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TALES FROM OUTSIDE THE CRYPT OR WHY DEATH CAN BE EMOTIONALLY DISTRESSING

by

Dr. Sharlene A. McEvoy*

Among the many causes of action associated with the tort of the unintentional inflection of emotional distress are incidents relating to the mishandling of dead bodies. This paper will discuss cases in which that tort theory has been used as a basis for recovery by injured plaintiffs. These cases may also prove helpful to instructors seeking to interest students in this category of the law of negligence.

INTRODUCTION

Among the most interesting examples of tortious conduct involve plaintiff's claim of the unintentional infliction of emotional distress suffered due to the mishandling of dead bodies. There have been numerous cases in which the bodies and ashes of dead persons have been lost, mishandled, and improperly buried which have led in some cases to large damage awards. Among the defendants in the cases described in this paper are hospitals, funeral directors, cemeteries and medical examiners. Interestingly, the cases seldom reach the appellate level and many are settled out of court.

The nature of this cause of action and its consequences can provide instructive cases for students in Business Law or Legal Environment of Business courses who are studying tort law.

CASES OF MISAKEN IDENTITY: WHEN FUNERAL HOMES AND HOSPITALS LOSE THE BODIES

It seemed like a routine wake in September, 1997; Willie Taylor had died in St. Louis, Missouri at the age of 62. However, when Margaret Taylor, Willie's widow, noticed that the body in her husband's suit at the funeral home did not look like her spouse of 33 years and the he was wearing a silver ring Willie never owned, Margaret sued.

Margaret had notified Randle and Sons Funeral Home of her concerns but an employee dismissed them. That same afternoon when James Hewitt, a co-worker at the car repair shop where Taylor had been employed came to pay his respects he also noticed that the corpse did not look like Willie.

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The next day, the casket remained closed during the funeral service attended by over 100 relatives. After the minister concluded his remarks and the casket was opened for a final viewing, many mourners began to voice their suspicions that the corpse was not Willie. Willie's brother noticed that the body had ten fingers, while Willie had only nine.

Despite their protestations, the funeral home insisted on proceeding with the burial until Margaret Taylor summoned the police to seize the body. The police took the body to the St Louis morgue where it was identified as one Frederick Ware. Apparently at his open casket service, no one had noticed that the corpse was not he. Taylor's body was located and later exhumed. As a result, Margaret Taylor sued Randle & Sons seeking $2.2 million in damages, for having suffered emotional distress, fear, and humiliation because she did not know where her husband's body was for a week.[1]

While cases like that of Willie Taylor are not typical and may provoke amusement, the type of mishaps that occurred in St. Louis cause considerable anguish for loved ones of the deceased and have resulted in some substantial damage awards for those plaintiffs who have sued claiming that they are victims of a tort called the unintentional infliction of emotional distress. The unintentional inflection of emotional distress is a relatively recent development in tort law. In general, when a plaintiff claimed damages for mental distress without also claiming physical injury, courts permitted no recovery. However, there had always been recovery allowed for mental distress without physical injury incases involving the negligent handling of dead bodies. Funeral home errors are not as rare as once thought. When Sarah Craig was killed by a drunken driver in May, 1996, her body was misplaced for three days by Norfolk funeral director, Brian Kenny and her family believes Kenny lied about its whereabouts, when her mother wanted to view the body. When Valerie Craig finally visited the body, she was distressed to find it lying on a blue tarp in a casket in the dark mortuary leaking embalming fluid. Craig's mother was also upset that Kenny did not embalm Sarah's body as he had agreed but sent it to Hartford Trade Services. Mrs. Craig is now considering exhuming Sarah's body for further examination in addition to bringing a lawsuit against the funeral director.[3]

Funeral homes are not the only culprits in misplacing bodies, hospitals have been held responsible for similar mix-ups. Kathy Getty was upset to learn that her daughter, Tiffany, had been critically injured in a truck accident and that her daughter's best friend Tiffany Moshier had been killed. She was even more distressed when, four days later and after holding a bedside vigil beside an unconscious girl, she learned that her daughter was dead and in the hands of the Williamson Memorial Funeral Home while the girl in the hospital was Tiffany Moshier.

While Vanderbilt University Medical Center said that it regretted the mix-up, it questioned why Kathy Getty could not tell that the injured girl was not her daughter. Getty said that she thought the girl's hair looked a little dark but "you focus on what you're given and that's what I was given, hope and life."

Both Tiffanys were friends and passengers in a pick-up truck that collided with another. Six people where involved in the crash, two died and four were injured. A relative of the driver of the pick-up truck incorrectly identified the girls to a police officer at the emergency room.

The Moshier family who had been planning a funeral for what they believed was their daughter did not closely examine the body at the suggestion of an employee of the Williamson Funeral Home until the badly lacerated face could be repaired.[4]

Instead of a case of confusing one child with another, another hospital was sued for losing one. In this case, the culprit was Maimonides Medical Center in New York which lost the 4 pound 2 ounce body of the stillborn daughter of Frances and Louis Correa. The fetus died less than a month before coming to term on May 4, 1990 after 23 hours of labor. The child was taken from the mother immediately after delivery and then lost.

There was no autopsy, no grave, no birth or death certificate for the baby the Correas named Frances Elaine. The only memento the Correas have is a Polaroid picture taken by the Hospital of the infant with the umbilical cord draped at its side. The grief-stricken parents spoke about burying the baby and arranging a funeral mass and both claimed to have told the attending physician that they wanted the baby back. The doctor promised that everything would be taken care of, but three weeks later, the Correas who had never received any autopsy results or the body of their daughter called the doctor, who urged them to wait a few more weeks. More than a month after the delivery the doctor finally told the family that both the autopsy report and the baby's body had been lost.

The Correas hired lawyer Lester Janoff, who, in March, 1991, filed a negligence suit against the hospital in New York state courts seeking $5 million in damages for the anguish suffered by the Correas for not being able to bury their child. The hospital argued that the Correas do not have a legal claim because the right to burial does not apply to a fetus. It also denied that the Correas asked for the boy to be returned.

Although the right to burial which assures that the dead are treated properly is among the oldest and damages have been awarded for interference with such rights, a New York judge ruled that the right to burial can be claimed only on behalf of a person who once lived. The fetus was not born alive. Under New York law, damages can be awarded against someone who interferes with a family's efforts to bury a dead person but since the judge ruled that there is no provision in the law that applies to fetuses, he dismissed the case. Critics of this decision argue that the judge's decision violated the Correas' religious rights as well as their parental rights.[5]

A similar case occurred in June, 1997 at Beth Israel Deaconess Medical Center in Boston. Jean Morrisey lost her baby due to a miscarriage after fourteen weeks of pregnancy. The hospital disposed of the remains as medical waste without offering them

to Jean and husband Michael for burial. All they received from the hospital was tissue taken from the fetus which they buried in the family plot. After numerous exchange letters in which Jean Morrissey took umbrage at the suggestion that her child was merely the "fetal remains" that a hospital representative suggested they were, the Morrisseys filed a complaint with the State Department of Public Health. Under state law, parents have the right to decide how to dispose of fetal remains and hospitals are required to tell parents in writing of their policy.[6]

"ASHES, ASHES: WHO'S GOT THE ASHES?"

Funeral homes are sometimes held liable not only for misplacing bodies but also for mishandling ashes. The Connecticut Department of Public Health asked the Board of Examiners of Embalmers and Funeral Directors to revoke the embalmer's license of Carl Swan, co-owner of Swan Funeral Home in Clinton, Connecticut, for mishandling the ashes of Mark Zubee. The funeral home was responsible for the cremation and internment of Zubee, age 23, who died in 1993.

In 1995, Zubee's family learned that his ashes had not been interred and that his remains had been kept in the basement of the funeral home along with the ashes of over 10 other people. Zubee's girlfriend visited the cemetery where he was supposed to have been buried, found the cover of the vault loose and the ashes missing. While Swan claims that there was a misunderstanding between the family and the funeral home, the funeral home has been sued because of the "mis-interment."

Zubee was apparently not the only victim of mis-interment, because the family of the late Richard Billings also learned that his ashes were not buried in Beaverbrook Cemetery after the interment was delayed by a snowstorm.[7] In addition to being made defendants in civil litigation, such gross errors by funeral homes have the potential to cause state authorities to revoke licenses of morticians and their licenses to operate a funeral home.

While a complaint about mishandling of cremated human remains is rarely brought against a funeral home, within a month of the report of this incident, a similar situation was found to have existed in a small town in northern California in June, 1997.[8]

Sheriff's deputies were called to Discovery Bay, a small town in California to investigate a complaint that the wall of a storage shed was collapsing. The manager of the storage company was concerned by what appeared to be puffs of ash blowing out of the building. The sheriff's department made a grim discovery of thousands of deteriorating cardboard boxes and carelessly tied plastic bags containing six pounds of cremated human remains. Deputies later learned that the man who rented the storage space was also using a private hangar at a nearby airport which contained a single engine airplane.

The responsible party, Allan Viera, was a coroner and airborne disposer of ashes. He is believed to have defrauded thousands of families over a ten year period who trusted

him to scatter the ashes of their deceased loved ones over the Pacific Ocean or the Sierra Nevada Mountains.

Class action lawsuits have been filed against Viera and the funeral homes with which he worked. Edward Wynn, lawyer for the outraged families, claims that funeral directors should have checked to determine that the ashes have been disposed of in accordance with the wishes of the deceased or their families. Subsequent investigation revealed that the Federal Aviation Administration had not licensed Viera as a pilot since 1985 and that his plane has been out of service for two years.

There are few federal or state regulations covering the disposal of human remains despite the fact that cremation has become more popular in recent years. In 1985, 13 percent of all funerals involved cremation, while in 1995 the figures rose to 21 percent. In California, cremation is more popular as it involves 42 percent of all funerals. One of the primary reasons for cremation's increasing popularity is the cost. Cremations can ranges from $500 to $2000, while burials can cost $4000 to $8000.

California has a law that forbids the dumping of ash anywhere in the state except in a cemetery. That law has prompted the rise of "professional remains disposers who pay a $100 registration as well as a $50 annual renewal fee, to dispose ashes at sea or by air. The law further requires such businesses to register and file reports of their flights. No complaints were made about Viera because he had filed reports, which apparently were bogus ones.[9]

Viera is being sued by Debra and Ken Payton, among others. The Paytons believed that their son's ashes were scattered over the Pacific near Northern California's rocky North Coast. Their case is being handled by two law firms who, in 1988, won $31.1 million against another pilot who promised to scatter the ashes of 5000 people but who dumped them on his own 10 acre lot in the Sierra Nevada foothills. It is estimated that 5,000 remains are involved in the Viera case. The lawsuit seeks damages for emotional distress as well as custody of the ashes.[10]

GRAVE MISTAKES

Laura and James Kimble purchased adjoining grave sites in 1956 because they wanted to be buried next to each other under a single tombstone. In May, 1989 when 65 year old Laura Kimble died of a heart attack, her husband noticed that Dale Sullivan who had died at age 23 in a motorcycle accident was buried in the Kimble family plot.

James Kimble called Windham Town Hall where records showed that the plot he purchased in 1956 was resold in 1986 to Mildred and Robert Sullivan, Dale Sullivan's parents.

The town of Windham has acknowledged that it is responsible for the error. Both the Kimble and the Sullivans have sued Windham for damages for the negligent inflection of emotional distress. Kimble also sought to have Sullivan's body removed but

his parents object to having his body dug up and reburied. Neither side would accept an alternate burial plot so the case must be resolved in court.[11]

Howard "Howie" Frost was also buried in the wrong plot in Sharis Israel Cemetery. In this case his relatives were not complaining because he was buried with his family near the headstone with the Frost family name. In this case, it is the cemetery association that is unhappy because the location of his grave is listed on cemetery charts as a walkway and the head of the association wants Frost's grave moved.

Frost's family is horrified at the idea of moving his body because doing so would violate Jewish laws on burial. While Frost's family has hired a lawyer to get a restraining order to block an exhumation, his niece pointed out that it was the cemetery association and gravedigger using their own paperwork that buried her uncle in the wrong spot. Connecticut law favors the Frost family because it makes it a crime to move an interred body without the family's permission.[12]

Criminal law was also invoked in a Kentucky case where it was discovered that 48,000 people were buried in already occupied graves in the Eater and Greenwood Cemeteries, which are owned by Louisville Crematory and Cemeteries Co. Acting on a gravedigger's tip, an investigator for the state attorney general's office discovered that dozens of infants were buried in too shallow graves, some as little as 10 inches below the surface and that the remains of more than 300 cremated bodies, many unidentified, are stored in the cellar of the crematory.

A sixty count indictment alleged that some remains were dug up so that the graves could be reused. The old remains were then scattered over the ground, mixed into other graves, or put in storage.

Among the criminal charges are: corpse abuse, grave desecration, theft, and failure to keep adequate funds in perpetual care and maintenance trust accounts. A civil action was also filed claiming violations of the Kentucky Consumer Protection Act which forbids reuse of previously sold or occupied graves, the sale of services not provided, failure to maintain graves, and failure to dispose of cremated remains.

Records indicate that at least one of the cemeteries was full by the early 1900s with a capacity of 18,000 bodies. It is estimated that 51,000 are buried there and that the other cemetery is at least 15,000 over capacity.[13]

Burying a body in too shallow a grave is also grounds for emotional distress damages. Thomas and Mary Monos made such a charge against Woodland Cemetery and the Leo P. Gallagher Son Funeral Home after they visited their son's grave and saw part of the burial vault protruding from the ground. The boy was also buried in the wrong grave.

