loans given by an issuer to executives are expressly prohibited after the Act's date of enactment, whether they be directly or indirectly made, or through a subsidiary, and includes the extension of credit.[11]

PCAOB and SEC Standards

In December, 2003 the PCAOB adopted the Auditing Standard AS 1. International auditors' reports must state that they are in compliance with the standards of the PCAOB. It is no longer appropriate or necessary to state that the auditors' reports are in compliance with Generally Accepted Auditing Standards (GAAS).[12] The SEC issued an interpretation of the requirement.[13] In it, the SEC makes it clear that AS 1 does not supersede any of the applicable rules or regulations of the Commission. Rather, the AS 1 requirement means that a report of an independent accountant must comply with both SEC and PCAOB rules and guidance. Registered public accounting firms must comply with the more restrictive of the rules and regulations of the SEC and the PCAOB.[14] The issue that has arisen was that the SEC, in the past, permitted some foreign issuers to file reports referring to compliance with both US GAAS and home country auditing standards. PCAOB rules now require that the entire audit must comply with PCAOB standards.[15]

Section 404 requires companies to include in their annual reports a statement analyzing and evaluating the effectiveness of their internal financial-reporting controls.[16] It appears that Section 404 not only applies to a firm's internal control structure but appears also to apply to export controls with

respect to end users and end uses; destinations (e.g., Cuba, Iran, North Korea); Commerce Control List determinations; screening of entities involved in the transaction; hardware, software, and technology controls; re-exports; and release of US-origin technology to foreign nationals.[17] There are significant criminal and civil penalties for the failure to comply with regulatory requirements.[18]

INTERNATIONAL RESPONSES

International responses have been rather mixed. Nearly one-half (44%) of executive management felt that SOX and the regulations issued by the Securities and Exchange Commission (SEC) would have little effect while 43% held the opposite view. The major complaints concerned the "noisy withdrawal statute" and the executive certification requirements. As a result of European complaints, a few of the regulations have been relaxed as to foreign companies and non-US lawyers practicing primarily abroad.[19] Nevertheless, European countries and, more particularly, the companies located therein, are rebelling against the US requirements. Specifically, there is increasing resentment at the pressure, costs, legal exposure, and possible violation of European law by attempting compliance with SOX. There is a consensus that European auditing standards, particularly, that of the major trading nations, are comparable to that of SOX.[20]

Companies, as a consequence, are considering de-listing or not listing their securities on US stock exchanges.[21] Inasmuch as there are some 470 non-US companies listed on US exchanges with a total capitalization of $3.8 trillion, the costs of compliance in some cases exceed $30-40 million as estimated by BASF, the German chemicals producer. Rank Entertainment Group and British Telecom are considering delisting even though SOX required statutory compliance

where there are 300 or more shareholders in the US[22] Fugro, a Netherlands-based engineering consulting firm, with a turnover of $1.2 billion (one-third in the US) said that SOX ended any hopes that the company would list its securities in the US The chairman of the International Corporate Governance Network and a senior adviser to Morgan Stanley said that SOX would cause Europe to become a haven for global public offerings. In addition, whereas a company had to be so listed in order to gain access to US capital markets, today, with the deregulation of global markets, the need to have a US exchange presence is less attractive.[23]

The EU lodged a series of complaints with respect to the promulgation and enforcement of SOX. The overall complaint concerned the extraterritoriality provisions of the statute. This concern was reminiscent of the bitterness caused by the extraterritorial enforcement of the US antitrust laws during the 1950s-1970s. Among the complaints by EU finance ministers were the US authorities' compulsion of access to the audit papers, including working papers; the SEC's grant of only a 30-day comment period for its impending regulations; and the subjecting of European audit firms to double oversight by both European member states and by the US[24] If there is a reference to another auditor's report by the principal auditor, then the said other auditor's report must also be included in the filing.[25]

The EU Finance Ministers' additional complaint, coupled with a threat, concerned the need for foreign firms to register with the PCAOB. The EU said that it already has established equivalent registration requirements for all member states and that compelling these firms to register with the PCAOB would be unnecessarily duplicative and expensive. Thus, it called for mutual recognition and equivalence of registration or else the EU may not be able to avoid reciprocity of member states which may require US firms to similarly register with the 25

member states wherein they may provide auditing services. Furthermore, the costs for registration by small EU auditing firms would be heavy and would exceed that of domestic US firms.[26]

The EU further noted that the PCAOB rules conflict directly with EU and national laws of member states. There were a number of examples given to illustrate the conflict of laws difficulty. In a Memorandum to the SEC Chairman,[27] the EU asked for an exemption under Section 106(c) of SOX[28] claiming that the PCAOB's proposal is "ineffective," "unnecessary," "disproportionate in that it involves significant costs of registration for EU audit firms with a relatively small number of US issuers," likely to cause distortions of the market for audit services…," and is "prejudicial to future EU policy making on audit issues."[29]

Some criticisms were more temperate. The UK banking industry, while recognizing the right and goal of the US to restore investor confidence by measures such as SOX, nevertheless, expressed its concern over regulations on companies which are already subject to equivalent or superior measures in their home states. The complaint is not only that of duplication but also may involve compliance with conflicting regulations. It also respected US regulations concerning raising capital in the US from domestic and foreign sources, but the US should not hold itself as being the sole determinant of such rules when other governmental authorities are equally competent to assure appropriate regulatory regulations. Specifically, the UK banking industry has suggested compromise concerning Sections 301, 302, 401 and 402 of SOX.[30]

With respect to Section 301, concerning the composition of audit committees, the EU published a report concerning the

Comparative Study of Corporate Governance Codes of member states and found the UK 's Combined Code to be widely adhered to and, though voluntary, compliance is a requirement under its Listing Rules of the Financial Services Authority. Among the standards discussed are the auditing standards and accounting issues. The UK, particularly after Enron and other debacles in the US and its own corporate scandals, have evolved standards that negate the need for enforcement of SOX standards. With respect to Section 302, certification of accounts, the concern is that of duplication, ambiguity and possible conflict with UK requirements. Under the UK Combined Code, the Board of Directors has specific responsibility to maintain a sound system of internal controls to safeguard shareholders' investments and company assets. At a minimum, an annual review by directors is mandated and a report to the shareholders is required. There are also additional proposals for further requirements of directors' duties and extension of obligations to auditors with possible criminal penalties for noncompliance.[31]

Concerning Section 401 rules concerning disclosures of off balance sheet transactions, the problem is that accounting and disclosure rules differ considerably between US and UK GAAP. Whereas US GAAP rules are detailed and require compliance to the letter of the rules, the UK GAAP looks to the principles and substance rather than to the legal form. The UK requires that in the examination of a transaction "all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect in practice. A group of series of transactions that achieves or is designed to achieve an overall commercial effect should be viewed as a whole." The substance of a quasi-subsidiary's transactions of an entity should also be reported in consolidated financial statements.[32] Section 402 rules forbid loans to directors and employees with the exception of loans made or maintained by

depository institutions subject to Federal Reserve Board restrictions, which restriction is not extended to foreign entities. It is the view of the UK Bankers' Association that such failure is anticompetitive.[33]

Not all commentators abroad have written or espoused highly negative commentaries concenring SOX. One commentator suggested that SOX is compelling European governments, legislators, and regulators to modernize their long overdue overhauling of oversights structures of accountants and corporate governance. SOX has facilitated the efforts of EU Commissioners to modernize market supervision, accounting oversight, and corporate governance. Fritz Bolkenstein, the EU Commissioner for Internal Market & Taxation, stated that the EU was faced with the choice of either engaging in a major dispute with the US, as exemplified by the debate over the Iraq War, or to find a constructive way of moving forward to the benefit of both arenas while considering the different traditions and culture. The choice of the latter was exacerbated by the Parmalat fraud and its complicity by the several professions. The need for corporate governance reform is evidenced by the EU's new Corporate Governance Action Plan. Neither area can ignore the demands and needs of the other. 15 % of all capital raised by EU equity issuers was from US investors; purchases and sales of foreign securities by US investors rose from $53 billion in 1980 to $6.6 trillion in 2003 while foreign investors bought and sold $30.9 trillion US securities (up from $198 billion in 1980).[34]

Bolkestein noted the enormous task of the EU in created a single financial market among the now 25 member states each of which has its own internal laws and regulations. The problem has been exacerbated by the adoption of SOX with its sizeable complex rules. His suggested solution is the engaging in a constructive Financial Markets Dialogue with US

regulators to address EU concerns. He expressed his growing impatience with the US especially in the light that the EU-US conflict was not raised under the World Trade Organization's General Agreement on Trade in Services (GATS). Thus, there is a need for cooperation on three fronts: (1) Cooperation daily or weekly concerning financial services and markets regulatory issues; (2) Convergence on common principles and understandings rather than an identical approach but with the same goal of investor protection. The convergence on International Accounting Standards and US GAAP is an example of such cooperation; and (3) Regulatory equivalence rather than one standard as promulgated by the US whether it concerns auditing, disclosure standards, market stability, or other such issues. The need for cooperation is immense given the volume of transaction and peoples involved on both continents.[35]

Advantages to SOX compliance

Although there has been significant complaints concerning compliance by foreign companies with SOX, nevertheless, it appears that it is advantageous for these companies to conform to the stringent rules of the Act. The main advantage is the greater ease in seeking public financing. The full transparent disclosure appears to assuage any lingering doubts about a company's financial well-being. Compliant public and voluntarily compliant companies appear to have a competitive advantage over non-compliant companies that remain private so that SOX is not applicable. Some one-fourth of private companies, mainly larger companies, have voluntarily adopted SOX best practices in order to attract public financing and position themselves for the issuance of future IPOs or for possible mergers with publicly financed companies. The large majority of private companies, nevertheless, oppose SOX

mainly because of the cost of compliance and because of its alleged impediment to profitable growth.[36]

FOREIGN WHISTLEBLOWERS AND SOX

Sections 301(4) and 806 of SOX provide protection to whistleblowers. Specifically, Section 301(4) provides that each audit committee is to establish procedures for "(A) the receipt, retention, treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." Section 806 is an extensive provision setting forth civil action and remedies for whistleblowers providing evidence of fraud.[37] The problem is that the information provided may concern data concerning other employees which, in turn, may violate the EU privacy laws. The SEC has refused to grant foreign companies exemption from this statutory requirement.[38] Item 8.1 of SOX's registration form provides that companies agree to provide information at any time in the future. Such agreement may violate the EU privacy regulation 95/46. Are foreign whistleblowers protected by SOX? The answer appears to be "No!" The laws, regulations, and court decisions of the country where the whistleblowing takes place would apply to the issues at hand.[39]