The Monos family accused the defendants of negligence and breach of contract. They claimed that they suffered mental anguish when, because of their Greek Orthodox religion, a second funeral and burial had to be performed. A six member jury awarded the couple $48,200, with the cemetery paying $45,000 and the funeral home $3200 for the funeral. By law, a vault is required to be buried 18 inches below the surface of the ground.[14]

Even cemeteries can misplace remains. Frank Davidson died on Valentine's Day, 1973 when his daughter, Cheryl Tomasso was eight. A lawsuit grew out of a visit Tomasso made to Fairfield Memorial Park in Stamford, Connecticut in June, 1992 when she found that her father's grave was in a different place, appeared freshly dug with the stone moved. In 1993, the grave was exhumed and the body there was found to be that of a man who had died in 1946. Davidson's grave was in another location. The case was settled on the first day of trial after tearful testimony from Tomasso. She received an apology and an undisclosed settlement. Her father's remains were later removed from the cemetery and cremated.[15]

Abuse by cemeteries is not limited to human inhabitants. Joyce Walp and Michael Bachman of Island Park, New York paid a pet cemetery $1,083 to have their 10 year old Old English Sheepdog, Ruffian, buried with his toys, pink blanket, and collar. The couple later discovered that Ruffian's grave was empty. The dog's grave was opened after the co-owners of the cemetery were charged with mail fraud for dumping an estimated 250,000 pets in mass graves and holding mass cremations. The cemetery owners were convicted in federal court and sentenced to five years in prison.

Ruffian's owners sued for $10 million in damages and testified at trial that they had to undergo psychological therapy because of the experience. Bachman testified that the stress of the discovery caused him to lose 10 pounds. Calling the actions of the Long Island Pet Cemetery "reprehensible", a New York State Supreme Court judge awarded the pair $1.2 million in damages.[16]

FUNERAL MAYHEM, AND UNHAPPY RETURN, AND BODY PARTS FOR SALE

Failing to bury a person without his or her body parts or a favorite hat can result in an award for money damages.

Barbara Hughes sued McVicker's Chapel on the Hill and its former funeral director after she learned that her husband was buried in the Western outfit but without his black cowboy hat. McVicker's former funeral director and the dean man's son-in-law, Kevin Robinson, acknowledge that the latter took the hat but said that Hughes had given a family member permission to keep it.

Despite the conflicting stories, Barbara Hughes was awarded $101,000 in damages because her late husband was buried without his hat.

More serious was the missing legs of Molly Cohen. Mrs. Cohen was of the Orthodox Jewish faith who had her legs amputated in 1986 due to circulatory problems. Her faith requires that amputated body parts be reunited with their owner upon burial.

Mrs. Cohen entrusted the funeral home, Menorah Gardens, with the legs but when sh died in September 1994, they could not be found. Her family wanted Mrs. Cohen to b buried with her amputated legs and sued the funeral home for misplacing the legs.[17]

An unseemly mishap occurred to Mr. and Mrs. Norman O'Bryan who filed su because their son's 375 lb body fell through the bottom of the casket as it was bein carried to a grave at Woodlawn Cemetery in Canandaigua, New York in 1974. Th O'Bryan's sued four defendants: Parker Manufacturing Co. which made the casket, Pre Manufacturing Co., maker of the casket bottom, National Casket Co., wholesaler o caskets, and Kennedy and Sons Funeral Home Inc. of Canandaigua for $150,000. Th case was settled for an undisclosed sum.[18]

Most cases involve a claim of unintentional infliction of emotional distress bu there are some cases that surely fit the tort of <u>intentional</u> inflection of emotional distre as well as provide ground for criminal charges.

In Richmond, Texas, Evans Mortuary picked up the body of 66 year old Geor Bojarski on a Saturday. He had died of cancer on the previous day. Larry Bojars allegedly paid $299 of the $683 he was told it would cost to cremate his father. When h went to the funeral home to pay the balance, he said that the was told it would co $2,000 and that if Larry did not pay, the body would be returned. The followi Monday, Larry found his father's body on his front porch covered only with a she Larry called the police who asked, "How do you know it's your father?" Bojars replied, "I see his face. I know what he looks like, what am I supposed to do with th body? He's my father."

Mortician Newell Evans admitted to leaving George Bojarski's body on th porch. When told that other funeral directors considered such behavior unethical, he sai "They can run their establishments as they see fit and I will run mine my way."

In the wake of this shocking incident, Hernandez Funeral Home agreed to han the arrangements free of charge. Joe Hernandez stated, "My father's been in the busin for 50 years and he's never heard of case like this."

An even more bizarre case occurred in New Orleans where Barbara Everett wh son was shot and killed in 1995, brought a lawsuit against the city morgue alleging th eyes, bones, and other body parts were removed and sold by Frank Minyard, the coron without her permission. Everett only learned that her son had been shot five hours aft the incident. When she called the coroner, she was told that the office had a unidentified body but that it was not Leroy Everett. Later she determined that the coro did have her son's remains and identified his body. Six months later, when a wom from Southern Transport Services, Inc called to ask about her son's medical hist because The Food and Drug Administration requires a transplant agency to determin done bodies had hepatitis or AIDS, Everett learned that her son's body parts had be sold. Under Louisiana law if relatives cannot be reached for permission, the coroner ca approve the taking of parts from any body. Southern Transport paid workers

Minyard's office, $10 per corpse to take the bones and corneas. The company paid clerks as well as a pathologist at the LSU Medical Center who performed autopsies to call when bodies arrived at the morgue. Louisiana law requires organs to be donated not sold.

Police considered what kind of criminal charges to level in the unusual case.[19] An official at South Transport revealed that the firm took bones from 686 bodies after autopsies in New Orleans, 117 of which were unidentified at the time of the autopsy. After an investigation by the FDA, in 1995, Southern Transport stopped taking bones from unidentified corpses.

Everett and others field a class action law suit against the coroner.[20]

CONCLUSION

While there are many cases in which a claim of the unintentional infliction of emotional distress may be raised, among the most fascinating are those in which dead bodies are mishandled. These incidents may seem amusing at first but they have proved to be so shocking and emotionally draining for the victims that they give rise to claims for many large damage awards and also provide excellent examples for student instruction in this unusual area of negligent torts.

ENDNOTES

Robert Berner, "Dead Ringers: Mortuary Mix-up Gives Grieving Widow a Grievance," <u>Wall St. J.</u>, Oct 14, 1997 at B-1.

[2] William L. Prosser, <u>Law of Torts</u>, West. 1971 at 328-330.

[3] Stan Fisher, "Mortuary Suit Seeks to Track Corpse," <u>N.H. Register</u>, Feb 15, 1998 at A-1 and A-8.

[4] "In Mix-up, Mom Learns Child Died," <u>Connecticut Post</u>, Dec 3, 1997 at C-5.

[5] Wade Lambert, "The Loss of a Body is Doubly Crushing to a Young Couple, <u>Wall St. J.</u> 1995, at A-1, A-6

[6] "Fetuses Tossed Out; Couple Enraged," Waterbury Republican-American, Jan 7, 1998, at 4A. In another incident, the body of a prematurely born 1 pound 7 ounce girl was lost by St. John's Episcopal Hospital in Queens, New York. On February 7, 1998, Rose Agosto gave birth to a baby girl who died within a few hours. The funeral home was told that by the hospital that the baby's body could not be found. The New York State Department of Health promised to investigate and fine St. John's if state standards were violated. Agosto's lawyers are suing the hospital. "Hospital in Queens Loses Body of Premature Baby," <u>N.Y Times</u>, Feb 10, 1998 at B8.

[7] "Funeral Home Faces Penalty" <u>Connecticut Post</u>, May 5, 1997 at A3.

[8] Stan Fisher, "State Seeks Revocation of Embalmer's License" New Haven Register, May 3, 1997 at A-2.

[9] "In Piles of Human Ashes a Grim Fraud," New York Times, June 22, 1997 at 17.

[10] "Storage Lockers Stuffed with Cremated Remains," Waterbury Republican – America, June 13, 1997 at 7-B.

[11] "Town Clerk Causes Grave Mistake," Bridgeport Post, Oct 10, 1990 at A-12.

[12] David Howard, "He's Resting But His Family Isn't In Peace," Waterbury Republican-American July 15, 1996 at B-4.

[13] "Scandalous Cemetery Misuse Is Discovered," Bridgeport Post, Dec 4, 1989.

[14] "Parents Awarded Damages in Burial of Son" New Haven Register, Aug. 1987, A-7.

[15] Cemetery Settles Lawsuit Over Lost Remains," Connecticut Post, Feb 12, 1998 at A9.

[16] "Dog's Empty Grave Costs Cemetery Owner's $1.2 Million" New Haven Register, Sept 1, 1992, at A-2.

[17] "Missing Legs Force Suit," Time, Sept, 1994 at 9.

[18] "Suit is Settled in Casket Mishap," New York Times, May 7, 1976 at B-3.

[19] "Mortician May Face Charges," Connecticut Post, Sept 24 at A-9

[20] "Mom Alleges Coroner Sold Body Parts of Murdered Son," Waterbury Republican American, Jan 31, 1998 at 5A.

SHOULD THE VALUE OF LIFE DEPEND ON THE PLACE OF DEATH?*

by

Peter M. Edelstein*

INTRODUCTION

On June 8, 1998, the U.S. Supreme Court decided *Dooley v. Korean Air Lines,*[1] in a decision that may impact all future air disasters occurring on the high seas. The case, however, is of immediate interest to the aviation tort law community because of its possible effect on pending and future claims relating to the crash in Long Island Sound, on July 17, 1996, of TWA Flight 800.

The case afforded the Supreme Court the opportunity to settle a question that has divided various Circuit Courts: whether pain and suffering, as an element of damages, is recoverable by the representatives of decedents whose death was the result of an airliner crash on the high seas?[2] This paper addresses the evolution of the issues now before the Court, and concludes with the position that a legal dilemma exists for which a remedy is necessary, and since the Supreme Court did not fashion one, Congress should.

FACTS

On August 31, 1983, Korean Air Lines Flight 007 (AKE007") departed from JFK bound for Seoul. The aircraft stopped for fuel in Anchorage and resumed its flight. The last contact from KE007 was a transmission to Tokyo to the effect that the plane was rapidly decompressing and descending.[3]

Investigation of the crash showed that the aircraft, a Boeing 747, had flown off its course by approximately 170 miles and had crossed into Soviet airspace. It was thereupon shot down over the Sea of Japan by the Soviet Union=s SU-15 interceptor aircraft. All 269 persons aboard were killed when the plane went down twelve minutes after being hit. The flight recorders were never recovered.

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Forty-two actions were initially commenced in various District Courts. [4] The actio were consolidated by the Judicial Panel on Multidistrict Litigation and transferred to th District Court of the District of Columbia.[5] At the trial, plaintiffs based their case on th contention that the flight crew erroneously programmed the Internal Navigation Syste (AINS≅) prior to departure from Anchorage and, knowing of the misprogramming, decid to proceed rather than turn back and face possible disciplinary action.[6]

THE LAW

Fifteen years after the crash, the issue of damages is still being litigated.[7] The unusu duration is, of course, due to the relative size of the corporate defendant and its well-financ defense, the number of plaintiffs and their desire for a substantial recovery. However, th process was prolonged substantially by the complexity of the issues related to applicable la and the appropriate measure of damages.

Modern tort law provides that the death of a person to whom a duty was owed ma result in two types of actions, a *wrongful death* action and/or a *survival* action.[8] A wrong death action affords the beneficiaries a right of action for losses *they suffered* as a result the decedent's death. This type of action is sometimes referred to as one for pecuniary los A survival action allows a decedent's estate to recover for injuries *suffered by the deced* such as pain and suffering, loss of income, or medical expenses and is sometimes refer to as one for non-pecuniary loss.[10]

The difference between these two types of actions can be dramatically illustrated comparing the recovery rights that may flow from the deaths of two different decedents dependent spouse and two children surviving a middle-aged head of household earn $100,000 a year, in a wrongful death action, may recover substantial damages because th personally suffered financially as the result of the death. A mother and father and tw siblings surviving a seventeen year old student with no income, in a wrongful death acti may receive no award because they did not suffer economically from the death. If, howe a survival action is available and in each case the victim suffered physically or economic prior to death, the decedent's representatives in both cases may recover damages on beh of the decedent. Thus, the availability of a survivor's action becomes a profoundly impo issue when a decedent experienced pain and suffering before dying.

The principal laws affecting the issue of recoverable damages in *Dooley* are t Warsaw Convention and the Death on the High Seas Act. *The Convention for Unific of Certain Rules Relating to International Transportation by Air*, commonly referred to the Warsaw Convention, was enacted after two international conferences held in 1925 a 1929[11] and became effective in the United States on October 29, 1934.[12] As an internat treaty, the Convention became the law of the land by application by the supremacy cla of the U.S. Constitution.[13] The Convention provided a limit on the potential liabili international air carriers and was designed to protect the commercial aviation business wh was then relatively new from possibly devastating liability claims, and to achieve unifo

among applicable laws.[14]

Article 17 of the Convention imposes liability on the carrier for damage sustained in the event of the death or wounding of a passenger if the accident occurred on board an aircraft in international flight. By the terms of Article 22 (1), and by application of the Montreal Agreement of 1966,[15] the liability imposed by Article 17 was limited to $75,000. If, however, the plaintiff could prove Awillful misconduct by the defendant, in accordance with Article 22 (1), the defendant was prevented from availing itself of the monetary limitation. By virtue of an Intercarrier Agreement[16] adopted in 1995 and an Order of the U.S. Department of Transportation[17] approving the agreement, the limit on liability was effectively waived by the airlines. Because the industry waiver of the limit of liability occurred after Flight KE007, the plaintiffs had to, and did, prove Awillful misconduct, to avoid the Convention's monetary limit.