SOX AND THE INVASION OF PRIVACY

A major complaint of SOX is that Section 106(b) violates the mandates of the EU privacy legislation by requiring consent of foreign public accounting firms that issue an opinion or other material services upon which a public accounting firm relies with respect to the production of audit workpapers. The EU has the strictest privacy protection

restrictions in the world. Its Directive 95/46/EC, *On the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data*, sets forth a mandatory minimum of protection to be given by Member States to their inhabitants. Underlying the Directive was the Its predecessor was the Recommendation of the Council Concerning Guidelines Governing the Protection of Privacy and Transborder Flows of Personal Data that had been adopted by the Organization for Economic Cooperation and Development ("OECD"), as early as 1980.[40] The Recommendation became the basis for such protection in a number of Member States.[41]

Part Two of the Recommendation established limits with respect to the collection of personal data, requiring it be done lawfully and with knowledge and consent of the data subject where appropriate. The personal data had to be relevant for the purpose for which it is gathered and is accurate, complete and up-to-date. The data should not be disclosed other than for the essential purpose underlying its collection. The data should be protected by the use of reasonable security safeguards against unauthorized access or use. The individual, about whom the data is collected, should have the right to ascertain whether data has been collected about him/her; have the data communicated to the individual at a reasonable charge in a form that can be understood; be given reasons for denial of such information; and have the right to challenge inaccurate data and have it rectified.[42]

Part Three of the Recommendation requires Member States to consider the implications of domestic processing and re-export of personal data for other Member States. Transborder flows of such data should be uninterrupted and secure. With certain exceptions, a Member State should permit unrestricted transborder flows of personal data between it and another

Member State and avoid passing laws creating obstacles to such transmission. The OECD Principles concerning collection of data, data quality, use, openness, and safeguards became the basis for international goals, codes and statutes.[43]

The E.C. Directive sets basic requirements for data protection, allowing Member States to enact stricter standards. The effective date for implementation is October 25, 1998. A number of Member States had not yet enacted data protective laws when the Directive was issued. Moreover, the laws of Member States that did enact such measures differed substantially, thereby causing potential obstacles to the free flow of data and difficulties for the inhabitants therein. The Directive was enacted to remove such obstacles, harmonize the national provisions, and guarantee the right of privacy.[44]

Part of the basis for the Directive are the provisions of the Treaty on the European Union that provides in Title I, Article F, that the EU "shall respect fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms signed in Rome on November 4, 1950." Article 8 of the Convention provides:

1. Everyone has the right to respect for his private and family life, his home and his correspondence.
2. There shall be no interference by a public authority with the exercise of this right except such as is in accordance with the law and is necessary in a democratic society in the interests of national security, public safety or the economic well-being of the country, for the prevention of disorder or crime, for the protection of health or morals, or for the protection of the rights and freedoms of others.

The specific requirements are set forth in the endnote.[45]

Thus, according to the EU, in its correspondence with US SEC Chairman Donaldson, the data protection requirement prevents EU audit firms from providing information with respect to employees including their names or social security numbers, information concerning criminal, civil, or administrative actions or disciplinary proceedings that are pending; and information relating to non-SEC audit clients.[46] The EU member states, such as Denmark, Finland, Belgium, and Germany, all provide by law protections against revealing personal information of employees. In Germany, a court found Wal-Mart's voluntary and anonymous telephone hotline for the reporting of misconduct to be violative of the German Works Council Constitution Act that gives the Council codetermination rights concerning the conduct of employees. Wal-Mart's failure to consult with the Council negated its practice.

Working Papers

The provision of Article 106(b) requiring access to working papers flies in the face of contrary provisions and prohibitions with EU national professional secrecy laws. Many of the EU member states provide that working papers may only be given to a courts therein, which provision may not be waived. In France, Article L225-240 of the French Commercial Code requires secrecy by auditors which secrecy as to working papers may be granted access to French authorities. Finland has a similar provision. In Denmark and Belgium, the unauthorized handing over of working papers of a client is a criminal offense.[47]

There are strict limitations to the collection, use, and disclosure of personal information. In a French court decision

on November 21, 2005, Group McDonald's France was denied a request by the company to put into place a procedure for certain high-level employees to voluntarily and anonymously report on alleged wrongful behavior by co-workers. The La Commission nationale de l'informatique et es libertes (the French Data Protection Authority or CNIL) stated that, although the SOX requirement was not per se invalid, nevertheless, employers would have to comply with eleven guidelines or limitations.[48] The difficulty is that the SOX provision appears to conflict with the French Data Protection Act of January 6, 1978 as amended and the EU Directive on Data Protection.[49]

RECONCILING SOX AND EUROPEAN CONFLICTING STANDARDS

Although European companies and regulators have bitterly complained about the extraterritoriality of SOX's provisions, nevertheless, there are significant attempts to reconcile their differences. The need for reconciliation is evident by the degree of cross-border investments both to and from the US to Europe. Among the efforts at a not unfriendly reconciliation are the US-EU Financial Markets Regulatory Dialogue, which is an informal discussion of US and EU regulatory approaches, developments, and timetables. It brings together experts from the Federal Reserve and their counterparts of the European Commission particularly with respect to banking operations. It has been estimated that, as of September 30, 2003, there were 34 US banking organizations in the EU with third-party assets of over $747 billion and much greater sums today. There were 68 EU banking organizations operating in the US with third-party banking assets of $937 billion. The Dialogue has served to diffuse tensions concerning SOX between the two entities.[50]

A major effort that was well received in EU capitals is that of the former Chairman of the US SEC, William H. Donaldson, who expressed his and that of the SEC's commitment to engaging in a constructive dialogue to assure friendly cooperation in an endeavor to safeguard the integrity of corporate governance. He noted that, although SOX addressed corporate malfeasance that occurred among US enterprises, nevertheless, Europe has had its own series of major corporate scandals, which include Parmalat, Vivendi, Hoolinger, Ahold, Adecco, TV Azteca, Royal Dutch Shell, Seibu, China Aviation, and other scandals. Thus, it is in the best interests of both the US and the EU to restore shareholder confidence in the integrity of the marketplace. There is a need for global cooperation to raise standards in all of the many markets on a worldwide basis. Although acknowledging the complaints of the rise in cost of capital as a result of SOX, it should be noted that the costs come with major benefits. Inasmuch as nearly one-half of all of the world's equity shares, by market capitalization, are traded in the US, non-US investors have approximately $4.5 trillion invested in US securities.[51]

Donaldson emphasized that the US, under SOX, enables a registered company to signal to others that it is committed to the highest audit reporting and governance standards. Nevertheless, he assured European regulators that the US is fully committed to working together to address the legitimate complaints of European regulators. Thus, the SEC has taken a number of steps to avoid have companies engaged in unnecessary and costly duplication of reporting standards. SOX requires that all members of audit committees be independent directors. The issue arose that German corporate governance have dual board systems that require corporate audit committees to include a labor representative. Inasmuch as SEC rules hold that employees of an issuer are not "independent," there was an inherent conflict between SOX and German

regulations. After a dialogue between the SEC and the EU, the former was given assurance that labor representatives in issuer audit committees are independent and, accordingly, the SEC provided an exception to its prior position.[52]

Two other examples of US and EU cooperation are the exemption for companies publishing financial information outside the US that were not in accord with US Generally Accepted Accounting Principles (GAAP) and the accommodation made to foreign issuers with respect to the information requested by the US Public Company Accounting Oversight Board (PCAOB) that may violate foreign privacy laws and blocking statutes. Thus, the PCAOB is engaging in a collaborative approach to reconcile its oversight role with the laws and regulations governing foreign issuers. Other accommodations include the extension of deadlines for filing requirements, reconciliation of reporting standards, and other efforts.[53]

A further effort of both reconciliation but also a potential retaliatory threat is the enactment of the 8th Directive[54] by the European Union.[55] The Directive aims at creating a high level harmonization of statutory audit requirement by Member States. It permits Member States to have more stringent requirements but the Directive serves as the minimum requirements for all of them.[56] Although the Directive places great emphasis on Member States to regulate statutory audits of accounts, the latter may not insist that a majority of the voting rights in an audit firm must be held by locally approved auditors or be the majority members of the administrative or management body of an audit firm.[57]

The closet threat is that the 8th Directive leaves it to Member States to determine whether to approve a non-EU Member State auditor as a statutory auditor. *Subject to*

reciprocity, such Member States may approve such person provided proof of compliance is furnished with the 8th Directive's mandates.[58] Compliance includes proof of good repute, educational qualifications, examination of competence, practical training, and continuing education.[59] Derogation from such compliance may be made on the basis of reciprocity provided that the foreign auditors and audit firms are subject to comparably systems of public oversight, quality assurance, and investigations and penalties. The EU Commission is to assess the alleged equivalence in cooperation with the Member States.[60] All such non-Member State auditors and audit firms which provide an audit report concerning the accounts of a company incorporated outside of the EU but whose securities are traded on an EU exchange. Exception is for companies' issues exclusively debt securities of EUR 50,000 or more traded on an EU exchange.[61]

All such foreign auditors and audit firms are to be subject to oversight, quality assurance systems, and systems of investigation. Exceptions may be made where the foreign entities can demonstrate equivalent third-country system of quality assurance within the past three years. Subject to proof and acceptance of equivalence by Member States in cooperation with the EU Commission, audit reports of accounts or consolidated accounts issued by non-EU Member State auditors or audit firms shall have no legal effect within the EU.[62]

EU CORPORATE GOVERNANCE INITIATIVES

Among the reasons for EU opposition to SOX is its own attempts to deal with European corporate scandals. In 2003, reacting to both US and comparable behavior by a number of European-based companies, the EU Commission communicated the following program: *Modernising Company*

Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward.[63] It proposed the enhancement of corporate governance structure. In a company's annual corporate governance statement, listed companies should state the key elements of their corporate governance structure which should include the operation of their shareholder meetings and key powers, the composition of the board and its committees, the shareholders possessing major holdings and voting rights, material transactions with other related parties and the existence and nature of a risk management system.[64] Shareholders' rights are to be strengthened by being granted access to information by electronic means, the right to vote in absentia and by electronic means, and the establishment of real shareholder democracy.[65]

The board of directors should be modernized by removal from voting, in favor of non-executive or supervisory directors, those board members with conflicts of interest, such as remuneration of directors and supervision of audit accounts; the creation of a one-tier board structure with executive and non-executive members or a two-tier structure with managing directors and supervisory directors; granting a special investigation right to shareholders to ask a court to investigate the affairs of a company; imposition of a directors' disqualification for misleading financial and other misconduct; and the development of a wrongful trading rule that would hold directors personally responsible for a company's failure and due to the conduct or lack of action.[66]

Groups and pyramids of companies would be compelled to provide complete and information and disclosure regarding their structure and intra-group relations as well as better financial and non financial information.[67] In the Annex to the EU Plan, it described the specific steps and timetables for member state actions and preferred types of initiatives. There

were Short-Term (2003-2005) steps, Medium-Term steps (2006-2008), and Long-Term (2009 and thereafter).[68]

CONCLUSION

The impact of SOX on foreign registrants has been divided depending on the European commentator. The positive aspects noted by foreign registrants include the restoration of investor confidence in the light of the major corporate scandals both in the US and abroad; the need for effective internal controls; and the effect on corporate governance; improved vigilance by boards of directors who hitherto was to often passive; the requirement of financial experts on audit committees; the uniformity of standards for corporations and their subsidiaries; the active dialogue and engagement of advisers; the compelling of companies to re-examine their internal auditing and other financial practices; and the creation of a governmental board to oversee auditing by accounting firms. The negative aspects has been the need for alleged extraordinary effort and cost to comply with the statute; the compelling of restatement of earnings; the great increase in insurance costs for board insurance; and the failure to recognize the auditing standards of foreign companies that are equal to or were greater than that provided by SOX.[69]

ENDNOTES

[1] *The Public Company Accounting Reform and Investor Protection* (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 2002.

[2] Section 404 requires each annual report required to be filed under the Act "to contain an internal control report, which shall:

(1) state the responsibility of management for establishing and maintaining an adequate internal

control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."

[3] Jill M. D'Aquila, *Tallying the Cost of the Sarbanes-Oxley Act,* THE CPA JOURNAL, www.nysscpa.org/cpajournal/2004/1104/perspectives/p6.htm. The medium-size firm costs have been calculated as follows: some 12,000 hours of internal work (from 1,150 to 35,000 hours); 3,000 hours of external work (from 846 to 6,197 hours), and additional audit fees of $590,000 (from $52,000 to $1.5 million). CRA International in its *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update*, (April 17, 2006), found that the actual average costs for Section 404 issuer compliance by smaller companies were $1,241,000 in the first year and $860,000 in the second year while for larger companies, the costs were $8,510,000 for year one and $4,770,000 for year two. For a discussion of the need for a small business exemption, see Joseph A. Castelluccio III, *Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 Brooklyn L. Rev. 429 (Fall, 2005).

[4] Section 102(b)(2).

[5] For a lengthy discussion see US SEC, *International Reporting and Disclosure Issues in the Division of Corporation Finance* (Nov. 1, 2004), http://www.sec.gov/divisions/corpfin/internal/cfirdissues1104.htm. The discussion herein is at p. 18.

[6] Sec. 106(b), "Production of Audit Workpapers," states as follows:

(1) Consent by foreign firms.—If a foreign public accounting firm issues an opinion or otherwise performs material services upon which a registered public accounting firm relies in issuing all of part of any audit report or any opinion contained in an audit report, that foreign public accounting firm shall be deemed to have consented—

(A) To produce its audit workpapers for the Board or the Commission in connection with any investigation by either body with respect to that audit report; and

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(B) To be subject to the jurisdiction of the courts of the United States for purposes of enforcement of any request for production of such workpapers.

(2) Consent by domestic firms.—A registered public accounting firm that relies upon the opinion of a foreign public accounting firm, as described in paragraph (1), shall be deemed—

(A) To have consented to supplying the audit workpapers of that foreign public accounting firm in response to a request for production by the Board or the Commission; and

(B) To have secured the agreement of that foreign public accounting firm to such production, as a condition of its reliance on the opinion of that foreign public accounting firm.

[7] Section 301(2) entitled "Responsibilities relating to registered public accounting firms" states:

The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight f the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

[8] Section 301(3). Entitled "Independence," it states:

(A) In general.—Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

(B) Criteria.—In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee---

(i) Accept any consulting, advisory, or other compensatory fee from the issuer; or

(ii) Be an affiliated person of the issuer or any subsidiary thereof.

[9] Section 302(a).

[10] Section 302(b). It states that "Foreign Reincorporations Have No Effect.—Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section 302, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.

[11] Section 402 (a) amends Section 13 of the Securities Exchange Act of 1934) It states:

> (k) "Prohibition on Personal Loans to Executives."
> (1) In general.—It shall be unlawful for any issuer…directly or indirectly including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

There are limited exceptions subsection (2) for certain home improvement loans, credit extensions under an open end credit plan, extension of credit by a broker or dealer made available by such issuer to the public, provided in the ordinary course of business, or made on market terms that are comparable to the general public.

[12] *Id.* at 10-11. The SEC approved AS 1 effective for auditors' reports issued or reissued on or after May 24, 2004.

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[13] *Commission Guidance Regarding the Public Company Oversight Board's Auditing and Related Professional Practice Standard No. 1* (Securities Act Release 33-8422).

[14] *Supra,* Note 4. Also stated in a note to PCAOB Rule 3600T *Interim Independence Standards.*

[15] *Id.*

[16] Section 404 entitled "Management Assessment of Internal Controls," provides:

> (a) Rules Required.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934)… to contain an internal control report, which shall—
>
> (1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
>
> (2) Contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
>
> (b) Internal Control Evaluation and Reporting.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagement issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

[17] *Public and Private Firms Adopt SOX for Export Compliance as Penalties Grow,* MANAGING IMPORTS & EXPORTS, Issue 07-01 (Jan. 2007), www.ioma.com/global.

[18] The civil and criminal penalties are scattered throughout SOX. Among the provisions are Section 802(a) amends Title 18, Chapter 73, to provide

imprisonment of up to 20 years for destruction, or falsification of records in federal investigations and bankruptcy as well as a possible fine. Any accountant who conducts an audit of an issuer of securities and fails to maintain all audit or review workpapers for a period of five years shall be subject to a fine and/or imprisonment of up to 10 years. Section 803 renders debts nondischargeable under the Bankruptcy Code if they are incurred in violation of securities fraud laws. Section 805 provides for the enhancement of federal sentencing guidelines for obstruction of justice and for significant criminal fraud. Section 807 provides for a fine and imprisonment of up to 25 years for defrauding shareholders of publicly held companies. Section 903 increases criminal penalties from 5 to 20 years for the commission of mail or wire fraud. Fines are increased from $5,000 to $100,000 against individuals and from $100,000 to $500,000 for corporate entities as well as increasing possible imprisonment from one year to 10 years for violation of the Employee Retirement Security Act of 1974. There are increased penalties for corporate fraud pertaining to the signing of corporate tax returns under Title X and increased fines for securities fraud under Section 1106 of up to $5 million for individuals as well as imprisonment of up to 10 years and up to $25 million for corporations. Whistleblowers who are wrongfully discharged under SOX shall be entitled under Section 806(c) to compensatory damages which shall include reinstatement with the same seniority status s/he previously possessed, back pay with interest, special damages resulting from the discrimination, litigations costs, expert witness fees, and reasonable attorney fees.

[19] Martindale-Hubbell's Counsel to Counsel, *International Reaction to Enron and Sarbanes-Oxley,* CONNECTIONS, Vol. 3, Issue 2 (Summer, 2003).

[20] For a discussion, see Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals, 23 Wis. Int.l L.J.* 367 (Summer, 2005) and Stefan W. Suchan, *Post-Enron: US and German Corporate Governance,* Cornell Law School L.L.M. Papers Series, Paper 4, (2004).

[21] Beth Carney, *Foreign Outfits Rue Sarbanes-Oxley*, Business Week, (Dec. 15, 2004), http:www.businessweek.com/bwdaily/dnflash/dec2004/nf20041215_9306_db016.htm.

[22] Fran Howarth, *Anti Sarbanes-Oxley mood rises in Europe,* **http://www.the** register.co.uk/2005/01/11/Europeans_slam_sarbox/.

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[23] http://www.wcfcg.net/news1002.htm.

[24] Klaus C. Engelin, *Preventing European "Enronitis,"* INTERNATIONAL ECONOMY, (Summer, 2004), 40-47.

[25] *Id.* at 24.

[26] Undated letter from the EU Finance Ministers to William H. Donaldson, Chairman of the SEC.

[27] Undated *Memorandum on Conflicts of European Union and National Law with Draft PCAOB Rules for Foreign Audit Firm Registration.* The said memorandum was annexed to the letter from the EU Council of Ministers to SEC Chairman, William H. Donaldson.

[28] Section 106(c) concerns exemption authority given to the SEC and the PCAOB with approval of the SEC. They "may, by rule, regulation, or order, and as the Commission (or Board) determines necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions exempt any foreign public accounting firm, or any class of such firms, from any provision of this Act or the rules of the Board or the Commission issued under this Act."

[29] *Supra*, note 20.

[30] British Bankers' Association, *Sarbanes-Oxley 2002: SEC Consultation on Certification of Disclosures* (Aug. 8, 2002), http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=681.

[31] *Id.*

[32] Financial Reporting Standard 5, *id.*

[33] *Id.*

[34] *Id.* at 45-46.

[35] Frits Bolkenstein, *EU-US Regulatory Cooperation on Financial Markets: A Matter of Necessity,* Speech before the European American Business

Council, Wash. D.C. (Feb. 24, 2003), http://www.eurunion.org/news/speeches/2003/030224fb.htm.

[36] PricewaterhouseCoopers, *Though Opposed to New Regulations, Fast-Growing Private Companies Voluntarily Adopt Sarbanes-Oxley Principles, PricewaterhouseCoopers Find,* TRENDSETTER BAROMETER, www.barometersurveys.com/production/barsurv.nsf/89343582e94adb61852 56b840....

[37] Section 806 is an extensive provisions amending section 1514 of USC. Title 18 Chapter 73: that grants protection for employees of publicly traded companies who provide evidence of fraud. Specifically it states: No company …, or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee---[who provides information which the employee reasonably believes constitutes a violation or any rule or regulation of the SEC relating to fraud against shareholders. Remedies include all relief to make the employee whole including compensatory damages consisting of reinstatement with the same seniority status the employee previously possessed, back pay with interest, litigation costs, expert witness fees, and reasoanble attorney fees. For a discussion, see Karen L. Corman and Kristin Major, *Employee Whistleblower Rights Under the Sarbanes-Oxley Act,* www.skadden.com/content/Publications/Publication1120_0pdf.

[38] Hunton & Williams, *Conflict between Sarbanes-Oxley Whistleblower Provisions and EU Data Protection Law* (2005) and *Whistleblower Hotlines May Violate EU Data Protection Law* (2005). See also Fran Howarth, *Anti Sarbanes-Oxley mood rises in Europe*, THE REGISTER (Jan 11, 2005), www.the register.co.uk/2005/01/11/Europeans_slam_sarbox/print.html, who cited a report by the United Kingdom's Institute of Chartered Accountants which stated that chartered accountants who complete item 8.1 of the registration form of SOX (agreement to provide information at any time in the future) are violating the EU's data protection rights.

[39] http://www.sarbanes-oxley-forum.com/modules.php?name=Forum&file=viewtopic&p=5195.