The Death on the High Seas Act (ADOHSA),[18] a maritime law statute applicable to death or injury on the high seas, was adopted in 1922 to provide compensation, which was otherwise unavailable, for lost income to widows and orphans of sailors lost at sea.[19] It is, in effect, a wrongful death statute.[20] Its authors probably never envisioned that it would be applied to air crashes, but today, DOHSA is involved when an air disaster occurs more than one league (three miles) out to sea.[21] Because the *Dooley* case involves an international carrier which crashed on the high seas, both the Convention and DOHSA apply.

On the one hand, while Article 17 of the Convention imposes liability, it does not address the issues of who may bring suit and for what damages they may be compensated. On the other hand, DOHSA does provide a cause of action A . . . for the exclusive benefit of the decedent's wife, husband, parent, child or dependent relative . . . [22] The relationship of the two laws was addressed by the Supreme Court, on January 16, 1996, in *Zicherman v. Korean Air Lines Co., Ltd.*[23]

Zicherman, a wrongful death action arising from the same Korean Air Lines flight as *Dooley,* was tried in the Second District of New York and appealed to the Second Circuit. Muriel A.M.S. Kole, a psychotherapist, died in the crash. Her mother and sister filed a suit asking for damages based on loss of society of Muriel Kole. ALoss of society refers to nonpecuniary benefits that the decedent would have provided to his or her family had he or she lived. ASociety includes many mutual familial benefits such as Alove, Aaffection, and Acare.[24]

On August 2, 1989, the jury found that the crash was due to the Awillful misconduct of Korean Air Lines, thus piercing the $75,000 limitation of the Convention.[25] On appeal to the Second Circuit, the court rejected Korean Air Lines arguments that: (i) because the crash occurred on the high seas, DOHSA applied to determine the parties plaintiff and the damages recoverable, and (ii) that DOHSA did not permit recovery for loss of society. The Second Circuit, citing the need for uniformity in cases brought under the Convention, held that general maritime law applied the substantive law of compensatory damages in an action

under the Convention whether the accident occurred on land or on the high seas, and that lo of society damages are recoverable under that law if the plaintiff was decedent's depende at the time of death.[26]

The Supreme Court granted certiorari and on January 16, 1996, held that: both th Convention and DOHSA apply to crashes involving international air travel on the high sea in a suit brought under Article 17 of the Convention, a plaintiff may *not* recover loss o society damages within the meaning of DOHSA; the Convention permits compensation fo legally cognizable harm, but leaves the specification of what harm is legally cognizable t the domestic law applicable to the forum=s choice-of-law rules; in *Zicherman,* United Sta law applies; and the death that occurred falls within the literal terms of DOHSA э761.[27] Since recovery in a э761 suit is, by the terms of э762[28] limited to pecuniary damag petitioners could not recover for loss of society (non-pecuniary damages) under DOHS

The Court in *Zicherman* did not address the availability of a separate a independent survival cause of action under general maritime law for pre-death pain a suffering.[29]

CONFLICT IN THE CIRCUITS

After *Zicherman*, the question of damages in the KE007 case was raised in th Federal Circuit Courts. *Bickel v. Korean Air Lines Co., Ltd.,*[30] (in the Sixth Circuit); a *Forman v. Korean Air Lines, Co., Ltd.,*[31] and *Oldham v. Korean Air Lines Co., Ltd.,*[32] (b in the D.C. Circuit), held that Korean Air Lines Co., Ltd. had failed to preserve its righ challenge the assertability of the survival actions by not raising the issue in its initial bri The Ninth Circuit in *Saavedra v. Korean Air Lines Co., Ltd.*[33] permitted Korean Air Li to challenge the award for pain and suffering. That Court held that the legislative int behind DOHSA supported the preclusion of non-pecuniary damages, and that a gen maritime law survival action could not, therefore, be asserted.

Korean Air Lines relying on *Zicherman*, moved for dismissal of all claims for no pecuniary damages that were still to be tried.[34] The motion was granted by the D.C. Dis Court[35] which then certified the decision for interlocutory appeal[36] and the Distri Columbia Circuit Court of Appeals accepted the appeal.

The D.C. Circuit Court noted that: (i) the Supreme Court had declined to allo general maritime law survival cause of action;[37] (ii) that a majority of Courts of Appeal recognized a general maritime law survival action for pre-death pain and suffering;[38] (iii) the First and Fifth Circuits permitted general maritime law survival actions in ca governed by DOHSA.[39] The Court agreed with *Saavedra* in the Ninth Circuit,[40] and de the availability of a survival action for pre-death pain and suffering based on its holdin DOHSA limited damages to pecuniary damages and that DOHSA preempted any gen maritime law that may provide for a survival cause of action.

The Eleventh Circuit examined the reasoning of the Ninth Circuit in *Saavedra* and concluded in *Gray v. Lockheed Aeronautical Sys. Co.,*[41] that while DOHSA may be the exclusive source for recovery for wrongful death on the high seas, Congress did not intend to preclude survival actions, and a general maritime survival cause of action is cognizable and may be asserted to recover pre-death pain and suffering with a wrongful death DOHSA action. To resolve the issues, the Supreme Court of the United States issued a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit.[42]

THE CASE IN SUPPORT OF A SURVIVAL CAUSE OF ACTION FOR PRE-DEATH PAIN AND SUFFERING

The Petitioners' brief[43] in *Dooley*, presents a well-reasoned and persuasive case for recognition of the availability in DOHSA cases of a survival action for pre-death pain and suffering. It focuses principally on three arguments: (i) inequity and unfairness should be prevented based on public policy considerations,[44] (ii) a survival action for pre-death pain and suffering is recognized by general maritime law,[45] and (iii) preclusion of a survival action was not part of the Congressional intent when DOHSA was enacted.[46]

A. Public Policy Dictates that Inequity and Unfairness Be Avoided

It is patently unfair (and illogical) that the value of a life should depend on the place of death. In the context of *Dooley* and similar cases, the value of life now depends on whether death occurred over land or sea. If the Supreme Court holds DOHSA to be the exclusive remedy available for death on the high seas as a result of an aircraft disaster, [47] the decision would have the effect of distinguishing those estates of persons who were unfortunate enough to die on the high seas, and then punishing them by withholding the right to sue for non-pecuniary damages; the very same rights the individual decedent could have asserted had he or she survived.[48]

Without the right to recover for pre-death pain and suffering, the hypothetical estate of the unemployed seventeen year old student who was a passenger in a plane that crashed on Long Island Sound rather than on Long Island, could not recover for pain and suffering. The unavailability of a survival action would probably result, in all similarly situated cases, in a minimal recovery under DOHSA.

The Convention was intended to assure compensation to victims of international aviation disasters.[49] So long as DOHSA is applicable to airliner crashes on the high seas it should not be interpreted to undermine the intention of the Convention.

The prevailing public policy in the United States is evidenced by the majority of states that have created statutory authority for survival actions.[50] To ignore that policy to the detriment of representatives of victims of an air catastrophe occurring on the high seas would be unfair and would procure an unduly harsh result.

B. Survival Action for Pre-Death Injuries is Recognized by General Maritime Law.

The Supreme Court in *Moragne v. States Marine,*[51] recognized the existence of general maritime law cause of action for wrongful death. In that case a wrongful death acti was brought by the widow of a seaman killed in territorial waters.[52] The defendant argu for dismissal on the basis that DOHSA expressly limited recovery to actions that arose o the high seas.[53]

The Supreme Court accepted the defendant's argument and held that althou DOHSA does not directly address a death remedy for death on territorial waters, A . . . n intention appears that the act have the effect of foreclosing any nonstatutory federal remed that might be found appropriate to effectuate the policies of general maritime law.[54]

In *Sea-Land Services, Inc. v. Gaudet,*[55] the Supreme Court held that separate caus of action existed for wrongful death *and* for pain and suffering.[56] In that case, a seaman w seriously injured, but before his death sued and settled for his personal injuries. After h death, his widow sued for his wrongful death. The Court held that the wrongful death act was separate from and not a continuation of the action for personal injuries. If it were n the doctrine of *res judicata* would have barred the subsequent action.[57] The Court, examin DOHSA, noted that DOHSA had not been interpreted to bar a wrongful death recovery wh the decedent had already recovered for personal injuries during his life time.[58]

After the recognition of a general maritime wrongful death action in *Moragne,* a acknowledgment of the disparate actions for wrongful death and for pain and suffering *Gaudet,* various District Courts continued to permit the general maritime law to supplem the DOHSA wrongful death action.[59]

In 1978, the Supreme Court again looked at the scope of DOHSA, in *Mobil Oil Co v. Higginbotham.*[60] In that case, a wrongful death action was brought by representativ passengers killed when a helicopter involved in an oil drilling operation crashed on the hi seas. As part of their action, the widows claimed damages for loss of society. The Dis Court denied recovery for the non-pecuniary damages of loss of society based on DOHS limiting recovery to pecuniary damages.[61] The Fifth Circuit Court of Appeals reverse relying on *Moragne* to the effect that DOHSA could be supplemented by a general mari law action for loss of society.[62]

The Supreme Court held that DOHSA was the exclusive wrongful death remedy deaths on the high seas [63] and that DOHSA precluded supplemental claims for non-pecu damages for loss of society by a wrongful death action either under general maritime or state law.[64]

Because *Higginbotham* was limited to the issue of recovery of non-pecu damages in a wrongful death action under DOHSA, it did not foreclose application of gen maritime law to a supplemental claim for pain and suffering in survival action.

C. DOHSA Does Not Preclude a General Maritime Law Survival Action.

DOHSA, as a wrongful death statute, is silent on the issue of a survival cause of action.[65] This silence created a vacuum that general maritime law may fill.[66] In determining the Congressional intent in adopting DOHSA, there is a strong presumption against preemption of other sources of available remedies unless there is specific reference to preemption in the statute or unless the structure and purpose of DOHSA is so comprehensive that it leaves no room for supplementation.[67]

The Supreme Court has already held that there was no intention by Congress that DOHSA have any effect in Aforeclosing non-statutory federal remedies that might be found appropriate to effectuate the policies of general maritime law.[68]

The terms of DOHSA, itself, refer to recovery of pecuniary damages and do not prohibit recovery of non-pecuniary damages by a survival or any other cause of action.[69] Any limitations on the types of recovery available under DOHSA should apply only to DOHSA, and not prevent supplemental survival actions.[70]

THE DECISION

Justice Thomas, writing for the unanimous Court, held in a very brief opinion, that survival actions under general maritime law for a decedent's pain and suffering, with respect to death on the high seas, are precluded by DOHSA. The opinion is based on the reasoning that since no survival statute was included in DOHSA, Congress intended there to be no such remedy.

> DOHSA expresses Congress' judgment that there should be no such cause of action in cases of death on the high seas. By authorizing only certain survival relatives to recover damages, and by limiting damages to the pecuniary loses sustained by those relatives, Congress provided the exclusive recovery for deaths that occur on the high seas.[71]

CONCLUSION

Understandably, there has been considerable public sentiment in support of law that would afford representatives of all decedents equal remedies regardless of the place of death. Congress has voted on several version of an AAirline Disaster Relief Act.[72]

If the Supreme Court in *Dooley* allows DOHSA to be supplemented by federal general maritime law including a cause of action for survival damages including pain and suffering such legislation may not be necessary.

Logic; equity and fairness; existing general maritime law; and the legislative histo of DOHSA, all support the position of Petitioners in *Dooley*. If the Supreme Court does n overrule the District Court, it seems probable that Congress shall remedy the situation.

ENDNOTES

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[1]*Philomena Dooley, Personal Representative of the Estate of Cecelio Chuapoco, et al. Korean Air Lines Co., Ltd.*, 524 U.S. 116, 118 S. Ct. 1890; 141 L. Ed 2d 102; 66 U.S.L. 4457 (1998), also known as *In re: Korean Air Lines Disaster of September 1, 19 Philomeno Dooley, et al. v. Korean Air Lines Co., Ltd.*, (hereafter sometimes referred to *Dooley*).

[2]See *Saavedra v. Korean Air Lines Co., Ltd.*, 93 F.3d 547 (9th Cir.), *cert.* denied, 117 S. 584 (1996); *Forman v. Korean Air Lines Co., Ltd.*, 84 F. 3d 446 (D.C. Cir.), *cert.* deni 117 S. Ct. 582 (1996); *Gray v. Lockheed Aeronautical Sys. Co.*, 125 F 3d 1371 (11th C (1997). See also*: Azzopardi v. Ocean Drilling & Exploration Co.*, 742 F.2d 890 (5th C 1984); *Barbe v. Drummond*, 507 F.2d 794 (1st Cir. 1974).

[3]See *In re Korean Air Lines Disaster of September 1, 1983,* 289 U.S. App. D.C. 391, 93 F.2d 1475, at 1477.

[4]Southern District of New York (15); District of the District of Columbia (8); Northe District of California (7); Eastern District of New York (6); Eastern District of Michigan (Northern District of Illinois (1); District of Massachusetts (1); District of New Jersey (1

[5]*In re Korean Air Lines Disaster September 1, 1983*, 575 F. Supp. 342 (1983).

[6]*See In re Korean Air Lines Disaster of September 1, 1983,* 932 F.2d 1475 (D.C. Cir.).

[7]The issue now before the Supreme Court on a Petition for Certiorari: whether relatives victims of air crashes over international waters may recover under general maritime law are they limited to remedies under the Death of the High Seas Act? See Petitioner=s Br on the Merits, Juanita Madole, Counsel of Record, Speiser Krause, Attorney for Petition

[8]See Keeton Prosser & Keeton on Torts at 126; Restatement of Torts at 924, 926; see al *Calhoun v. Yamaha Motor Corp.*, 40 F.3d 622, 737-38 (3d Cir. 1974).