[40] The OECD is composed of almost all of the members of Western Europe together with the US, Canada, and Japan. Among the nations acting in

accordance with OECD Principles is Canada. Its provisions concerning privacy of electronic data may be found in the *Personal Information Protection and Electronic Documents Act*.[40] Canada sought to address three major concerns, namely, fear by consumers of tracking their usage on the Internet, consumers' lack of confidence concerning the security of Internet transactions, and the growing international concerns about data privacy. The statute repeats the principles set forth by the OECD and the UN. See Julia M. Fromholz, *The European Union Privacy Directive,* 15 BERKLEY TECH. L.J. 461 (2000)

[41] The United Nations thereafter adopted *Guidelines Concerning Computerized Personal Data Files* on December 14, 1990. While leaving to individual countries to issue and implement regulations concerning computerized personal data, it issued a series of principles that should guide each State's initiative. Included among the principles were those of: lawfulness and fairness, accuracy, legitimate purpose, access, and non-discrimination. The Council of Europe adopted the *Convention for the Protection of Individuals with Regard to Automatic Processing of Personal Data* on October 1, 1985. It also sets forth a series of principles very similar to those later outlined in the Privacy Directive of the European Union. In addition thereto, Article 14 of the Convention provides for assistance to data subjects residing abroad. It states that each party to the Convention shall give to such persons aiding in exercising the right to ascertain the existence of a personal file on him/her, its content, and to make corrections or erasures of data violating his/her privacy rights. Argentina enacted a statute in December 1996 giving data protection ("full protection of personal information") in conformance with another law giving its inhabitants the right to obtaining formation about data collected on them. In addition, a Bicameral Commission on Monitoring of Data Protection was established to enforce the statute. Australia and Belgium, as members of the OECD, enacted a statute in conformity with its principles. Hong Kong, prior to its takeover by the People's Republic of China, enacted a Personal Data (Privacy) Ordinance that is still in effect and is reflective of the EU Directive. The same types of protection may be found in the statutes and ordinances of many other countries. Japan, Taiwan, and Hong Kong have enacted measures to insure the some degree of protection concerning the accumulation and processing of personal data. Among the measures that have been enacted are: (1) In Japan: *The Act for Protection of Computer Processed Personal Data held by Administrative Organs* (December 1988); (2) In Taiwan: *Law Governing Protection of Personal Data Processed by*

Computers (July 1995); and (3) Hong Kong: *The Personal Data (Privacy) Ordinance* (September 1995).

[42] The Recommendation can be found at: http://europa.eu.int/comm/internal_market/en/media/dataprot/inter/priv.htm.

[43] See, for example, William J. Clinton and Albert Gore, Jr., *A Framework for Global Electronic Commerce*, http://www.ecommerce.gov/framewrk.htm, ISSUES, No. 5.

[44] See European Commission, *Data Protection: Background Information*, http://europa.eu.int/comm/internal_...en/media/dataprot/backinfo/info.htm.

[45] *Scope* (Article 3). The Directive concerns "any operation or set of operations which is performed upon personal data." Exceptions include data flowing outside of the European Union and data involving state and public security. "Personal data" is defined as "any information relating to an identified or identifiable natural person ('data subject')." The obligations are imposed upon the "controller" who is any person determining the purposes and means of processing data.

Data Quality Principles (Article 6). The Directive provides that Member States are to ensure that the personal data is: (1) processed fairly and lawfully; (2) that it is collected for specific and legitimate purposes; (3) relevant and not excessive for the intended purposes; (4) accurate and kept up to date when relevant; and (5) kept for no longer than necessary except when kept for historical, statistical or scientific use in which case appropriate safeguards are to be enacted.

Criteria for Legitimacy (Article 7). Personal data may be collected only if:

> The data subject has consented unambiguously (agreed freely after being adequately informed);
> It is necessary for contract performance involving the data subject (for example, data for job applicants or for billing purposes);
> It is necessary for compliance with a legal obligation of the controller;
> It is necessary to protect the vital interests of the data subject;

> It is necessary to carry out a task in the public interest or for exercise of official authority involving the parties (for example, by police or tax authorities); or
> For legitimate interests of the controller or third party receiving the disclosure that outweigh the protection of the legitimate interests of the data subject.

Prohibited Data (Article 8). Member States may not collect personal data concerning racial or ethnic origin, political opinions, religious or philosophical beliefs, trade-union membership, and data concerning health or sex life. There are exceptions to such prohibitions including consent from the data subject and legitimate and lawful objectives and persons. For example, health professionals need health data for proper diagnosis, police authorities need data concerning prior convictions, and journalists may require background data.

Information to be given to Data Subject (Articles 10 and 11). The Directive provides different criteria of information to be given to the data subject depending on whether the data was obtained from the data subject or from some other source. If the data is derived from a third party, the data subject is entitled to know the identity of the controller and his/her representative; the purposes, thereof; and additional information such as categories of the data concerned, the recipients or groups of recipients of the data, and the right of access. If the data is from the data subject, s/he is entitled to the same type of information plus information as to corrections of errors. Exceptions are made for collection of data for historical or scientific research purposes.

Right of Access to Data and Exemptions (Articles 12 and 13). The data subject is entitled to know whether or not data about him or her is being collected, the purposes thereof, the categories of the data, and the recipients, as well as how to rectify, erase or block data. There are exemptions for national and public security, defense, prevention, detection, and prosecution of criminal offenses, and for economic or financial interest of a Member State.

Miscellaneous Provisions: Right to Object (Article 16). The data subject has the right to object on compelling legitimate grounds to processing of data about him or her. S/he also has a right to object on request and free of charge any data to be given to direct marketers.

Confidentiality and Security (Article 17). Member States are to ensure that agents of controllers not process data except on instructions from the controller. Measures are to be taken to protect the security of the data from accidental or unlawful destruction, alteration, unauthorized disclosure or access and all other unlawful uses.

Remedies (Articles 22-24). There are broad remedies available to the data subject for violation of his/her rights under the Directive, including judicial access and claim for damages.

Notification and Exemptions (Article 18). Controllers or representatives thereof are to notify Member States of automatic processing operations of their names, addresses, the purposes of data collection, and other such information. Exemptions are permitted where the data are unlikely to adversely affect the data subject. Among the exemptions is Article 3(2) that states the Directive does not apply to data falling outside the scope of EU law, to wit, in matters of public security, defense, state security, and matters pertaining to criminal activities. Article 13(2) also exempts member states from permitting access to data by the data subjects with respect to scientific research and for the collection of statistics. The third exemption provision is that of data transfer to non-member states.[45]

Data Transfer to Non Member States (Articles 25-26). Data is not to be transferred to countries outside of the European Union, unless those countries ensure "an adequate level of protection." What is "adequate" depends on all of the attending circumstances of the transfer, including the proposed processing operations, the level of security, its professional rules, and other such qualifications. Nevertheless data can be sent irrespective of such safeguards if the data subject consents; the transfer is necessary in connection with contract performance between parties of the respective countries; on public interest grounds; is necessary to protect the vital interests of the data subject; and where the controller assures protection of privacy concerning the data being sent abroad.

[46] *Letter from the EU Finance Ministers to Chairman William H. Donaldson*, *supra*, note 24.

[47] *Memorandum of EU Finance Ministers to SEC Chairman, William H. Donaldson*, *supra*, note 25.

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[48] http://www.cnil.fr. See, also, commentary by Alan Berkowitz and Jacqueline Bronson, Bingham McCutchen Esqs., *Sarbanes-Oxley Act Whistle Blowing Measures Meet Resistance in the EU,* (Dec. 2005), http://www/bingham.com.

[49] Directive 95/46/EC (Oct. 24, 1995).

[50] Testimony of Federal Reserve Governor Susan Schmidt Bies before the US Committee on Financial Services, US House of Representatives (May 13, 2004).

[51] William H. Donaldson, *US Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers* (Jan 25, 2005), http://www.sec.gov/news/speech/spch012505whd.htm.

[52] *Id.*

[53] *Id.*

[54] *Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts.* The Directive replaced the Eighth Council Directive 84/253/EEC of 10 April 1984 that concerned the approval of persons responsible for carrying out the statutory audits of accounting documents.

[55] The European Union is composed of 27 member states as of 2007. They are as follows in the order of accession: the initial six states (Belgium France, Italy, Luxembourg, Netherlands, and West Germany), followed by three added states (Denmark, Ireland, and the United Kingdom), Greece, Portugal, Spain, Austria, Finland, Sweden, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, and, as of 1 January 2007, Bulgaria and Romania. Other potential future member states who are in accession negotiations, candidate country, or potential candidate countries are Croatia, Turkey, Republic of Macedonia, Albania, Bosnia and Herzegovina, Montenegro, and Serbia. http://en.wikipedia.org/wiki/List_of_European_Union_member_states_by_ accession.

[56] Paragraph 5 of the 8th Directive.

[57] Paragraph 6 of 8th Directive.

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[58] Article 44 of the 8th Directive.

[59] Article 44 which incorporates Articles 4, and 6-14 of the 8th Directive.

[60] Article 46 of the 8th Directive.

[61] Article 45(1) of the 8th Directive.

[62] Article 45 (3)(4) with exception of equivalence as provided in Article 46 of the 8th Directive.

[63] EU Commission, *Communication from the Commission to the Council and the European Parliament*, COM (2003) 284 final (Brussels, May 5, 2003).

[64] *Id.* at 3.1.1.

[65] *Id.* at 3.1.2.

[66] *Id.* at, 3.1.3.

[67] *Id.* at 3.3.

[68] *Id.* Annex.

[69] See, e.g., comments made by Jeffrey Marshall, *Sarbanes-Oxley: An International Perspective*, http://accounting.smartpros.com/x42166.xml.

OF BASEBALLS CAUGHT AND KEPT

by
Kathleen M. Weiden*
Christopher Companik**

INTRODUCTION

A baseball stadium seems an unlikely place to think about taxes. More likely than not, fans and players gathering for a baseball game consider recent team records, batting averages and fielding percentages, the likelihood of a perfect game, or maybe even the hotdog and beer to be consumed, as they prepare for the game to begin. However, on a regular basis, fans or players go home from a baseball game with something they did not have when the game began – a baseball that had been in play during the game. Those fans or players may also take home a tax liability when they go home with a baseball that had been in play during the game.

Several legal scholars have recently examined the theories by which a fan or a player could claim ownership of a baseball that had been in play.[1] These are not frivolous inquiries, as milestone or monumental home runs can have very significant economic value in the sports memorabilia marketplace. For example, the baseball Mark McGwire hit for his 70th home run in 1998 ultimately sold for $3 million, and

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the baseball Eddie Murray hit for his 500th home run in 1996 ultimately sold for $500,000.

The market for foul balls hit into the stands, tossed into the stands by players, or retained by players is markedly different from the market for home runs hit into the stands. It may even be non-existent. However, the presence or absence of a market for used baseballs has not been cited by the legal scholars as a determinative factor in their analysis of how ownership of a foul or home run baseball can pass from the home ball clubs to a fan or player.[2]

An additional, related, issue is the tax consequences associated with a fan or a player coming into possession of a baseball that had been in play. For example, what are the tax consequences to a fan that catches a baseball (milestone, home run or foul ball) hit into the stands? What are the tax consequences when two fans claim to have caught the same baseball? We begin with these two tax questions, but also examine several others arising from well-publicized events involving fans, players and a baseball at recent games. We use as our starting point the analysis of the aforementioned legal scholars, Finkelman (2002) and McEvoy (2005). As we simply summarize the arguments made by the legal scholars for purposes of our examination of potential tax consequences, we refer readers who wish for a more complete understanding of the underlying legal theories to the full works of those legal scholars.

"WATCH OUT FOR FOUL BALLS"

At every Major League Baseball game played, a baseball is hit into the stands and either caught or retrieved by a fan. Sometimes, the baseballs are hit out of the stadium and are retrieved by an individual not attending the game.

Finkelman (2002), McEvoy (2005), and other legal scholars argue that the ownership of a baseball hit into the stands or out of the stadium passes to the person who catches or retrieves the ball, and offer several arguments in support: (1) the traditional law of abandonment, (2) the "common law of baseball", (3) a statutory claim argument and (4) a contract claim argument.

Abandonment occurs when there is a relinquishment by the former owner, either intentionally or by failure to retrieve after an unintentional loss. Thus, legal scholars argue, home ball clubs intentionally and routinely abandon baseballs hit into the stands by not sending agents of the home ball club into the stands to retrieve the baseballs. Legal scholars also argue that under the "common law of baseball," most Major League Baseball clubs have allowed the evolution of fan property rights, by permitting and even urging fans to bring baseball gloves into stadiums. Because baseball gloves are of not much use in holding a beverage or a hot dog, it can reasonably be assumed that, by allowing fans to bring their gloves, the club is signaling its intention to abandon baseballs hit into the stands and allow ownership to pass to the lucky fan. Statutory claims of ownership can be made by fans, legal scholars further argue, in stadiums where home ball clubs have posted signs indicating fans are free to keep foul and home run balls, where the home ball club has a posting to that effect on the team web site, or where the home ball club uses the public address system to encourage and/or celebrate a catch by a fan.[3] And finally, legal scholars argue that a contract claim may arise in stadiums where the ticket to the game contains a warning that physical injury may result from baseballs hit into the stands.

Consider the case of a baseball club that posts signs in the stadium, or on its web page, indicating that fans may keep any foul or home run baseballs hit into the stands, and/or which encourages fans to bring gloves to the game (i.e., common law

of baseball or statutory claim arguments). According to the on-line encyclopedia, dictionary.com, prizes are given as "rewards for victory, to provide incentives in competitions, etc."[4] If title to foul balls and home run balls is transferred from the home ball club to fans when those baseballs enter the stands under either a common law of baseball or statutory claim argument, then home ball clubs can be viewed as creating a *de facto* competition or contest when they allow title to the baseball to pass to the fan who catches it, in lieu of some other means of selecting the fan to receive the baseball, such as, the fan sitting in a randomly selected numbered seat. Thus, because the fan who catches the baseball must compete with, or strive against, other fans to catch the baseball, the baseball can be viewed as a prize in a competition or contest.[5] Fans appear to be aware of this potential competition, as many arrive at the stadium with their personal baseball gloves, to improve their chances of catching a ball. It is unknown how many fans select their particular seat as a further means of improving their odds of catching a baseball. Joe Fignone, who sat waiting in a boat in a cove outside Pacific Bell Park (now known as AT&T Park) for Barry Bond's 500th career home run in April 2001, gave quite a bit of thought to how he could improve his odds of catching or retrieving that milestone baseball.[6] Other fans apparently use baseball players' stadium-specific batting statistics to select seats for upcoming games.[7]

Internal Revenue Code ("IRC") §74(a)(1) indicates that, in general, gross income includes amounts received as prizes and awards, and that the term includes amounts awarded in contests of all types. An exclusion from income is provided by §74(b) for awards for religious, charitable, scientific, educational, artistic, literary and civic achievements (e.g., Noble- or Pulitzer-type awards), so long as the taxpayer was selected for the award or prize without any action on his or her part to enter the contest or competition, and is not required to

render substantial future services as a condition of receiving the award or prize. An exclusion from gross income for scholarships that meet the requirements of §117 is provided by §74(c).

While no one is likely to argue that a baseball hit into the stands is akin to either a Noble or Pulitzer Prize, taxpayers have shown initiative in arguing that certain prizes were received for one or more of the achievements specified under §74(b). For example, the taxpayer in *Simmons v. U.S.* argued, unsuccessfully, for the exclusion of a $25,000 cash prize received for catching a special tagged fish in a contest sponsored by, and promoting, a local brewery, claiming a civic achievement in catching the fish (i.e., promoting the recreational and resort aspects of the state of Maryland).[8] Try as it might, the *Simmons* court could not "swallow" the taxpayer's argument, nor conceive of some other public good being served by the taxpayer's capture of the tagged fish. The court did not consider the stimulation of the sale of beer a civic achievement, but indicated it might have reached a different conclusion if the fish had instead been a killer whale terrorizing the Maryland seashore. Thus, it appears that, barring the existence of a realistic (and highly creative) argument that catching or retrieving a foul or home run baseball hit into the stands achieves some "greater public good," fans catching or retrieving a foul ball or a home run hit into the stands would be required to include the value of the caught or retrieved baseball in gross income.

Under both §74(a)(2) and Reg. § 1.74-1, if a prize is not given in cash, but in property, the amount includible in gross income is the fair market value of the property received. Thus, in terms of amount of income to include, fans catching foul balls or home runs are required to include the fair market value of the caught baseball in income. The definition of fair market

value, formulated by *U.S. v. Cartwright,* is "... the price at which the property would exchange hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[9] Recent prior sales of the same or a similar item are typically relied upon by appraisers to establish the fair market value of property. The number of sports memorabilia auction web sites suggests a healthy market for historic home run baseballs, and that the fair market value of milestone baseballs can be estimated without too much trouble. The same may not be true of foul balls.

The fact that income is received in the form of property, as opposed to cash, does not alter the timing of the recognition of (prize) income associated with catching the baseball. If most baseball fans use the cash method of accounting for tax purposes (one of the permitted methods under Sec. 446), then the fan that catches a baseball will be required to include the fair market value of the baseball in income in the year in which the ball was caught or retrieved, pursuant to Sec. 451(a) and Reg. Sec. 1.451-1(a). Under these rules, a fan would be required to recognize the income on the day of the catch or the retrieval, even though a substantial amount of time may pass before the baseball is sold.

In stadiums where the home ball club does not post a sign, either at the stadium or on the club website, indicating fans can keep foul and home run baseballs hit into the stands, title to a baseball hit into the stands would remain with the ball club. Fans that caught any baseballs in such a stadium would be required to return the ball to the club. However, as discussed above, under the traditional law of abandonment, ball clubs that do not assert their ownership rights and request the return of the baseballs are considered as abandoning their

ownership rights by their failure to attempt to retrieve the baseball.

Gross income includes all income from whatever source derived, pursuant to §61. The IRS has generally interpreted this section broadly in its administration of tax law, and taxpayers have spent a lot of time and money arguing otherwise. The courts have also interpreted the statute to mean that Congress intended a broad, all-inclusive definition of income, and generally find in favor of the government.[10] Despite the courts' predilection to include virtually all items in gross income, some taxpayers have nonetheless argued that "found" property is not within the category of items meant to be swept into the definition of gross income. In *Cesarini v. U.S.*[11], the taxpayers sought to exclude from their 1964 gross income the amount of cash found in a piano purchased several years earlier. The IRS had issued a revenue ruling in 1953, indicating that the finder of treasure-trove is deemed to be in receipt of taxable income, in an amount equal to the U.S. currency value of the found property, in the year the property is reduced to the taxpayer's undisputed possession. The taxpayers in *Cesarini* argued that the enactment of §74 subsequent to the issuance of the 1953 revenue ruling indicated that found property or treasure-trove should be excluded from gross income, since Congress enacted only a statute explicitly including prizes in gross income. The *Cesarini* court noted that both the taxpayer and the government seemed to miss completely Reg. §1.61-14, which specifically provides that treasure trove constitutes gross income in the year in which it is reduced to the undisputed possession of the taxpayer. Thus, based on the 1953 revenue ruling, a lengthy judicial record of the broad interpretation of the meaning of gross income, and a Treasury Regulation, the court concluded that the $4,467 of cash found in the used piano in 1964 constituted gross income to the taxpayer in that year.

If ball clubs are considered to have abandoned their property by not seeking return of the foul or home run baseball hit into the stands, then the fan who catches or retrieves the property can be viewed as the "finder" of the abandoned property. If a fan who catches or retrieves a baseball hit into the stands, abandoned by the former owner, is the finder, then under §61, the fan would be required to include the caught or retrieved baseball in income. Although a caught or retrieved baseball is non-cash, Reg. §1.61-1(a) (analogous to Reg. § 1.74-1), indicates that gross income includes income realized in any form, whether in money, property or services. And, consistent with the above arguments, if most baseball fans use the cash method of accounting for tax purposes, the fan that catches or retrieves a baseball abandoned by the home ball club will be required to include the fair market value of the baseball in income in the year in which the ball was caught or retrieved, pursuant to Sec. 451(a) and Reg. Sec. 1.61-1(a).

Thus, whether a caught or retrieved foul or home run baseball is viewed as a prize or as found property, fans are required to include the fair market value of the baseball in income in the year it is caught or retrieved.

"I GOT IT, I GOT IT"

A Barry Bonds home run plays the central role in our second baseball tax analysis. In October 2001, Bonds hit his 73rd home run of the season into the stands at Pacific Bell Park in San Francisco.[12] When the ball reached the stands, Alex Popov got his glove on the ball or part of the ball, but the momentum of the fans around him, all simultaneously trying to catch the baseball, knocked him to the ground. A melee ensued, and the ball did not remain in Popov's glove. Another fan, Patrick Hayashi, was also knocked to the ground by the

out-of-control crowd, but emerged holding the ball. Popov demanded the return of the ball, but Hayashi refused. Popov filed suit, claiming that he had caught the baseball but that Hayashi had ripped it from his glove. The California Superior Court took possession of the baseball until the question of ownership could be resolved.

Under the assumption that title to baseballs hit into the stands at Pacific Bell Park passes to fans, an alteration in tax consequences occurs in the case of the Bonds' 73rd home run because two taxpayers both claimed to have caught the baseball.[13]

The first alteration is with respect to the timing of the recognition of income. Although the general rule of Sec. 451 would require the income realized by catching the Barry Bonds' baseball to be included in the year the ball was caught, the regulations under Sec. 451 provide for situations where taxpayers are not able to enjoy, or make use of, their income. Reg. Sec. 1.451-2 indicates that income not actually reduced to a taxpayer's possession is constructively received by the taxpayer (and includible in income) if it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, even if notice of intent to withdraw was required. This regulation keeps taxpayers from turning their backs on income that is really available to them. However, this same regulation goes on to indicate that a taxpayer is not considered in constructive receipt of income if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A long line of case law, beginning with *North American Oil Consolidated v. Burnet*[14] provides support for the exclusion of contested income from a taxpayer's gross income, and until such time as the contest is resolved. In 1916, North American Oil Consolidated operated a section of oil land owned by the U.S. government. Sometime

prior to 1916, the government filed suit to remove the company from possession of the oil lands, and a receiver was appointed to collect and retain the 1916 oil revenue until entitlement to the oil revenue could be resolved by the courts. The suit concluded in 1917, with the determination that North American was entitled to the oil revenue. The court-appointed receiver released the funds and paid them over to the taxpayer later that same year. In holding that the revenue constituted gross income to North American in 1917, the Supreme Court held that the taxpayer was not in constructive receipt of the income in 1916 because the company had no right during that year to compel remittance of the revenue. The oil revenue constituted gross income only when released by the receiver to North American in 1917.