[9]See *In re Korean Air Lines Disaster of September 1, 1983, Philomeno Dooley, et al. Korean Air Lines Co., Ltd.;*117 F.3d 1477 (1997), at 1479; *Nelson v. American Nat=l R Cross,* 307 U.S. App. D.C. 52, 26 F.3d 193, 199 (D.C.Cir. 1994); *Calhoun v. Yamaha Mo Corp.,U.S.A.*, 40 F.3d 622, 637 (3d Cir. 1994), aff=d, 133 L. Ed. 2d 578, 116 S. Ct. 6 (1996); *McInnis v. Provident Life & Accident Ins. Co.*, 21 F.3d 586, 589 (4th Cir. 1994

[10]See *Eastern Airlines, Inc. v. Floyd,* 499 U.S. 530, 544 n. 10, 113 L. Ed. 2d 569, 111 S

Ct. 1489 (1991); *Scarfo v. Cabletron Sys., Inc.*, 54 F.3d 931, 939 (1st Cir. 1995).

[11]See *In re Tel Aviv,* 405 F. Supp. 154 (1975).

[12]See *In re Korean Air Lines Disaster of Sept. 1, 1983*, 156 F.R.D. 18 n.1 (1994).

[13]U.S. Const. Art VI, cl. 2 A The Constitution, and the Laws of the United States which shall be made in pursuance thereof; and all Treaties made, or which shall be made, under the authority of the United States, shall be the Supreme Law of the Land,....≅

[14]See *Husserl v. Swiss Air Transport Co.,* 351 F. Supp. 702 (1972); *Husserl v. Swiss Air Transport Co.,*388 F. Supp. 1238, (1975), disapproved on other grounds by *In Re Mexico City Air Crash,* 708 F.2d 400 (1983); *Evangelinos v. Trans World Airlines, Inc.*, 396 F. Supp. 95 (1975), rev=d on other grounds 550 F. 2d 152 (1977); *Domangue v. Eastern Air Lines, Inc.*, 722 F.2d 256 (1984), disagreed with on other grounds by *O=Rourke v. Eastern Air Lines, Inc.*, 730 F.2d 842 (1984); *Rosman v. Trans World Airlines, Inc.*, 34 N.Y. 2d 385, 314 N.E. 2d 848 (1974); *Manion v. Pan American World Airways, Inc.*, 80 App.Div. 2d 303, 439 N.Y.S. 2d 6 (1981).

[15]See 44 C.A.B. 819 (1966), reprinted in 49 U.S.C. ɘ1502 note (1970).

[16]See *In re Tel Aviv*, 405 F. Supp. 154 (1975).

[17]See Kreindler, NYLJ, August 30, 1996; Shapiro, AU.S. Clears Way for IATA Agreements,≅ BUSINESS INSURANCE, January 20, 1997; ADOT Order Should Encourage Airlines to Waive Liability Limits,≅ AIR SAFETY WEEK, January 20, 1997.

[18]46 U.S.C. Appx, Sections 761-767 (1996), Death on the High Seas Act referred to herein as ADOHSA≅.

[19]A Whenever the death of a person shall be caused by wrongful act, neglect, or default occurring on the high seas beyond a marine league from the shore of any state, or the District of Columbia, or the Territories or dependencies of the United States, the personal representative of the decedent may maintain a suit for damages in the district courts of the United States, in admiralty, for the exclusive benefit of the decedent=s wife, husband, parent, child, or dependent relative against the vessel, person, or corporation which would have been liable if death had not ensured,≅ 46 USC, Section 761.

[20]See *Sea-Land Services, Inc. v. Gaudet,* 414 U.S. 573 (1974), at 575-76, n.2. DOHSA requires that suit be brought by the personal representative of the estate of the decedent. See 46 U.S.C. ɘ762.

[21]See *Offshore Logistics, Inc. v.* Tallentire, 477 U.S. 207; 106 S.Ct. 2485 (1986); *Lacey v. L.W. Wiggins Airways, Inc.*, 95 F. Supp. 916 (1951); *Stoddard v. Ling Temco-Vought,*

Inc., 513 F. Supp. 339 (1981).

[22]46 USC, App x, Section 761. See note 19 *supra.*

[23]*Zicherman, etc., et al. v. Korean Air Lines Co.*, 116 S. Ct. 629 (1996).

[24]See Stephen J. Fearson, ARecoverable Damages in Wrongful Death Actions Governed by the Warsaw Convention,≅ 62 Def. Couns. 367, 368 (1995).

[25]*In re Korean Air Lines Disaster of Sept. 1, 1983,* 932 F.2d 1475, 1478-79 (D.C. Ci (1991), *cert.* denied *sub nom. Dooley v. Korean Air Lines,* 502 U.S. 994, 112 S.Ct. 6 (1991).

[26]*Zicherman v. Korean Air Lines Co., Ltd.*, 43 F.3d 18, 221-22 (2d Cir. 1994).

[27]Recovery in a DOHSA ϶776 suit Ashall be a fair and just compensation for the pecunia loss sustained by the persons for whose benefit the suit is brought.≅ 46 U.S.C. App. ϶76

[28]See *In re Korean Air Lines Disaster of Sept. 1, 1983,* 932 F.2d 1475 (D.C. Cir.), *ce* denied, 502 U.S. 994 (1991); *Zicherman v. Korean Air lines, Co., Ltd.*, 516 U.S. 217 (199

[29]See *Zicherman* at 230, n.4.

[30]*Bickel v. Korean Air Lines Co., Ltd.*, 83 F.3d 127 (6th Cir. 1996); amended on reheari 96 F. 3d 151, *cert.* denied 117 S. Ct. 770 (1996).

[31]*Forman v. Korean Air Lines Co., Ltd.*, 84 F.3d 446 (D.C. Cir.) *cert.* denied, 117 S. Ct 582 (1996).

[32]*Oldham v. Korean Air Lines Co., Ltd.*, 127 F.3d 43 (D.C. Cir. 1997), *cert.* pending Docket No. 97-1180.

[33]*Saavedra v. Korean Air Lines Co., Ltd.*,93 F.3d 547 (9th Cir.), *cert.* denied, 117 S. Ct 584 (1996).

[34]Docket Entry 2/26/96.

[35]Docket Entry 6/4/96.

[36]Petition for interlocutory appeal granted on August 15, 1996, based on 28 U.S.C. ϶1292(b).

[37]See *Moragne v. States Marine Lines, Inc.*, 398 U.S. 375 (1970).

[38]See *Dooley*, 117 F.3d at 1480-1481. See note 1 *supra.*

[39]Citing *Azzopardi v. Ocean Drilling & Exploration Co.*, 742 F.2d 890 (5th Cir. 1984); *Barbe v. Drummond*, 507 F.2d 794 (1st Cir., 1974).

[40]*Saavedra v. Korean Air Lines., Ltd.*, 93 F.3d 547 (9th Cir.), *cert.* denied, 117 S. Ct. 584 (1996).

[41]*Gray v. Lockheed Aeronautical Sys. Co.*,125 F.3d 1371 (11th Cir. 1997).

[42]118 S. Ct. 679, 139 L. Ed 2d 628 (1998).

[43]Petitioners= brief is herein referred to as the ABrief.≅

[44]Brief, p. 40.

[45]Brief, p. 12.

[46]Brief, p. 23.

[47]See *Offshore Logistics, Inc. v. Tallentire,* 477 U.S. 207, 106 S. Ct. 2485 (1986); *Lacey v. L.W. Wiggins Airways, Inc.*, 95 F. Supp. 916 (1951); *Stoddard v. Ling Temco-Vought, Inc.*, 513 F. Supp. 339 (1981).

[48]See Ugo Colella, The Proper Role of Special Solicitude in the General Maritime Law, 70 Tul. L.Res. 227, 246 (1995).

[49]*In re Air Disaster at Lockerbie, Scotland on Dec. 21, 1988,* 37 F.3d 804, 829 (2nd Cir. 1994), *cert.* denied, 513 U.S. 1126 (1995).

[50]See *Miles v. Apex Marine Corp.*, 498 U.S. 19 (1990).

[51]398 U.S. 375 (1970). See also *Heredia v. Davies*, 12 F.2d 500, 501 (4th Cir. 1926); *Dennis v. Central Gulf S .S. Corp.*, 453 F.2d 137, 140 (5th Cir. 1972); *Downie v. United States Lines Co.*, 359 F.2d 344, 347 (3rd Cir.), *cert.* denied, 385 U.S. 897 (1996).

[52]*Moragne*, 398 U.S. at 376. See note 37 *supra.*

[53]*Id.* at 375.

[54]*Id.* at 400.

[55]See *Sea-Land Services v. Gaudet,* 414 U.S. 573 (1974).

[56]*Id.* at 575-76, n. 2. See note 55 *supra.*

[57]*Id.* at 578-579.

[58]*Id.* at 583 n. 10.

[59]See *Barbe v. Drummond,* 507 F.2d 794 (1st Cir. 1974); *Spiller v. Thomas M. Lowe, Jr. & Assoc. Inc.,* 466 F.2d 903, (8th Cir. 1972); *Greene v. Vantage Steamship Corp.,*466 F. 2d 159 (4th Cir. 1972); *Dennis v. Central Gulf S. S. Corp.,* 453 F.2d 137 (5th Cir. 1972); *Dugas v. Nat=l Aircraft Corp.,* 438 F.2d 1386 (3rd Cir. 1971).

[60]436 U.S. 618 (1978).

[61]*Higginbotham v. Mobil Oil Corp.,* 360 F. Supp. 1140, 1150 (W.D. La. 1973).

[62]*Higginbotham v. Mobil Oil Corp.,* 452 F.2d 422 (5th Cir. 1977).

[63]*Mobil Oil Corp. v. Higginbotham,* 436 U. S. 618 (1978).

[64]*Id.*, at 623-25.

[65]*Gaudet,* 414 U.S. at 575-576, 575 n. 2. See note 55 *supra.*

[66]See cases in which DOHSA applied: Eleventh Circuit, *Gray, supra,* 125 F.3d at 1381-1386; First Circuit, *Barbe, supra,* 507 F.2d at 799-800; Fifth Circuit, *Azzopardi, supra,* 742 F.2d at 893-894; *Law v. Sea Drilling Corp.*, 523 F.2d 793, at 795 (5th Cir. 1975); Second Cir. (*Zicherman, supra*, 43 F. 3d at 23; *Preston v. Frantz,* 11 F.3d 357 (2nd Cir. 1993).

[67]See *Cipollone v. Ligget Group, Inc.,* 505 U.S. 504, 516 (1922); *Hillsborough County, Fla. v. Automated Medical Lab., Inc.,* 471 U.S. 707, 716 (1985); *California v. ARC American Corp.,* 490 U.S. 93, 101 (1989).

[68]*Moragne,* 398 U.S. at 400; *Gaudet,* 414 U.S. at 588 n. 22; *American Export Lines Inc. Alvez, 446 U.S. 274, 285 (1980).*

[69]*Barbe*, 507 F.2d at 800. See note 59 *supra.*

[70]46 U.S.C. App. 762 (1994) DOHSA Section 762 states that recovery is to be a fair and just compensation for the precuniary loss sustained by the person for whose benefit the suit is brought.

See H.R. 2005, A A Bill to Amend Title 49, United States Code, to clarify the applicati of the act popularly known as the Death on the High Seas Act to aviation accidents.≅ T bill was introduced in the House by Representative Joseph M. McDade (R-PA), whose district includes Montoursville, the home of the high school that lost its French class o TWA Flight 800. See also H.R. 603.

[71]*Dooley v. Korean*, see note 1, *supra.*

[72]*Id.* at 1894.

PLANNING FOR RETIREMENT PLAN DISTRIBUTIONS

by

Martin H. Zern *

INTRODUCTION

For someone nearing retirement age, a major consideration is how to stru distributions from a qualified employee retirement plan for optimum tax advantag planning for such distributions, consideration also must be given to the provisions employee plan, the health and financial needs of the plan participant and famil estate tax implications. Complaints about the complexity of our tax laws are de ri and more than justified when one tries to analyze the mind-boggling labyrinthine that pertain to retirement distributions. For purposes of this article, it will be ass that retirement funds are all in pre-tax dollars, and will thus be fully taxable distribution.

What to do with funds in a retirement plan is also a consideration for a gr number of people who are not retiring, but who are being laid off due to cor downsizing or merger activity. Despite a robust economy and strong corporate p there has been a wave of layoffs due to massive corporate *restructurings*.[1] Also, t a perception that *bigger is better* which is fueling a wave of so-called *megamerge* example, the recently announced mergers of Citicorp with Travelers Grou NationsBank Corp. with BankAmerica, Corp.[2] Wall Street seems to reward conglomerations by bidding up the price of the stock of the companies involved theory that a behemoth will be better able to compete in the new and growing economy. A collateral factor pushing up stock prices when a merger is announced expectation that the new combined company will be more efficient due to em layoffs, which usually follow a merger.[3] Redundant employees quite ofte significant assets in a company retirement plan.

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BASIC CHOICES

An employee separated from service, for whatever the reason, must consider the choices available to him with respect to funds he has accumulated in a company retirement plan.[4] Some retirement plans permit an employee to withdraw everything to his credit in the plan in a lump sum when leaving the employ of company. If this is done, however, the entire distribution will be subject to immediate income taxation. Moreover, if the employee taking a lump-sum distribution has not reached the minimum age of 55, the amount withdrawn will be subject to a special 10% penalty tax.[5] Consequently, a lump-sum distribution is generally the worst choice to make from a tax viewpoint, and should be avoided unless there is an urgent need for the funds and no other resources, such as loans, are available.

Another option available upon separation from service is to leave the funds in the plan and withdraw them as annuity payments. If an annuity option is chosen, and the annuity is to be paid over the life of the employee (or joint lives of the employee and a beneficiary), the 10% penalty will not apply even though the annuity begins before age 55.[6] It may be noted that some plans do not permit lump sum withdrawals, in which case annuity payments are the only option.