Because the court took possession of the Bonds' baseball until the issue of ownership could be resolved, it would appear that there were substantial limitations and restrictions on the ability of either Popov or Hayashi to enjoy, or make use of, the baseball while the lawsuit was in progress. Thus, under Reg. Sec. 1.451-2 and following *North American Oil Consolidated*, neither Popov nor Hayashi would be required to realize any income arising from catching the baseball until the court decided the question of ownership.

On December 18, 2002, the Judge Kevin M. McCarthy handed down his decision: the legal claims of Popov and Hayashi were equal and both men were entitled to the baseball. The judge ordered the baseball sold and the proceeds split.[15] Thus, because the ownership question was resolved in 2002, following *North American*, it would appear that the income realized from catching the baseball would be includible in the 2002 income of Popov and Hayashi. Popov and Hayashi would each be required to report a significant amount of gross income in 2002, but would not have the cash to pay the income taxes

until the baseball was sold, which occurred in June, 2003.[16] However, because the two adversaries had to work together following the judge's decision to arrange for the sale of the baseball, efforts that would likely consume a significant amount of time, an argument be could made that such efforts to sell would constitute new and different substantial limitations or restrictions for purposes of Reg. Sec. 1.451-2.

Neither man was free to do as he pleased without the other's cooperation. Their respective interests in the baseball were not severable. Cutting the ball in half would destroy the ball's value and be a violation of the court's order. Further, the judge's decision on December 18, 2002 left the parties with twelve days remaining in the 2002 tax year to effect a sale. While it was possible that Popov and Hayashi could have begun to make these arrangements in advance of the judge's decision, it is unreasonable to have expected them to work together, when each believed his position would prevail. The awarding of joint ownership and the requirement that the ball be put up for sale imposed a new set of substantial limitations or restrictions on the enjoyment of the baseball. As a result, pursuant to Reg. Sec. 1.451-2(a) and *North American*, the recognition of the income from the baseball would be deferred from 2002 until those particular limitations or restrictions were lifted, at the auction of the baseball in 2003.

The second alteration in tax consequences is with respect to the amount to include in income. While in the general case of a fan catching a baseball, the amount includible in income is the fair market value at the time the baseball is caught, in the presence of a dispute over ownership, the amount of income to be recognized is determined at the time the ownership dispute is resolved. §74(a)(2) indicates that the amount to include in income as a result of receiving a non-cash prize is the fair market value of the property received, and

North American indicates that the time of recognition is when the income is placed in the taxpayer's unfettered control. Taken together, these authorities still leave open the issue of the appropriate fair market value - the fair market value of the baseball at the time it was caught (October 2001) or the fair market value when the ownership dispute is resolved (December 2002). According to media reports, the estimated fair market value of the Bonds' baseball in October 2001 was in excess of $1.0 million, but the baseball ultimately sold for $450,000 at auction in June 2003.[17] As *North American,* and the case law that follows deal with contested income ultimately paid out in the form of cash, further guidance is required. The analogy is to §83, which deals with the transfer of property to a taxpayer in exchange for services. When a taxpayer receives property in exchange for services rendered, the amount includible in income is the fair market value of the property received over the amount paid for the property at the time the taxpayer gains unfettered control of the property, pursuant to §83(a). Although neither Popov nor Hayashi rendered services in catching the Bonds' baseball, it seems equitable, following §83(a), to include the fair market value of the baseball at the time all restrictions on their control of the baseball lapse or expire. Because all restrictions on their control of the baseball expired with the sale of the baseball at auction in June 2003, each man would include one-half of the baseball's selling price of $450,000, or $225,000, in income for 2003.

The sale of the Bonds' baseball in June 2003 was also a tax event, and gave rise to tax consequences for both Popov and Hayashi. Under Sec. 1001(a), the gain or loss realized at the sale of the baseball is the difference between the amount realized from the sale and the adjusted basis of the baseball on the sale date. Under Sec. 1001(b) and Reg. Sec. 1.263(a)-2(e), the amount realized from the sale of the baseball was the selling price, less any selling expenses. According to media

reports, the ball sold for $450,000, and Popov and Hayashi engaged the services of a sports memorabilia agent and an auction house to represent them and handle the sale.[18] It is likely that they also engaged the services of an attorney with respect to the sale. Thus, the amount realized by each man would be $225,000 less his share of the fees to the sports memorabilia agent, the auction house and the attorney handling the sale. In terms of adjusted basis, each man's initial basis, for purposes of Sec. 1012, would equal the amount of income he realized from catching the baseball. Based on the discussion above, each man's initial basis in the baseball was approximately one-half of $450,000, or $225,000. Sec. 1016(a) provides that property's initial basis is adjusted by capital expenditures made with respect to property, and under Reg. Sec. 1.212-1(k), expenditures paid or incurred in defending or perfecting title to property constitute part of the cost of the property. Because both Popov and Hayashi incurred substantial legal fees in asserting ownership over the baseball, those fees would be required to be added to their initial basis to determine adjusted basis for calculating gain or loss at sale.

Hayashi's arrangement with his attorney was initially on a 20% (of sale price) contingency basis, although his attorney agreed after the sale to reduce his fees so Hayashi could actually receive some money from the sale of the baseball.[19] If we assume the legal fees for perfecting title were 15% of the sales price of the baseball, Hayashi's adjusted basis in the baseball would likely be approximately $258,750 [$225,000 initial basis plus $33,750 legal expenses to perfect title, calculated as 15% of baseball sale price]. Hayashi's amount realized, without considering the agent's commission or the auction house fee at sale, is no more than $255,000. If his adjusted basis is at least $258,750, then Hayashi's loss on the sale could be in excess of $33,750.

Popov was on a time basis with his attorney, and his legal fees to perfect title were approximately $473,000.[20] Based on this information, it would appear that Popov's adjusted basis in the baseball was approximately $698,000, and his loss realized at the sale of the baseball, after including the agent's commission and the auction house fee, would exceed $473,000.

Clearly, both Popov and Hayashi realized a loss from the sale of the baseball. However, there is the issue whether they would be able to recognize the loss for tax purposes, and if so, in what amount. For tax purposes, gains and losses are treated somewhat asymmetrically as a function of the use to which a particular asset or property is put. Gains realized by individuals from trade or business, production-of-income or personal use assets are generally recognized, unless a provision specifically allows for exclusion or deferral. Recognition of losses realized by individuals is limited to those arising from any form of disposition of trade or business or production-of-income use property, or only those dispositions arising from casualty, theft, fire, storm or shipwreck for personal use property (Sec. 165(c)). Because the sale of the baseball took place via an auction, Popov and Hayashi could not claim the loss arose via a casualty, theft, etc. If either man was a dealer in milestone baseballs or baseball memorabilia, the baseball arguably would constitute trade or business property for that man. However, since Hayashi was reported to be a software engineer and Popov a restaurant owner, the baseball was not dealer property.[21] It is reasonable to assume that Popov and Hayashi considered the baseball a production-of-income asset, to be held for long term appreciation, and thus, pursuant to Sec. 1221, a capital asset. Under Sec. 1211, the loss from the sale of the baseball, a capital asset, would be available to offset capital gains, if any, the men had. To the extent that the loss

from the sale of baseball exceeded capital gains realized in 2003, the excess loss could deducted in 2003 to the extent of $3,000 (assuming Popov and Hayashi file jointly with their spouses). In the absence of realized capital gains arising from other sources at any point in time in future tax years, Popov and Hayashi would be entitled to deduct $3,000 per year until the loss was fully recognized; simple division indicates that would take Hayashi approximately 12 years to amortize the loss and Popov approximately 158 years.

In conclusion, Popov and Hayashi would each recognize, in 2003, ordinary income of approximately $225,000 and a capital loss of $3,000, but have capital loss carryforwards to future tax years of in excess of approximately $30,000 for Hayashi and $470,000 for Popov.

"I'M TAKING MY BALL AND GOING HOME"

Mike Piazza's 300th career home run plays the central role in another baseball tax analysis.[22] On July 13, 2001, Piazza hit this milestone home run into the picnic area, just outside the stands, at Shea Stadium in New York. The Mets organization has a policy of permitting fans to keep baseballs hit into the stands.[23] The ball was retrieved by Rafael Vasquez ("Vasquez"), who attended the game with his wife and six-year old daughter. Vasquez immediately handed the ball to his daughter, Denise, a Piazza fan, but within minutes, the Vasquez family was surrounded by as many as ten Shea Stadium security guards, who forced her to turn the ball over to them. In exchange for the ball, Denise was promised the bat used by Piazza to hit that particular home run. However, when a security guard later returned to the stands with a bat, it was another bat, definitely not the one Piazza used to hit the home run. Denise was subsequently invited to meet Piazza and received a collection of souvenirs at this meeting.

Because the Mets and Shea Stadium have a policy of allowing fans to keep baseballs hit into the stands, Vasquez took title to the ball when he picked it up. At the same time, he realized income under Sec. 74, because the ball equates to a prize he won. The amount of income realized at that moment was equal to the fair market value of the baseball, and, under Sec. 1012, Vasquez's initial basis in the baseball would be the amount he was required to include in income.

When Vasquez handed the baseball to his daughter, either he was just letting her hold the ball for him, without relinquishing ownership, or he made a gift to her for tax purposes, relinquishing ownership. If Vasquez intended to make a gift of the baseball to Denise and if the fair market value of the baseball exceeded $10,000 (the annual gift tax exclusion in 2001), Vasquez likely incurred a federal (and possibly at state) gift tax liability. Assuming the baseball was a gift, then, pursuant to Sec. 1015, Denise would take an initial basis in the baseball equal to her father's. Similar to the treatment accorded to Popov and Hayashi above, Denise would have to determine the character of the baseball in her hands. Because, at the age of six, it is unlikely that Denise was a dealer in milestone baseballs or sports memorabilia, the baseball was not inventory to her. And, because Denise was a baseball fan in general, and a Mike Piazza fan, in particular, it is also unlikely that she intended to take the baseball home and use it for personal purposes. It is likely that the baseball was production-of-income type property to Denise, to be held for long-term appreciation, and therefore would be treated as a capital asset under Sec 1221.

There are three possible ways to characterize what happened after Vasquez handed the baseball to Denise: (1) She was the victim of a theft, (2) she was a participant in a sale or

exchange transaction, or (3) she was simply holding the baseball for her father, who voluntarily returned the ball to the Mets Organization.

The Theft Scenario

If we accept the first possible characterization of events, Finkelman (2002) suggests that Denise has a case against the Mets for theft. Because the Mets have a stated policy of letting fans keep balls hit into the stands, the ball became Vasquez's when he picked it up. When he gave the ball to his daughter, it became her property, and the confiscation of the ball from Denise by the agents of the Mets (i.e., the security guards) amounted to, in Finkelman's opinion, confiscation or theft of property. Since the baseball was a capital asset in Denise's hands, the confiscation of the baseball would result in a capital loss to Denise. While Sec. 1001(c) allows a deduction for a capital loss sustained during the year, Sec. 1211(b) limits the deduction of net capital losses (the extent to which the sum of long and short-term capital losses exceeds the sum of long and short-term capital gains) by individuals to $3,000 per year for a single taxpayer. Any loss limited by operation of the rules under Sec. 1211(b) is allowed in subsequent years as a carryover under Sec. 1212(b), but again subject to the annual limit of $3,000 of net capital losses in excess of net capital gains. If Denise was otherwise required to file a tax return for 2001, the $3,000 net capital loss deduction would have been used to offset her other taxable income. If not, the capital loss deduction is, in a sense, wasted, in that it was reported on Denise's tax return but yielded no benefit via the reduction of her tax liability.[24]

From the perspective of the Mets, it appears that the Mets would have a tax event arising from the confiscation of the baseball. The security guards, in their capacity as

employees and agents of their employer, carried out the confiscation on behalf of the ball club. Reg. Sec. 1.61-14(a) specifically states that illegal gains constitute gross income, and a long line of cases, including *James v. U.S.*[25] indicate that where money or property is received, lawfully or unlawfully, without restriction on its use and without recognition of an obligation to repay, the money or FMV of the property is includible in gross income. It is interesting to note that, following *Zuckerman*[26], taxpayers need not be charged or convicted of illegal acts as a prerequisite to the inclusion of illegal gains in gross income. Thus, for tax purposes, the Mets would be required to include the fair market value of the confiscated baseball in gross income under Reg. Sec. 1.61-14 at the time of confiscation.

In addition, a second tax event would arise for the Mets. While employees of the Mets (i.e., the security guards) were the means by which the baseball was confiscated from Denise, the Mets did not retain ownership of the baseball. Piazza, another employee of the Mets, ended up going home with the baseball. It would appear that the Mets transferred the baseball to Piazza. The Mets cannot call the baseball a gift to Piazza; Sec. 102(c) prohibits the characterization of the transfer of money or property by an employer to an employee as a gift. Assuming the Mets either allowed or ordered the security guards to turn the baseball over to Piazza, the transfer of the baseball to him should be construed as the payment of additional employee compensation to Piazza, and under Sec. 61, the fair market value of the baseball should have been included in his 2001 gross income as additional compensation for services. The Mets would end up with no net tax effect from the confiscation of the baseball and its subsequent transfer to Piazza, as the amount required to be included in gross income as income from illegal activities would be offset

by a deduction for employee compensation of the same amount.

The Sale or Exchange Scenario

If Denise was a participant in a sale or exchange transaction, she realized a gain or loss for the difference between the fair market value of the collection of souvenirs and the adjusted basis of the baseball in her hands. As discussed above, under Sec 1015, the basis of the ball in Denise's hands would have been the same as the basis of the ball in the hands of her father before he gave her the ball. Since his basis in the baseball was equal to the amount of income he realized when he picked up the baseball in the picnic area, her basis in the baseball was that same amount. What was the fair market value of the collection of souvenirs Denise received? It is useless to speculate here, but suffice to say that, if the items she received were the typical ones found at the numerous concession stands at Mets stadium, the fair market value of the collection of items she received would have been easily determined. It is reasonable to assume for purposes of this paper, that Denise received, in value, souvenirs with a fair market value significantly less in value than the baseball. Thus, Denise realized a loss on the exchange of the baseball for the collection of souvenirs. Since the baseball was likely a production-of-income asset to Denise, held for long-term appreciation, her loss would have been capital loss and she was entitled to recognize the loss. However, similar to the result reached in the theft analysis above, Denise's recognition of the net capital losses is limited to $3,000 annually, with carryover of amounts not permitted to be recognized by operation of Sec 1212(b).

Denise might be able to rely on Sec. 1031, *Exchange of Property Held for Productive Use or Investment*, to defer

recognition of the loss she likely realized on the exchange of the Piazza baseball for the memorabilia. Although taxpayers generally use Sec 1031 to defer the recognition of gain until a later time, given Denise's age of six years, she might have incentives to defer recognition of the loss realized until such time as she could generate cash flow tax benefits from the recognition of the loss on her tax returns. Since the baseball was a production-of-income asset in Denise's hands, Sec 1031 can be used if the memorabilia received was of the same type – production of income property. It appears that Denise received a baseball bat and a variety of other typical ballpark memorabilia. If Denise holds those items for the production of income (e.g., waiting for their appreciation in the sports memorabilia marketplace), she could defer the recognition of the loss realized until the sale of those items at some future time.

It would appear that the Mets would again be treated as taking part in two distinct tax events. First, the club acquired the baseball from Denise in an acquisition transaction, and, under Sec. 1012, took a basis in the baseball in an amount equal to the total fair market value of the items given to Denise. As part of this transaction, the Mets should also have recognized a gain on the difference between the cost and fair market value of the inventory (i.e., the memorabilia transferred to Denise). Second, since Piazza claimed the baseball, it appears that the Mets allowed or ordered the transfer of ownership of the ball to him. Similar to the conclusion reached above, the transfer of ownership of the baseball generates additional employee compensation to Piazza, and an amount equal to the baseball's fair market value should have been included in Piazza's compensation for 2001.

The potential sale, involving a player and a fan, of another historic home run was reported in the sports media in

2007. On August 4, 2007, Alex Rodriguez hit one of the three 500th home runs of 2007 (the other two were each hit by Frank Thomas and Jim Thome), and Walter Kowalcyk, a graduate student attending Rutgers University, caught A-Rod's historic hit. Some sports memorabilia commentators estimated the value of the baseball (and the amount Kowalcyk would be required to include in his 2007 gross income) at the time of the historic hit at approximately $500,000, while others suggested that the value of the ball could change dramatically as a function of eventual findings as to Bonds' alleged steroid use.[27] Still other reports indicated that the New York Yankees offered to purchase the baseball for $10,000, but Kowalcyk apparently refused that offer, expressing an interest to negotiate directly with A-Rod.[28] There have been no further reports of the disposition of A-Rod's 500th home run.

The Voluntary Return Scenario

Under this characterization, Vasquez did not transfer ownership of the baseball to his daughter, simply letting her hold it for a few minutes, and then, when asked by the Mets Stadium security guards, returned the baseball to the Mets ball club. Here, Vasquez should be able to rely on Rev Rul 57-374 to exclude the fair market value of the baseball in income.[29] Under Rev. Rul. 57-374, a contestant who immediately declines to accept a contest prize may exclude the fair market value of the prize from income. Vasquez should be successful making the argument that the revenue ruling should apply to a baseball caught in the stands, relying on the characterization of the baseball as a prize in a de facto competition created by the home ball club. This treatment would appear to align with the IRS' view. IR News Release 98-56 (09/08/1998) specifically applies to the case of a baseball hit into the stands, and indicates that a fan that catches a home run ball and immediately returns the baseball would not have taxable

income arising from the catch.[30] It analogizes the baseball fan to the prize contestant who immediately declines to accept a contest prize, although it does not cite Rev. Rul. 57-374. It does go on to indicate that the outcome might be different if the fan decided to sell the ball, rather than return it to the club.

From the perspective of the Mets, the declination by Vasquez was a non-event for tax purposes. However, the transfer of ownership of the baseball to Piazza should, as in the previous characterizations of events, be treated as the payment of additional employee compensation to Piazza, in an amount equal to the fair market value of the baseball at the time of ownership transfer.

Baseball fans Todd Eisenlohr and Will Stewart will likely both rely upon Rev Rul 57-374 and IR News Release 98-56 when preparing their 2007 personal income tax returns. These fans caught two of the three 500-home run club balls hit in 2007. Eisenlohr caught the 500th home run of Frank Thomas while sitting at the Metrodome, home of the Minnesota Twins. Eisenlohr, in arranging the voluntary return of the historic baseball to Thomas, asked only the opportunity to meet Thomas.[31] Stewart caught the 500th home run of Jim Thome while sitting at U.S. Cellular Field (formerly Comiskey Park), home of the Chicago White Sox. Stewart, from Austin, Texas, and in Chicago on a business trip, voluntarily returned the ball to Thome during a press conference.[32]

"THE GAME BALL"

In Game Four of the 2004 World Series at the St. Louis Cardinals ballpark, Keith Foulke of the Boston Red Sox (the away team) fielded a hit by Edgar Renteria of the St. Louis Cardinals (the home team), and then threw the ball to Doug Mientkiewicz. Mientkiewicz tagged first base for the final out

of the inning and the game and the series. Mientkiewicz kept the baseball after the game, had it authenticated by MLB the next day, and during a press conference, announced that the baseball would serve as either his personal retirement fund or a college education for one of his children.[33] Although Mientkiewicz seemed to have no doubt about his ownership of the baseball, media reports included comments by representatives of Boston that seemed to indicate that Boston viewed the historic baseball as its property.[34] In fact, a negotiation ensued between Boston and Mientkiewicz with respect to the use of the baseball in a traveling Red Sox World Series trophy exhibit.[35]

Finkelman (2005) argues that the St. Louis Cardinals Organization was the owner of the Renteria hit, and that the baseball should have been returned to them.[36] This argument is consistent with ownership arguments made in Finkelman's (2002) analysis of baseballs hit into the stands and caught by fans. The home team owns baseballs used during a game, and under the abandonment theory, allows ownership of a baseball hit into the stands to pass to fans. However, McEvoy (2005) points out that since ball clubs generally do not have stated policies about the passage of ownership of baseballs that remain on the playing field, and St. Louis apparently did not seek return of the baseball from Mientkiewicz, St. Louis can be treated as having abandoned ownership of the historic ball. Since St. Louis abandoned ownership, McEvoy (2005) concludes that Mientkiewicz can claim ownership of it.

From a tax perspective, under the assumption that St. Louis abandoned its ownership of the baseball, Mientkiewicz is in the same position as a fan who catches the ball in the stands; that is, Mientkiewicz is the finder of abandoned property. And like the fan who catches the baseball in the stands, under Sec.

61, Mientkiewicz would be required to include the fair market value of the baseball in gross income in 2004.