A qualified plan must provide that, *unless the participant otherwise elects*, distributions will begin not later than the 60th day after the close of the plan year in which the *latest* of the following occurs: (1) the date the participant attains the age of 65 (or the plan's normal retirement age, if earlier); (2) the 10th anniversary of the year in which the participant commenced participating in the plan; or (3) the termination of employment.[7] For example, if a participant retires at age 60 under a plan in which he has been participating for 10 years, and where normal retirement is age 65, the plan may defer distributions until 60 days after the close of the plan year in which the participant reaches age 65. On the other hand, if the participant retires at age 67, distributions would have to begin within 60 days after the close of the plan year in which the employee retired. These provisions are intended to protect the employee by mandating that distributions begin by a certain point. *But if the employee does not immediately need money from the retirement plan, he may prefer to keep the funds intact and growing tax-free for as long as possible.*

The government, however, does not permit unlimited tax deferral of pension accounts. Therefore distributions must begin by a certain date which is no later than April 1st of the calendar year following the calendar year in which the employee attains age 70 ½, unless the employee continues to work past this point. If the employee works past age 70 ½, distributions must begin no later than April 1st of the calendar year following the calendar year in which he retires.[8] The later of the two dates is referred to as the *Required Beginning Date*.[9] It should be noted that the possibility of deferring distributions past age 70 ½ does not apply to a participant who owns more than 5% of the employer.[10] Also, as discussed in more detail hereafter, the possibility of deferring

distributions past age 70 ½ if still working does not apply to funds in an Indiv Retirement Account (IRA).

Besides mandating that retirement distributions begin by a certain date government decrees that minimum distributions be made once that date is reached. concept behind the *Minimum Distribution Requirement*, detailed hereafter, is retirement funds should be withdrawn and used for retirement by a reasonable age an course, taxed at such time.

Another choice for an employee is to transfer the funds in the retirement pla an IRA.[11] This option, as many people are aware, is known as a *rollover*. A rollo frequently chosen where the employee separated from service is still young and ha immediate retirement plans. Rather than keeping the retirement funds under the co of a trustee designated by the employer for many more years, with possibly no or li investment choices, the employee may desire to take control of the funds in order able to make investment decisions among a broader spectrum of investments. Incr investment flexibility may also be a reason for an employee who is about to retire to out of an employee plan into an IRA. Additionally, an IRA generally offers consid more leeway regarding setting up multiple accounts and designating beneficiarie does an employee retirement plan. Consequently, it is commonplace today for IR hold considerable funds rolled over from employee retirement plans, in addit contributions that might have been made otherwise. Because of this, plannin distributions from an IRA or IRAs has become an important financial considerati many people. In numerous cases, IRA funds constitute the major assets of an indiv

REQUIREMENTS FOR ROLLOVER INTO IRA

If an employee separated from service decides to transfer funds from a qua employee retirement plan into an IRA, it is important for him to understand and co with the rules regarding rollovers. The safest method is a direct rollover, whe employee advises the plan administrator to make the check for the lump-sum an payable directly to the financial institution where the employee has an establishe Of course, if the employee does not have an available IRA, one will have to be se The plan administrator should then remit the check for the lump sum distribution di to the financial institution; if the check is given to the employee, it should be dep with the financial institution within 60 days.

The check should not be made payable to the employee. It if is, the gove will presume he is cashing out of the plan and will require the plan administr withhold income tax in the amount of 20% of the distribution.[12] The employee th 60 days to transfer the distribution, including the 20% withheld, into an IRA in or avoid the distribution being subject to income tax.[13] Unfortunately, under this sc the employee will have available only 80% of the amount required to be deposite IRA, and therefore will have to come up with the remaining 20% from other res To the extent the employee does not deposit the distribution within 60 days, it w subject to income tax.[14] To make matters worse, if the employee is under age 5

distribution, to the extent not rolled over within the 60-day time frame, will be subject to the 10% penalty tax. Consequently, having the distribution made payable to the employee should be avoided unless the employee is in dire need of a short-term loan and is certain that he will be able to come up with the money necessary to make a full rollover within the 60 day deadline.[15]

Once the rollover into the IRA is successfully completed, the funds in the account can continue their tax-free growth, and investment decisions can now be made by the owner of the account. Ultimately, as will be detailed herein, the funds in the IRA account will have to be withdrawn. This paper will discuss the requirements for withdrawal and the options that are available in planning for distributions from an IRA. However, it should be recognized that the Minimum Distribution Requirements also apply to employee retirement plans.

HIGHER MINIMUM AGE FOR IRAS

It is important to be aware that the minimum age one must reach to avoid the 10% penalty tax on funds withdrawn from an IRA, as opposed to a company plan, is increased to age 59 ½ from age 55.[16]

MINIMUM DISTRIBUTION REQUIREMENTS

Although tax deferred retirement plans were created by Congress as an incentive for people to save for retirement, deferral is not unlimited. The government mandates that when the owner of the retirement account reaches a certain age, the untaxed funds be distributed. If an individual lives long enough, the time of reckoning will arrive and minimum distributions from the IRA (or employee plan) will have to be made to avoid a significant penalty.

REQUIRED BEGINNING DATE

The owner of an IRA must either withdraw the *entire amount* in the account (i.e., in a lump sum) or begin withdrawal by making *periodic distributions*, no later than the taxable year in which the account owner attains the age of 70 ½. However, distributions may optionally be deferred until April 1st of the year following the attainment of age 70 ½ which, as mentioned, is designated as the Required Beginning Date. Subsequent periodic distributions must be made annually no later than December 31st. The only downside of deferring distributions until April 1st of the year following attainment of age 70 ½ is that a distribution for such following year must be made by December 31st. Consequently, there will be two taxable distributions flowing into one taxable year if the initial distribution is deferred until the next April 1st, which could result in income being taxed in a higher tax bracket. For example, if you turn age 70 ½ in 1998, the minimum distribution for 1998 must be made by April 1, 1999, and the minimum distribution for 1999 must be made by December 31, 1999.[17]

A TOUGH PENALTY

To assure that distributions from an IRA meet the minimum distrib requirements, the government imposes a hefty 50% excise tax on the difference be what is distributed each year and what should have been distributed.[18]

PERIODIC DISTRIBUTIONS

If it is decided to withdraw the amount in the IRA by making pe distributions, as opposed to a lump-sum distribution, a period over which the distrib are to be made must be selected. The choices are to make distributions over (a) the l the owner of the account, or shorter term period, or (b) the joint lives of the owner designated beneficiary, or shorter term period. Single Life and Joint Life and Su Expectancy tables are contained in Treasury Regulations.[19]

DETERMINING LIFE EXPECTANCY

If an election is made to make periodic distributions, rather than wit everything in a lump sum, life expectancy must be determined. As noted, distrib can be made over the single life expectancy of the account owner or over joint Whether the choice is single or joint lives, one option is to use an initial fixe expectancy. In effect, this results in distributions being made over a term of years, is the initial life expectancy. Thus, if a person lives past life expectancy, there wo no more distributions. For a husband and wife, however, life expectancy c *redetermined* each year (either for both of them or either one of them), which res distributions continuing over lifetime. Redetermining life expectancy is an available only to the owner of the IRA, or the owner and his spouse if distributio based on the joint lives of the owner and spouse.[20] Although redetermining a pe life expectancy at first blush may seem illogical, the actuarial fact is that the long lives the longer one is expected to live. In other words, everyone alive has at least life expectancy.

DESIGNATED BENEFICIARY

If an election is made to make distributions over joint lives, a desi beneficiary must be selected to calculate the joint life expectancy. A desi beneficiary can be any individual.[21] If more than one beneficiary is named, the on the shortest life expectancy must be used in determining the minimum distribution. designated beneficiary must be chosen by the Required Beginning Date.[23] The sel of a designated beneficiary, and other relevant elections, should be in writin delivered to the institution holding the account by the Required Beginning Date owner of the IRA can change the designated beneficiary, and this can be done before or after the Required Beginning Date. If a new designated beneficiary is after the Required Beginning Date with a life expectancy shorter than the orig named beneficiary, the period over which future withdrawals must be made m redetermined using the life expectancy of the new designated beneficiary. In

words, the old distribution period must be replaced by a new distribution period. The new period is the remaining period under the Joint Life and Last Survivor Expectancy Tables as if the new beneficiary had been the one originally designated by the Required Beginning Date. However, if the new designated beneficiary has a life expectancy longer than the original beneficiary, a redetermination of the period over which withdrawals must be made is not permitted.[24]

CALCULATING THE MINIMUM DISTRIBUTION

The minimum distribution for a particular year is determined by dividing the account balance as of December 31st of the prior year by the applicable life expectancy. Minimum distributions may be determined based only on the IRA owner's life, or the joint life of the IRA owner and any other person. As mentioned, if more than one beneficiary is named, the one with the shortest life expectancy must be used in determining the minimum distribution. Special rules apply, however, where joint lives are used and there is a non-spouse beneficiary more than 10 years younger than the IRA owner. In such case, as detailed below, there must be compliance with a *Minimum Distribution Incidental Benefit Requirements* rule.

Example:

If a person reaches age 70 ½ in 1998, the distribution for 1998 may be made in 1998, or by April 1, 1999. The distribution for 1999 must be made by December 31, 1999. Assume an individual has an IRA balance of $100,000 as of December 31, 1997, an account balance as of December 31, 1998, of $115,000 (before any distributions), and reaches age 70 ½ early in 1998 so that by December 31, 1998, he is age 71. Based on his age at December 31, 1998, his life expectancy is 15.3 years per the IRS actuarial tables. The minimum distribution that he must make for 1998 is $6,536 ($100,000/15.3). This amount may be distributed in 1998, or as late as April 1, 1999. Assuming that to avoid the bunching of two distributions into 1999, the 1998 distribution is made on the last day of the year, so that the account balance at that time is $108,464 ($115,000 - $6,536). The minimum distribution for 1999, which must be made by December 31, 1999, is $7,585 ($108,464/14.3). Notice the reduction of the divisor from 15.3 to 14.3. If the distribution for 1998 is delayed until April 1, 1999, the minimum distribution for 1999 would be $8,042 ($115,000/14.3) and would have to be made by December 31, 1999. Thus, both the 1998 and 1999 distributions would be taxed in 1999.

If the individual were married to someone who was age 50 at December 31, 1998, the joint lives table would provide an initial divisor of 33.9 years which obviously would require smaller minimum distributions. The divisor for the next year would be 32.9 and for the next year 31.9, and so on.

REDETERMINING LIFE EXPECTANCY

As an alternative to the above method, and if the IRA terms permit, the owner an owner's spouse may *elect* to redetermine life expectancy each year rather than use a life expectancy.[25] If the plan permits, the life expectancy of the owner ma redetermined even though the life expectancy of his spouse is not, and vice versa.[26] election must be made by the Required Beginning Date, and is irrevocable.[27] Th may specify a default method, either redetermination or no redetermination, if the o fails to make an election. If a plan does not contain an optional provision, or if th no election and no default provision, redetermination is mandatory.[28] Und redetermination method, the divisor is not reduced by one each year. Rather, the di in the actuarial tables for the particular year is used. For example, the life expecta age 72 (December 31, 1999) for the individual in the above example is 14.6 und single tables (recall that without redetermination in the above example it is 14.3), a a couple age 72 and 51 under the joint tables the life expectancy is 32.9. For ages 7 52 it would be 32 (notice that without redetermination in the above example it is after two years). Each year, reference would have to be made back to the IRS act table to determine the correct divisor, whereas with no redetermination only an initi expectancy determination is necessary.

The main advantage of redetermining life expectancy is that the IRA is not to be fully distributed, possibly before death, because, as noted, there is always som expectancy. For those who anticipate a long life and fear outliving the distributio redetermination method may be preferable. The main drawback is that redetermin expectancy always goes to zero in the calendar year following the year of de Consequently, if the single life expectancy tables are used, the account must be distributed by December 31st of the calendar year following the calendar year of In contrast, if there is no redetermination, distributions may continue as before beneficiary.

If the redetermination method is used on the joint lives of a husband and wi method may continue to be used by the survivor, but only the survivor's life exp is used to redetermine distributions for years after the year of the first spouse Subsequent to the death of the surviving spouse, life expectancy is zero, and the account balance must be distributed to the beneficiary of the survivor on or before th day of the year following his or her death. Consequently, it may not be a good id the surviving spouse to continue to use the redetermination method. As allu previously, another option discussed later in this paper is for the surviving spouse to to treat the account as her own or roll it over into her own IRA.

As noted, life expectancy of the account owner may be redetermined even of his spouse is not, and vice versa. If there is some uncertainty as to whether the will survive the account owner, it may be preferable to elect redetermination f owner and not for the spouse where joint lives are being used. The reason is tha spouse predeceases, the owner can continue to use the spouse's life expectancy in distributions during his lifetime. He can't do this, however, if his spouse's life exp

is being redetermined since her life expectancy goes to zero in the year following her death. On the other hand, if the account owner dies first, his spouse can elect to treat the account as her own or roll it over into her own IRA. The flexibility afforded the spouse of treating the account as her own or rolling it over into her own IRA is discussed below.

As noted, only the account owner and his spouse can use the redetermination method. Accordingly, if the designated beneficiary is not the spouse, and an election is made to make distributions over the joint life of the owner and non-spouse beneficiary, only the life of the owner may be redetermined in calculating the correct divisor. If the account owner dies, the fixed life expectancy of the designated beneficiary is used to determine distributions after the death of the owner. In other words, a non-spouse beneficiary may not redetermine life expectancy either before or after the death of the account owner. Furthermore, the special *Minimum Distribution Incidental Benefit Requirements* rule is applicable in redetermining life expectancy each year on joint lives where the joint life used is not a spouse.