If Mientkiewicz caught the ball at a home game (at Fenway Park), with Boston abandoning its ownership of the baseball, Mientkiewicz's tax position would be the same as Piazza's. Mientkiewicz would be required to include the fair market value of the baseball in gross income as additional wages or compensation, because Boston, Mientkiewicz's employer, would be treated for tax purposes as effectively paying him additional compensation by allowing him to keep the abandoned baseball. This additional compensation would be subject to the usual withholding tax rules.

CONCLUSION

Because taxpayers' tax filings are private matters between the taxpayer and the IRS, it is unknown whether the government has used its authority under the tax law to assess and collect income (and other types of taxes) from fans, players and ball clubs, when historic baseballs are caught and kept. Media reports concerning the sale of an historic home run baseball usually mention taxes due at the time of sale, as one tax event, but there seems to be either confusion or disagreement about the tax consequences associated with catching the baseball, a separate tax event. For example, Matt Murphy, the Mets fan who caught Barry Bonds' 756th home run, said he is too poor to keep the baseball, and expected to pay taxes of $175,000 when the ball is sold.[37] The report correctly suggests that income taxes arise from catching the baseball, but the estimates of taxes due at the sale seem to imply that Murphy will be taxed on the full sales price of the baseball, without credit for his tax basis in the baseball. A recent news report recalled that when an IRS spokesperson suggested, in the summer of 1998, that a fan who gave Mark

McGwire's single season home run record baseball back to McGwire would incur a gift tax, a "tax tempest" ensured.[38] This report further suggests that while tax expert consensus was that a tax liability arises when a valuable baseball is caught, it was unlikely the IRS would be willing to make a public argument for taxing fans when they catch an historic baseball.[39]

The only direct guidance on the income tax effects of catching an historic baseball is IR News Release 98-56 (09/08/1998), which addresses only the situation of a fan immediately throwing back a baseball hit into the stands. Then-IRS Commissioner Rossotti issued the news release in the wake of the "tax tempest" surrounding the return by a fan of a home run baseball to Mark McGwire. The lack of IRS official guidance on this issue, coupled with the public nature of the issue, obliges the IRS to do more to clarify the tax rules. Taxpayer compliance with income tax laws is predicated on the understanding that the system is fair. The perception that baseball fans who catch historic home runs are treated more favorably than talk show fans who receive automobiles could do much to undermine confidence in the IRS' ability to administer tax laws fairly. Media reports of Oprah Winfey's September 2004 give away of cars to each of the 276 members of her audience seemed to have no question that the recipients were subject to income tax on the value of the cars received (sticker price of $28,500).[40] If the IRS perceives a difference between a baseball fan catching an historic home run and a talk show fan receiving a car, it should articulate it. Perhaps the IRS is beginning to turn its attention on the transfer of valuable sports related items. In early 2005, several sportswriters reported that the IRS had notified the National Basketball Association, Major League Baseball, National Hockey League and National Football League that the value of complimentary tickets given to players should be included in their income and

that the teams should withhold income taxes on this additional income.[41]

From a tax planning perspective, should fans throw historic baseballs back onto the field or should players pass an historic baseball around the field like the proverbial "hot potato" as a tax planning strategy? As much as recent efforts might signal IRS willingness to venture into controversy in order to provide clarification, it appears that more could be done by the IRS, at least with respect to the tax treatment of historic baseballs, to increase the public's confidence in the IRS ability to administer our tax laws in a fair manner.

ENDNOTES

[1] Paul Finkelman, *Fugitive Baseballs and Abandoned Property: Who Owns the Home Run Ball?*, 23 Cardozo Law Review 1609 (2002), and Sharlene McEvoy, *Whose Ball is it Anyway? Mienkiewicz v Henry, Raising Issues of Ownership, Possession and Abandonment*, unpublished working paper, Fairfield University (2005).

[2] It should be noted that there is also a healthy sports memorabilia market for baseballs that have never been in play, but have been autographed by players for special occasions.

[3] For example, the Seattle Mariners website contains the following statement: "Foul Balls & Home Run Balls: We encourage you to keep any balls that are hit into the stands." <http://seattle.mariners.mlb.com/sea/ballpark/sea_ballpark_guide.jsp>.

[4] <http://dictionary.reference.com/browse/prize>.

[5] Finkelman (2002) essentially makes this same argument when he analogizes a ticket to a baseball game to a lottery ticket.

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[6] John Shea, *Bonds Blasts Historic Home Run intoCcove – It's a Game Winner,Ttoo* San Francisco Chronicle, Apr. 18, 2001 at A-1.

[7] See, for example, the July 27, 2007 MLBlog of Zack Hample, also known as "The Baseball Collector." <http://www.snaggingbaseballs.mlblogs.com/the_baseball_collector/2007/07/not_chasing_aro.html>

[8] Simmons v. U.S., 10 AFTR 2d 5523, 308 F2d 160, 62-2 USTC ¶9713.

[9] United States v. Cartwright, 411 U.S. 546, 93 S. Ct. 1713, at 1716-17, 73-1 USTC ¶12,926 (1973).

[10] Glenshaw Glass Co., 348 U.S. 426, 47 AFTR 162; Helvering v. Clifford, 309 U.S. 331, 23 AFTR 1077 (1940); Helvering v. Midland Mutual Life Ins. Co., 300 U.S. 216, 18 AFTR 1144 (1937).

[11] 23 AFTR 2d 69-997

[12] This scenario is similar, but not identical to the events surrounding Sammy Sosa's 62nd home run in 1998 at Chicago's Wrigley Field. Sosa's home run actually landed outside the stadium on a local street, and was reputedly picked up by a delivery driver named Gary Mullins, a regular outside the stadium during games. During a melee involving other fans on the street, the ball somehow ended up in the hands of another individual, and Mullins filed suit for return of the baseball. Mullins eventually dropped his suit due to the legal expense of the suit. See Sheldon I. Banoff and Richard M. Lipton, *Contested Historic Homers: What Are the Tax Consequences?*, 98-3 Journal of Taxation 189 (2003).

[13] Technically speaking, Popov argued in court that he had possession of the baseball and that Hayashi took it from him. Hayashi argued in court that Popov's actions were merely attempts to gain possession of the baseball, but did not result in possession by Popov. Hayashi argued that when he picked up the baseball as it rolled from under the crowd, his actions allowed him to possess the baseball.

[14] 11 AFTR 16, 52 S Ct 613, 3 USTC ¶ 943

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[15] Popov v. Hayashi, 2002 WL 31833731, California Superior Court, December 18, 2002.

[16] Matt Bean, *Million-dollar Bonds ball sells for $450,000*, CourtTVNews, Jun. 23, 2003, at <http://www.courttv.com/trials/baseball/ballsold_ctv.html>.

[17] Matt Bean, *Baseball Dispute in Court,Aagain,* CourtTVNews, Jul. 9, 2003, at <http://www.courttv.com/trials/baseball/moneydispute_ctv.html>.

[18] *Supra,* note 14.

[19] *Supra,* note 15.

[20] *Ibid.* Popov's attorney filed a petition with the San Francisco Superior Court to freeze payment of Popov's share of the sale proceeds until Popov settled his $473,530 bill for legal services.

[21] *Supra,* note 14.

[22] See Finkelman (2002) 1624, and in particular, footnotes 46, 61, 62 and 63.

[23] <http://newyork.mets.mlb.com/nym/ballpark/guide.jsp>.

[24] The IRC contains a provision, Sec. 1033, *Involuntary Conversions,* which allows taxpayers to defer recognition of gains realized via involuntary conversions (e.g., theft, seizure, condemnation) until a later time. One of the requirements is that the property be either used in a trade or business or held for the production of income. Although the Piazza baseball was a production-of-income asset in the hands of Denise, Sec. 1033 was not applicable, since Denise realized a loss on the sale or exchange. Sec. 1033 applies only to defer the recognition of gains.

[25] 7 AFTR 2d 1361, 366 US 213, 61-1 USTC ¶ 9449 (1961, S. Ct.)

[26] T.C. Memo 1997-21

[27] Ted Sherman, *Is Barry Bonds' 756 Home Run Ball worth $500,000,* Helium Sports & Recreation, Sept. 5, 2007 at

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<http:www.helium.com/channels/708-Baseball-History/debates/sbs/94989-barry-bonds.html>

[28] Mike Jaccarina and Corky Siemaszko, *Guy Who Caught A-Rod's Homer Wants Francesca and Russo's Advice,* TSE Sports & Entertainment, Aug. 8, 2007 at <http://www.tseworld.com/press/2007087-arod-500th-homerun-ball.php>

[29] 1957-2 CB 69.

[30] The news release also indicates that no gift tax liability would arise either.

[31] Sports Collectors Daily Staff, *Fan Gives 500th Home Run Ball Back to Thomas",* Sports Collectors Daily, Jun. 29, 2007 at <http://www.sportscollectorsdaily.com/latest/fan-gives-500th-home-run-ball-back-to-thomas.html>

[32] Alex Gyr, *Fan Gives Home Run Ball to Thome,* MLB.com, Sept. 16, 2007, at <http://www.mlb.mlb.com/news/article.jsp?ymd=20070916&content_id=2212817&vkey=news_cws&fext=.jsp&c_id=cws>

[33] Tyler Lepner, *Title is Theirs and Red Sox Want Ball That Goes With It,* N. Y. Times, Jan. 8, 2005, at A1.

[34] Mel Antonen, *Having a Ball from Series could have Consequences,* USA Today, Oct. 25, 2005 at C6.

[35] Tyler Kepner, *Mientkiewicz Bringing a Hot Glove*, N. Y. Times, Jan. 27, 2005 at D3.

[36] Paul Finkelman, *This One's for the Birds,* N. Y. Times, Jan. 12, 2005 at A-21.

[37] *Supra,* note 27. See also *Barry Bonds: Reaction to HR 756,* Salisbury Post, Aug. 9, 2007 at <http://www.salisburypost.com/sports/363272162510070.php>.

[38] Tom Herman, *The Big Catch Could Have A Big Catch*, Wall Street Journal, Jul. 25, 2007 at D1.

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[39] *Ibid.* When asked, in this 2007 interview about the correct income tax treatment of an historic catch, Don Korb of the IRS replied to the reporter, "Please, whatever you do, don't ask me that question."

[40] CNN Staff, *Oprah Car Winners Hit with Hefty Tax*, CNNMoney.com, Sept. 22, 2004, at http://money.cnn.com/2004/09/22/news/newsmakers/oprah_car_tax/index.htm

[41] Scott Soshnick, *NBA Starts Collecting Tax on Free Tickets to Players, Referees*, Bloomberg.com, Jan. 19, 2005 at <http://www.bloomberg.com/apps/news>, Scott Soshnick and Purva Patel, *No Free Lunch, or Basketball Tickets, IRS Says*, Houston Chronicle, Jan. 24, 2005, at 4, Joseph A. Reaves, *IRS Guidelines Stem Flow of Free Tickets*, USA Today, Sept. 20, 2005, at <http://usatoday.com/sports/baseball/2005-09-30-irs-tickets_x_htm>.