MINIMUM DISTRIBUTION INCIDENTAL BENEFIT (MDIB) REQUIREMENTS

Since joint lives can be used to calculate life expectancy, selecting a much younger person as the beneficiary will operate to considerably extend the number of years over which distributions can be made. To prevent an exceedingly lengthy deferral, the MDIB rule mandates that a non-spouse beneficiary will be considered to be no more than 10 years younger than the owner of the IRA. The MDIB rule is inapplicable to a spouse who is the beneficiary regardless of age. Thus, for example, if the husband is age 60 and the wife age 30 when distributions begin, these ages will be used in computing their joint life expectancy. But if the beneficiary is not a spouse, such person will be considered no younger than age 50 in computing joint life expectancy.

An important exception is that the MDIB rule ceases after the death of the owner of the IRA. In other words, the MDIB rule operates to prevent an inordinately long distribution period resulting from the selection of a beneficiary significantly younger than the account owner *only* while the owner is alive. After the death of the owner, the IRA may be distributed over the then fixed life expectancy of the beneficiary regardless of how young the beneficiary may be. Accordingly, with a very young beneficiary, distributions can be spread out over many years and tax deferral optimized. For example, if the designated beneficiary is a 10-year old grandchild, distributions could be spread out over his or her lifetime upon the death of the grandparent.

DEATH OF ACCOUNT OWNER

Once the account owner dies, the options available to the designated beneficiary of the IRA for withdrawing funds depends upon whether distributions have begun to the account owner and whether the designated beneficiary is the spouse.

DEATH OF OWNER BEFORE REQUIRED BEGINNING DATE - SPOUSE AS DESIGNATED BENEFICIARY

Various possibilities exist where the spouse is the designated beneficiary and the acc owner dies before distributions have begun.

PERIODIC DISTRIBUTIONS

If distributions had not yet begun prior to the death of the account owner surviving spouse may elect to take distributions based upon either her fixed expectancy or her life expectancy redetermined annually, at her election.[30] The sp however, can defer distributions until the *later of* (1) December 31 of the calendar subsequent to the calendar year in which the account owner died [31], or (2) Decembe of the calendar year in which the account owner would have reached age 70 ½ h lived.[32] The possibility of waiting until April 1st of the subsequent year does not here. The election to take periodic distributions must be made by the later o aforesaid dates.[33] If the spouse waits past the date for electing periodic distributions the Five Year Rule, discussed below, is applicable, unless the spouse elects to tre IRA as her own or rolls it over into her own IRA, also discussed below. If the s needs money, however, she may desire to take distributions immediately. In such it may be noted that the 10% penalty provision is not imposed even if the spouse h yet reached age 59 ½ since the penalty is inapplicable in the event of death.[34]

A *special rule* is applicable if the spouse dies after the account owner but b distributions have commenced to her - e.g., the account owner dies at 67 and the s dies at 69 with no distributions having been made to her (she can wait until her hu would have been 70 ½). In this case, the surviving spouse will be treated a employee.[35] Thus, periodic distributions will have to commence to her desig beneficiary over such beneficiary's lifetime (or shorter term) by December 31st of th following her death, or the entire account would have to be distributed to her benef under the Five-Year Rule. If the spouse remarries, the rule permitting a spouse to until age 70 ½ to take periodic distributions will not apply to her new spouse. periodic distributions to him would have to begin by December 31st of the year foll her death, or the Five-Year Rule must be used. Also, the new spouse apparently not roll over the account into his own IRA or elect to treat it as his own.

FIVE-YEAR RULE

Rather than taking periodic distributions, another option available to a spous distribute the *entire* account balance within five years of the account owner's de The election and distribution would have to be made by December 31st of the ca year which contains the fifth anniversary of the death of the account owner.[37] Thi outside date, and distributions can be taken earlier. Again, the 10% pena inapplicable even thought the spouse is under age 59 ½.

ELECTION TO TREAT IRA AS OWN OR ROLL OVER INTO OWN IRA

A final election, and the one providing the most flexibility, especially for further deferral is for the surviving spouse to treat the IRA as her own or roll the balance in the account into her own IRA.[38] If the spouse does this, she can defer distributions until she reaches age 70 ½, make her own beneficiary designations, and thus make distributions over a new extended period. She can also elect whether to redetermine her life expectancy. A rollover is permitted even if the spouse has reached her Required Beginning Date.[39] In this case, however, she can only name a new beneficiary and make new elections if she treats the deceased spouse's account as her own or rolls it over into a brand new IRA to which she has made no contributions. The two prior methods, periodic distributions and five-year rule, might be favorable where the spouse needs cash and is under age 59 ½ since the 10% penalty would be inapplicable. Where the IRA is treated as her own or rolled over into her own IRA, the 10% penalty for premature distributions is applicable.

It should be recognized that the foregoing are all minimum distribution rules. *The surviving spouse can always withdraw more than the minimum, and even the entire account balance at any time if she is willing to foot the tax bill.*

DEATH OF OWNER AFTER REQUIRED BEGINNING DATE - SPOUSE AS DESIGNATED BENEFICIARY

If the account owner dies after distributions have begun, any undistributed amount must be distributed at least as rapidly as under the method being used by him as of the date of his death.[40] Thus, distributions would be made over the remaining joint life expectancy, reduced by one for each successive year. If the account owner had been using the redetermination method, his life expectancy would go to zero in the year following his death. Consequently, only the surviving spouse's life expectancy would be used for years after the owner's death.[41] These rules will not apply, however, if the spouse elects to treat the IRA as her own or rolls it over into her own IRA, as just discussed. The ability to treat the IRA as her own is applicable even if the spouse has already reached her own Required Beginning Date, as previously noted.[42]

DEATH OF OWNER BEFORE REQUIRED BEGINNING DATE - NON-SPOUSE DESIGNATED BENEFICIARY

If the account owner dies before distributions have begun, everything in account must be distributed by December 31st of the fifth year following the ye death, or over the life expectancy of the designated beneficiary, or shorter term. Usu the provisions of the IRA permit the owner or the beneficiary to choose the metho distribution. If the plan says nothing, however, or no choice is made, which woul unlikely, a complete distribution must be made by the end of the fifth year follo death. Contrast this with the rule regarding a spouse-beneficiary, where if the plan nothing or no choice is made, the default provision is for payments over life expect (unless the spouse elects to treat the IRA as her own or roll it over into her own IRA)

DEATH OF OWNER AFTER REQUIRED BEGINNING DATE - NON-SPOUSE DESIGNATED BENEFICIARY

If distributions had started prior to the death of the owner of the IRA that sa the Minimum Distribution Requirements, whatever has not been distributed mu distributed at least as fast as the method being used by the owner.[43] For example, owner of the IRA died five years after he had started taking distributions based on year life expectancy, the beneficiary would have to use 15 years in figuring the mini distribution. If the owner had been redetermining life expectancy using a single lif life expectancy would be zero in the year after death, and a distribution of the account balance to the named beneficiary would be required by the last day of the following the owner's death. If the owner had been redetermining life expectancy joint lives, the MDIB rule, discussed above is applicable. In such event, upon the of the owner, the life expectancy of the designated beneficiary at such time must be to determine minimum distributions for years after the year of death. The benefic however, may not redetermine life expectancy since this is an option that is avai only to the account owner and his spouse.

MULTIPLE ACCOUNTS

There is no limit on the number of IRAs an individual may own. A rollover an employee plan into a number of IRA accounts may be advisable if the partic desires to benefit multiple beneficiaries. With multiple accounts, separate expectancies can be used, rather than the life expectancy of the eldest beneficiary w would be required if only one account is used for everyone. Moreover, since beneficiaries most likely will have different needs and desires, different invest choices can be made if separate accounts are established. Conflicts can be avoided separate accounts will facilitate estate planning by the beneficiaries.

AVOID ROLLOVER WITH APPRECIATED COMPANY STOCK

Although a rollover into an IRA of all assets in an employee retirement pl often warranted, there is one situation where a complete rollover should be avoided

that is where the plan holds employer stock that has significantly appreciated in value. Here, the employee may be better off withdrawing the stock from the plan and rolling over only whatever remains. As noted, a partial rollover is permitted. The reason is that if an employee withdraws stock from a company plan attributable to employer contributions, as part of a total distribution, he is taxed only on the cost of the stock.[44] This could be, and often is, a small fraction of the stock's current fair market value. No tax will be owed on the appreciation in value until the stock is sold, and then only at a 20% capital gain rate (assuming the requisite holding period is met).

Furthermore, if the stock is not rolled over into an IRA and held by the owner until death, its tax basis will be stepped up to date of death value. Thus, no income tax will be imposed on the pre-death appreciation when the beneficiary inheriting the stock sells it.

On the other hand, if the stock is rolled over into an IRA, no taxes will be paid up front. The full amount withdrawn from an IRA, however, must be included in gross income, whether withdrawn by the account owner or a designated beneficiary.[45] Consequently, it is poor strategy to roll over company stock in an employee plan that is highly appreciated. Whether there should be a rollover of stock somewhat appreciated can only be determined by crunching the numbers.

ESTATE AS BENEFICIARY

Although it is not generally advisable to name one's estate as beneficiary of an employee retirement plan or IRA, many ill-advised or non-advised people do so. The problem is that an estate is not a recognized beneficiary.[46] Accordingly, if distributions have begun during the account owners lifetime, they can only be made over his *single* life expectancy. There is no looking through the estate to its beneficiary or beneficiaries in order to compute distributions based upon joint lives.[47] Upon the death of the account owner, the distributions would have to continue at least as rapidly as during lifetime. If the account owner had been redetermining life expectancy annually, his life expectancy at death, as discussed previously, would go to zero in the calendar year following the year of death. Consequently, distribution of the entire account balance would have to be made to the estate by December 31st of the calendar year following the year of the owner's death. If the estate has been named as beneficiary and the account owner dies before distributions have begun, the entire account balance would have to be distributed to the estate by December 31st of the fifth calendar year following the year of the owner's death. Since it may not be feasible to keep the estate open this long, the distribution may in fact have to be taken sooner. If an account owner has selected an individual as a designated beneficiary, and after distributions have begun changed the beneficiary to his estate, future distributions must be computed on his single life expectancy.[48] Consequently, naming an estate as beneficiary limits the ability to defer income tax on distributions by using joint lives. *If no one is named as beneficiary of a retirement plan or IRA, it is as if the plan owner's estate is named, unless the plan has a beneficiary default provision.*

In a special set of circumstances, the IRS has ruled that a surviving spouse, was the beneficiary of an estate that had been named as the beneficiary of a retire plan, could roll over the plan benefit into her own IRA although she was not directl designated beneficiary. In this situation, the spouse was the sole personal represent and residuary beneficiary of her husband's estate and had complete discretio distribute the benefits to herself or a trust she absolutely controlled.[49]

It is possible to possibly salvage the situation where an estate is ill-advis named as beneficiary by executing disclaimers so that the retirement account wind going to the surviving spouse, who can then roll over the plan into her own IR Executing multiple disclaimers, however, so that there is an intestacy, resulting i estate going to an individual, will not result in such individual being regarded designated beneficiary, since a person who becomes a beneficiary only by operati law does not qualify as a designated beneficiary.[51]

TRUST AS BENEFICIARY

By naming a young designated beneficiary, an account owner may feel that h minimized the income tax impact on his IRA account since distributions can be over a long life expectancy once he is gone. It is important, however, to recogniz the needs and desires of the beneficiary may be inconsistent with the account ow plans for maximum tax deferral. The rules discussed in this paper have to do minimum distributions. It should be understood, however, that nothing may prohib beneficiary from withdrawing more than the minimum, or even withdrawing the account. This possibility is frequently not considered. It should be of concern th especially with a youthful beneficiary or a beneficiary who is under a disability, su drug addiction, alcoholism, or mental illness. For a minor designated benefi distributions could be made into a Uniform Transfers to Minors Account, but this w mean distribution no later than age 21.

In order to assure that distributions are spread out over at least a certain peri until a mature age, and that the beneficiary does not waste the money, a trust arrange may be desirable. The trust could be kept going until the beneficiary reaches the de age, or even over a lifetime. Discretion could be given to the trustee as to whethe when to make distributions of the money flowing into the trust from the employee pl IRA.

Until recently, the rules for designating a trust as beneficiary of an empl retirement plan or IRA were quite restrictive and somewhat uncertain in applic However, recently proposed regulations in 1997 significantly liberalize the rule naming a trust as designated beneficiary, and appear to eliminate the prior uncertaint

Under the new rules a *revocable trust* can be named as the designated benef of the retirement account, provided the trust becomes irrevocable upon the death o account owner. The prior rule mandated an irrevocable trust. Consequently, it longer necessary, as some professionals thought, to establish an *inter vivos* irrevoc

trust before the account owner's death when it is desired to name a trust as the beneficiary of a retirement account. Either an *inter vivos* revocable trust, which becomes irrevocable on death, or a testamentary trust will now suffice.

The IRS also liberalized what has to be given to the retirement plan administrator. A copy of the trust document need no longer be given to the administrator, although voluntarily this can be done. In lieu of the trust document, the plan administrator may be provided with a list of the beneficiaries, including those that are contingent, with a description of that part of the trust showing to what they are entitled and any conditions imposed thereon. The account owner must certify that the information is correct and complete to the best of his knowledge, and that he will agree to provide the administrator with any relevant changes to the trust. Finally, the account owner must agree to provide a full copy of the trust to the administrator if requested. A final certification of the trust information must be provided to the administrator no later than the end of the ninth month following the death of the account owner, even if the administrator was given a complete copy of the trust by the account owner before death.

The prior requirement that the trust be valid under state law, or valid except for the lack of corpus, was retained. Also left unchanged was the requirement that the beneficiary or beneficiaries be identifiable from the trust instrument, or that if the beneficiaries are members of a class that may increase or decrease, it must be possible to identify the beneficiary with the shortest life expectancy.

If a trust meets the applicable requirements, distributions made to the trust will be treated as paid to the beneficiary of the trust. Thus, the trust only nominally will be the designated beneficiary since the life expectancy of the beneficiary of the trust will be used for purposes of determining the distribution period. If the trust has more than one beneficiary, the life expectancy of the trust beneficiary with the shortest life expectancy is used. If a trust designated as beneficiary does not meet the requirements of the proposed regulations, the account owner will be treated as having no designated beneficiary. Accordingly, distributions during lifetime will have to be based on a single life expectancy, and at death will have to continue at least as rapidly as before. If distributions have not yet begun, the entire account balance would have to be paid to the trust under the five-year rule discussed above.

Since the shortest life expectancy is used if there are multiple beneficiaries, it may pay to set up multiple trusts under the same rationale discussed above for setting up multiple IRA accounts. Of course, the sums involved should be large enough to warrant the cost of establishing and administering multiple trusts.

INCOME IN RESPECT OF A DECEDENT

It should be recognized that there is no step-up in basis to fair market value for retirement accounts at the death of the account owner. If this were permitted, then distributions, however taken, would not be taxable. Rather, distributions of untaxed retirement funds constitute *Income in Respect of a Decedent,* which is a type of income

that is taxable to whomever receives it. If paid into a trust or estate, fiduciary incom principles come into play, which are beyond the scope of this paper. If a person's e is large enough, pension accounts could also be subject to estate tax. The incom effect of this *double whammy* of taxation is ameliorated by making pension distribu over as long a period of time as possible. Also, lessening the impact of the double t a special tax law section which permits a deduction on the tax return of the p (including an estate or trust) required to pick up the retirement benefits in income fo allocable estate tax attributable to the inclusion of the retirements benefit in the estate.[53] The estate planning implications of retirement accounts is also a major co for many people. This must also be taken into account in planning, but again is be the scope of this paper.

CONCLUSION

Unfortunately, the rules regarding how distributions from an IRA or emp retirement plan are taxed are notoriously complicated. It is therefore no wonder tha is such a confusing area to laypersons. Planning for retirement plan distributions req a sophisticated knowledge of income taxation, estate taxation, trust law, and def compensation. Even many so-called *tax experts* are often befuddled by the myria complex rules. However, the rules exist and therefore anyone wishing to minimi tax impact of retirement distributions must seek out competent advice.

ENDNOTES

[1] *It's The Best Of Times – Or Is It?*, Business Week, January 12, 1998, at 36.

[2] *$1,000,000,000,000 Banks*, Business Week, April 27, 1998, at 32.

[3] *Id.*

[4] To avoid awkward references to "he or she," the owner of the retirement account w referred to as "he," or "his," or "him," and the spouse will be referred to as "she', or "hers," or "her." Although the account is being given to the husband, to equalize thi the wife will be the survivor.

[5] I.R.C. § 72(t)(1) and 72(t)(2)(v). The 10% penalty does not apply in the case of de or disability.
I.R.C. § 72(t)(2)(A)(ii), (iii). References herein to "I.R.C." are to the Internal Reve Code of 1986, as amended.

[6] I.R.C. § 72(t)(2)(A)(ii)-(iv).

[7] I.R.C. § 401(a)(14).

[8] I.R.C. § 401(a)(9)(C).

[9] *Id.*

[10] *Id.*; I.R.C. § 416(i).

[11] I.R.C. § 402(c).

[12] I.R.C. § 3405(c).

[13] I.R.C. § 402(c)(3).

[14] A partial rollover is permitted. I.R.C. § 402(c)(1). In other word, the employee does not have to roll over the entire distribution. To the extent not rolled over the distribution is subject to income tax, and possibly the 10% penalty tax.

[15] Except for direct transfers between IRA accounts, an individual is restricted to one tax-free rollover within the one-year period beginning with the date of the last distribution. I.R.C. § 408(d)(3)(b); Rev. Rul. 78-406, 1978-2 C.B. 157.

[16] I.R.C. § 72(t)(2)(A)(i). The 10% penalty does not apply in the case of death or disability. I.R.C. § 72(t)(2)(A)(ii), (iii). The waiver of the 10% penalty for employees separating from service after attainment of age 55 does not apply for distributions from IRA accounts. I.R.C. § 72(t)(3)(A).

[17] It may be noted that the minimum distribution requirements do not apply to the new Roth IRAs.
I.R.C. § 408A(c)(5). This would include amounts rolled over into a Roth from a regular IRA.

[18] I.R.C. § 4974(a). The excise tax is reported on Form 5329. The tax may be excused if due to reasonable error and steps are taken to correct the insufficient distribution.

[19] Life expectancy tables for Single Life and Joint Life and Survivor Expectancy may be found in
Treas. Reg. § 1.72-9 (as amended in 1986) and IRS Publication 590. More extensive life expectancy tables may be found in IRS Publication 939.

[20] I.R.C. § 401(a)(9)(D).

[21] I.R.C. § 401(a)(9)(E); Prop. Treas. Reg. § 1.401(a)(9)-1, D-2 (1987). All references herein to "Prop. Treas. Reg." are to Proposed Treasury Department Regulations interpreting the Internal Revenue Code of 1986, as amended. The proposed regulations noted herein will be applied by the IRS in issuing rulings and examining returns pending the issuance of final regulations. If final regulations are less favorable, they will not be

applied retroactively (Preamble to Proposed Regulations). References herein to "Tre Reg. " are to final Treasury Department Regulations.

[22] Prop. Treas. Reg. § 1.401(a)(9)-1, E-5 (1987).

[23] Prop. Treas. Reg. § 1.401(a)(9)-1, D-3 (1987).

[24] Prop. Treas. Reg. § 1.401(a)(9)-1, E-5 (1987).

[25] I.R.C. § 401(a)(9)(D); Prop. Treas. Reg § 1.401(a)(9)-1, E-7 (1987).

[26] Prop. Treas. Reg. § 1.401(a)(9)-1, E-7 (1987).

[27] *Id.*

[28] *Id.*

[29] Prop. Treas. Reg. § 1.401(a)(9)-1, E-8 (1987).

[30] If the account owner was not using joint lives, the account would have to be distr at least as rapidly as under the method of distribution being used as of the date of de I.R.C. § 401(a)(9)(B).

[31] Prop. Treas. Reg. § 401(a)(9)-1, C-3 (1987).

[32] I.R.C. § 401(a)(9)(B)(iv)(I).

[33] Prop. Treas. Reg. § 1.401(a)(9)-1, C-4 (1987).

[34] I.R.C. § 72(t)(2)(A)(ii).

[35] I.R.C. § 401(a)(9)(B)(iv)(II).

[36] I.R.C. § 401(a)(9)(B)(ii); Prop. Treas. Reg. § 1.401(a)(9)-1, C-1(1987).

[37] Prop. Treas. Reg. § 1.401(a)(9)-1, C-4 (1987).

[38] I.R.C. § 402(c)(9); Prop. Treas. Reg.. § 1.408-8, A-4 (1987).

[39] Priv. Ltr. Rul. 9704019 (1997).

[40] I.R.C. § 401(a)(9)(B); Prop. Treas. Reg. § 1.401(a)(9)-1, B-4 (1987).

[41] Prop. Treas. Reg. § 1.401(a)(9)-1, E-8.

[42] Priv. Ltr. Rul. 9704019 (1997).

[43] I.R.C. § 401(a)(9)(B).

[44] I.R.C. § 402(e)(4)(B); Treas. Reg. § 1.402(a)(1)(b) (as amended in 1991).

[45] I.R.C. § 408(d); Treas. Reg. § 1.408-4 (1980).

[46] Prop. Treas. Reg. § 1.401(a)(9)-1, D-2A (1987).

[47] Prop. Treas. Reg. § 1.401(a)(9)-1, E-5 (1987).

[48] Priv. Ltr. Rul. 9548031 (1995).

[49] Priv. Ltr. Rul. 9604027 (1996).

[50] *See, e.g.*, Priv. Ltr. Ruls. 9247026 (1992), 9540041 (1995) and 9615043 (1996).

[51] Prop. Treas. Reg. § 1.401(a)(9)-1, D-2 (1987).

[52] Prop. Treas. Reg. § 1.401(a)(9)-1, Q&As D-5 and D-6, and new Q&A D-7 (December 30, 1997).

[53] I.R.C. § 691(c).

STUDENTS' VIEWS OF THE ETHICAL IMPLICATIONS OF THE LAWS OF CONTRACT DAMAGES

by

Arthur M. Magaldi*

One approach in determining whether a law is effective is to determine whether the law achieves the ends set forth by the proponents of the law at the time of its passage. Where there are no specifically stated objectives for its passage, e.g., when the law has been in effect for a long time, ascertaining whether the law accomplishes the goals generally associated with it will similarly reflect on its effectiveness. A related and equally important consideration is whether the law in question moves people in the direction of ethical or unethical conduct.

In the area of contract damages, it is generally accepted that the goal of the law is to compensate the victorious plaintiff for the loss caused by the breach. It is commonly stated that contract damages should put the plaintiff in the same financial position the plaintiff would have been in had the contract been properly performed. A study of contract damages by the writer has led to the conclusion that the law of contract damages is seriously flawed and frequently fails to properly compensate victorious plaintiffs. In addition and perhaps more importantly, the writer has concluded that in failing to properly compensate for contract breaches. The law encourages parties to contracts to make conscious unethical decisions to breach contracts protected by the knowledge that they will not later be called upon to fully compensate for those breaches. The law thus encourages unethical conduct rather than ethical conduct.

Concerns about the failings in the laws of contract damages centered on the failure of the law to compensate for reasonable attorneys' fees when the defendant did not make a good faith attempt to perform the contract, and the failure to compensate for the mental distress or stress caused by the breach when the defendant did not make a good faith effort to perform the contract and the mental distress or stress was reasonably foreseeable by the defendant. With co-author Ivan Fox. "Contract Damages: A Proposal for Reform"[1] set forth below:

1. In cases where a breach of contract has been clearly established and the trier of facts determines that the defendant did not make a reasonable, good faith attempt to perform the contract, the trier of the facts may award a reasonable amount of damages for attorneys' fees.

2. In cases where a breach of contract has been clearly established and the trier of the facts determines that the defendant had reasonable grounds to foresee that the breach would cause substantial mental distress and that the defendant did not make a reasonable, good faith attempt to perform the contract, the trier of the facts may award a reasonable amount of damages for mental distress.

3. In the cases where damages are awarded for attorneys' fees and/or mental distress, where the trier of the facts is the jury, the jury shall state the amount so awarded. If the trial judge deems the amount(s) awarded to be excessive, the trial judge shall have the right to reduce any amounts so awarded to a reasonable amount.

It is important for students to consider the effectiveness of specific laws and to determine the extent to which laws accomplish their stated or traditional aims. Students also need to understand the ethical implications of our laws. With such understanding, students may form ethical guidelines for use in their affairs and also offer input in setting the policies of the future. Knowing and understanding the views of students is critically important as part of the necessary exchange and sharing of knowledge which is fundamental to true education. To help students evaluate the effectiveness of the laws of contract damages and to consider the ethical implications of such laws, the survey, which is the subject of this paper, was created. The purpose of this paper is to set forth the positions of the students on the effectiveness and the ethical implications of the laws of contract damages.

The survey consists of nine statements concerning the laws of contract damages and the ethical implications of those laws. The students are asked to register one of five responses to each statement. The responses range from strong agreement to strong disagreement. The opportunity to indicate that the student has no opinion on the matter is also presented. See Appendix A for a copy of the survey. Three hundred fifty students in business law/legal environment classes were surveyed. All of the students had exposure to the laws in question through their studies and as a captive audience provided a 100% response ratio. In a very few cases, students did not register a response to a particular question. Each statement and comments on the observations of the students are set forth below. No attempt at detailed statistical analysis is attempted. Rather, this paper attempts to convey the sense of the views of the students.

Survey and Findings

1. <u>It is ethical to complete those contracts entered into in a fair and free manner</u>.

There was over whelming support for this position with only one student registering strong disagreement and five students registering disagreement. It

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seems safe to conclude that the surveyed students strongly believe that the ethical course is to perform a contract freely entered into.

2. Where one has breached a contract, the ethical course of action is to compensate the victim of the breach for the actual loss caused by the breach.

   There was even greater support for the idea that the victim of a breach should be compensated for the actual loss. Four students registered disagreement and 14 expressed no opinion out of the 344 registered responses, while 173 express a strong agreement and 153 expressed agreement. Clearly the subjects of the survey believe that victims of breaches of contract should be fully compensated.

3. When it is established in a lawsuit for breach of contract that the defendant did not make a good faith effort to perform the contract, the plaintiff should be entitled to a reasonable award for attorneys' fees.

   Only 30 students registered disagreement with this position and 264 supported awards for attorneys' fees. This, of course, runs contrary to the law in its present state which unrealistically perceives each person to be capable as acting as his/her own attorney.

4. Since the law in its present state generally does not allow an award of damages for attorneys' fees in breach of contract cases even if the defendant did not make a good faith effort to perform the contract, the law does not properly compensate plaintiffs.

   One hundred eighty-six students agreed with this position and 54 disagreed (5 strongly). Therefore, more than 3 out of 4 students indicated support for the idea that failure to compensate for reasonable attorneys' fees results in the victorious plaintiff not receiving complete redress for the breach. Although not as strong as the response to question #3, this finding follows logically from that basis.

5. Since the law in its present state generally does not allow an award of damages for attorneys' fees in breach of contract cases even if the defendant did not make a good faith effort to perform the contract, the law does not encourage ethical conduct.

   Sixty-one and six tenths percent of the respondents expressing an opinion supported this proposition (154 in agreement versus 96 in disagreement). This would seem to be an expression of a serious reservation about the ethical thrust of the law. Ninety-six of those surveyed were apparently unsure and expressed no opinion on the matter.

6. When it is established in a lawsuit for breach of contract both that the defendant did not make a good faith effort to perform the contract and that the defendant should have reasonably foreseen that the breach would cause emotional distress, the plaintiff should be entitled to a reasonable award for the emotional distress caused by the breach of contract.

   Agreement with this position was extremely strong with 214 respondents expressing support (52 strongly) and 73 expressing disagreement (17 strongly). By a margin of slightly less than 3-to-1, student respondents indicated their support for damages for emotional distress in circumstances set forth in the proposition. This differs dramatically from the present law, which does not allow for such damages.

7. Since the law in its present state generally does not allow an award of damages for mental distress in breach of contract cases even if the defendant did not make a good faith effort to perform the contract and the mental distress was foreseeable, the law does not properly compensate plaintiffs.

   This proposition would seem to follow logically from statement #6 and it received strong support, but not to the same extent as the previous statement. One hundred fifty-six respondents supported this principle and 90 disagreed. So, by slightly more than a 5-to-3 ration, students registered their belief that the law does not properly compensate plaintiffs in situations where emotional distress is foreseeable and caused by a breach in a situations where the defendant did not truly make an effort to perform the contract. It should be noted that a relatively high number (103) expressed no opinion on this matter.

8. Since the law in its present state generally does not allow an award of damages for mental distress in breach of contract cases even if the defendant did not make a good faith effort to perform the contract and the mental distress was foreseeable, the law does not encourage ethical conduct.

   Support was substantial for this position, but not as strong as the support for propositions #6 and #7 to which it is related. On hundred thirty-eight respondents supported this idea while 121 opposed. Again, a high number of respondents were apparently undecided, as 95 expressed no opinion.

9. In a lawsuit for breach of contract when damages are awarded for attorneys' fees and/or mental distress, the jury should state the amount awarded. If the trial judge deems the amount(s) awarded for attorneys' fees an/or mental distress to be excessive, the trial judge should have the right to reduce the amount(s) to a reasonable amount.

   Possibly as a safeguard against abuse, respondents overwhelmingly advocated this position with 247 expressing agreement (91 strongly) and a mere 48 expressing disagreement (15 strongly). By more than 5-to-1, the students support this safeguard on the system they envision.

Conclusions

The laws establishing contract damages originated centuries ago. Significant principles of the damage laws remain in effect relatively unchanged.

In earlier, simpler times, perhaps it was feasible an/or advisable to represent oneself in litigation. Today, with the acknowledged complexity of business matters and of life itself, most people would be neither competent nor confident representing themselves. Most would turn to attorneys for legal representation. The responses of the students seem to recognize this fact by strongly advocating that a victorious plaintiff should be entitled to a reasonable sum for attorneys' fees. It should be noted that the responses indicate very strong support for the proposition that the ethical course to take when a contract is breached is to compensate the party aggrieved by the breach. The students' responses recognize that the failure to provide for reasonable attorneys' fees often leaves the innocent victim of the breach without true compensation. Therefor, the conclusion is reached that the law in its present state dies not encourage ethical conduct, i.e., and true compensation for the loss caused by the breach.

Two additional matters are worth noting. First, the survey elicited the students' views on a situation where the defendant did not make a good faith effort to perform the contract. Second, people who have studied these matters are aware that unscrupulous parties will often use the present law's prohibition of awards for attorneys' fees in contract cases as a weapon. In short, they elect the unethical choice of breaching the contract and defying the other party to sue knowing that the cost of paying one's attorney frequently makes the institution of the lawsuit impractical.

Stress and mental distress were certainly present throughout history, but it seems to be generally accepted that modern life contains a high amount of stress. The role of mental distress and stress in many mental and physical illnesses is well documented.

It is well established that the failure to receive that which one has contracted for in good faith often causes mental distress. In situations where it is established that the defendant did not make a good faith effort to perform the contract and the defendant should reasonably have foreseen that the breach would cause mental distress, the students indicate that the ethical thing to do is to compensate the victim of the breach in damages for this loss. The students would seem to be in agreement with the following position.

> Since there is no recovery for attorneys' fees and damages due to stress and mental disturbance caused by the breach, the law does not properly compensate those aggrieved by the breach. In failing to do so, the law encourages the unethical choice of contract breach over contract performed. As the law now stands, a party who does not wish to do what is contractually called for, e.g., pay what is due, may refuse to do so and put the other side in a position where it must incur the cost of an attorney to pursue its rights. Upon a successful conclusion of the case, the plaintiff must still absorb the expense of paying the attorney. At worst, the breach g party has simply postponed doing what was required of it. At best, if the aggrieved party does not persevere through lawsuit, the breaching party may completely avoid the responsibility for the breach. In any event, the breaching party is not called to account for whatever mental distress or stress the breach has caused in spite of the fact that it may have been clear that such distress or stress was a probable consequence.[2]

The responses of the students seem to reflect thoughtful consideration of the issues raised by the questionnaire and a high degree of ethical integrity. The students strongly supported as ethical the fulfillment of one's contracts and in the event of failure to do so, compensation for the aggrieved party. Their strong support for the inclusion of reasonable attorneys' fees where the breaching party did not make a good faith effort to perform the contract would seem to be an attempt to truly put the victorious plaintiff in the position the plaintiff would have occupied had the contract been properly carried out. More difficult to quantify would be an award from mental distress of stress reasonably foreseen by the breaching party and caused by a defendant who failed to make a good faith effort to perform. Accordingly, although the students supported such awards, their support was not nearly as strong as their support for the attorney' fees.

Inasmuch as the students expressed that it was ethical to compensate for breaches of contract and that it was appropriate to include in such compensation sums for reasonable attorneys' fees and mental distress, their support for the proposition that the law in its present form was not encouraging ethical action followed logically. Further, they overwhelmingly supported the proposition that the trial judge should have the right to reduce to a reasonable sum any excessive amount awarded for attorneys' fees or mental distress.

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[1] Arthur M. Magaldi & Ivan Fox, *Contract Damages: A Proposal for Reform*, J. of L. & Com., Spring 1997, at 6.

[2] *Id.* At 8.

AN OVERVIEW OF THE COMPOSITION, STRUCTURE AND LAWS OF THE EUROPEAN UNION

by

Winston Spencer Waters*

INTRODUCTION

The European Union is one of the most important and closely watched international regional organizations in the World today. This organization has a gross community product that exceeds that of the United Sates and Canada combined.[1] It has produced an economic integration involving some 367.7 million people in the fifteen European nations that produced a combined gross national product (GNP) of $6,593.5 Billion in 1993.[2] The European Union is by far the United States' largest commercial partner, providing a market of more than $1 trillion in exports and services for American companies. Furthermore, according to the U.S. Department of Commerce, is four times as large a market for U.S. exports as either Canada or Japan.[3]

This paper conducts a brief examination of the history of the European Union. It also reviews the membership of the European Union. It examines the internal organization and structure of the European Union. Finally, a review of some of the laws of the European Union are compared with similar laws from the United Sates.

HISTORICAL PERSPECTIVE

The European Union arose from the ashes of World War II.[4] Its goal was then as it is now to ensure peace, prosperity, and a new start for a continent whose political and economic foundations had effectively disintegrated.[5] World War II left in its wake economic as well as human destruction throughout Europe.[6] To help rebuild Europe, the U.S. Congress passed the Marshall Plan, a $13 billion aid package.[7] A sixteen country Organization for European Economic Cooperation (also referred to herein as "OEEC") was established to facilitate utilization of the aid as well as to improve currency stability, combine economic strengths, and improve trade relations.[8] However, the OEEC did not appear strong enough to provide the necessary economic growth.[9] Thus, further efforts at cooperation were initiated.[10]

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Since the 1950's, European nations had been working toward a real common market by eliminating the financial, technical, and physical barriers that traditionally restrained trade between those nations.[11] The nations had a common philosophy, whereby a common market should be developed to : eliminate all restrictions to the free flow of goods, capital, and person, and allow for the harmonization of economic policies, and create a common external tariff.[12]

The precursor of today's European Union was effectively the European Coal and Steel Community ("ECSC"), which came into force in 1952.[13] Unlike other organization, its six founder members-Belgium, the Federal Republic of Germany, France, Italy, Luxembourg and the Netherlands-quite consciously sought to sow the seeds of greater European integration and lasting peace by pooling all their coal and steel production under this single organization.[14]

Three interrelated treaties constitute the EU: The European Coal and Steel Community (ECSC) Treaty, signed in Paris in 1951, the European Economic Community (EEC) Treaty(which has since been renamed the European Community (EC) Treaty[15], signed in Rome in 1957, and the European Atomic Energy Community (EAEC or Euratom) Treaty, also signed in Rome in 1957.[16] The European Economic Community (EEC) was established via the Treaty of Rome. These three treaties form the basis for the institutions that have become an integrated system of regional international organization known today as the European Union.[17]

Since their adoption, the original treaties have been amended several times. In 1965, the members ratified a treaty establishing common institutions for all three communities. Under the Merger Treaty signed in 1965, however, the three entities agreed to have common institutions, and the three entities agreed to have common institutions, and reference was typically made thereafter to the European Community, or EC.[18] By 1968, most tariffs within the EC had been eliminated. In 1986, the EC countries ratified the Single European Act, which furthered the objective of attaining a unified European market[19] creating as of December 31, 1992, a single internal market without frontiers.

The Maastricht Treaty (more formerly known as the Treaty on European Union), signed in 1991 and adopted in 1993,[20] sets as its goals the establishment of a monetary union, and the adoption of a Social Charter.[21] The European Community (EC) became the European Union (EU) when the Treaty on European Union, otherwise known as the Maastricht Treaty, came into force in November, 1993.[22] The Treaty also added to the Common Market (now called the internal market) the ambitious goals of the Economic Monetary Union (the EMU) and political union of the member states.[23] By 1995, the EC, which is now known, as the European Union had become a single integrated European trading unit, made up of fifteen European nations.[24]

There are three stages to the Common Market. First, there is the internal market where resources move freely across member nations. (for Example, one can get a job in any 15 nations, can go to a bank in any of the 15 nations, etc.) This became effective on January 1, 1993. The second stage is for the monetary union to go into effect, January 1, 1999. There will be a common currency, a central bank and common monetary policy. Of the 125, three sates have dropped out of this part despite meeting the criteria, the United Kingdome, Sweden, and Denmark. Greece was unable to meet the criteria for the second stage and consequently withdrew from the first round. However, Greece has started preparing to join the second stage in round two by devaluing its currency. The Monetary Union will establish a Comm Central Bank-The Eurofed in Frankfort, Germany. Stage three is set to take effect on January 1, 2020. It will establish a common defense policy, a common foreign policy and all countries will give up their national identity and national sovereignty.

MEMBERSHIP TO THE EUROPEAN UNION

In 1957, the European Atomic Energy community (Euratom) was established. In 1957, three years after the France National Assembly had rejected a European Defense Community, Belgium, France, West Germany, Italy, the Netherlands and Luxembourg decided to create an economic community, built around the free movement of workers, goods, and services,[25] and in the same year, the Treaty of Rome outlined three goals: (1) to preserve European peace; (2) to establish a European common market-that is, a market in which goods, capital, and labor could move freely from one country to another; and (3) to form a politically unified Europe.[26]

The success of the six led Denmark, Ireland and the United Kingdom to apply for Community membership.[27] They were finally admitted in 1973 following difficult negotiations during which France, under General de Gaulle, used its veto twice, once in 1961 and again in 1967.[28] This first enlargement, which increased the number of Member States from six to nine in 1973, was matched by further deepening, the Community being given social responsibility for social, regional and environmental matters.[29] Greece became a member in 1981. Spain and Portugal became members in 1986. Austria, Finland and Sweden joined the EU in 1995. Some believe that the result will eventually be a "United Sates of Europe."[30]

The EU scrutinizes countries applying for membership in a very intricate and detailed manner. A detailed investigation and analysis is made of a country's economic, social, political and human rights policies.

INTERNAL ORGANIZATION OF THE EUROPEAN UNION

A. Council of the European Union

The Council of the European Union is the main decision making institution.[31] It is also known as the Council of Ministers.[32] It is composed of a variety of different

ministers from the member countries.[33] For example, when issues concerning fishing are to be discussed, the "Ministers of Fishing: from the different EU States come together.[34]

The Council of the European Union is the main decision making institution.[35] The Council has the final say in legislative matters in cooperation with Parliament.[36] It is responsible for the policy area under discussion at a given meeting: foreign affairs, agriculture, industry, transport, the environment, etc.[37] It legislates for the European Union, set its political objectives, coordinates their national policies and resolve differences between themselves and with other institutions.[38] Some matters require unanimity while others require only a majority vote.[39] It is the EU's legislature, as it were; although in certain areas specified by the Single Act and the Maastricht Treaty it shares this function with the European Parliament.[40]

Essentially, the Council of Ministers is the dominant institution at present, with authority to override the Parliament and direct the Commission.[41] It is responsible for taking major decisions on the basis of Commission proposals.[42]

The Council and parliament also have joint control over the Union's budget.[43] The Council adopts international agreements negotiated by the Commission.[44] The Council is responsible for coordinating the general economic policies of the Member States.[45] It decides some matters by qualified majority voting, and others by unanimity.[46] The Presidency of the Council rotates between the Member States every six months: January until June, July until December. It must arrange and preside over all meetings; elaborate acceptable compromises and fund pragmatic solutions to problems submitted to the Council; seek to secure consistency and continuity in decision making.[47]

B. European Commission

A single Commission for all three Communities (the ECSC, the EEC and Euratom) was created when the Treaty merging the executives entered into force on July1, 1967.[48] The role and responsibilities of the European Commission place it firmly at the center of the European Union's policy-making process.[49] In some respects, it acts as the heart of Europe, from which the other institutions derive much of their energy and purpose.[50]

The Commission's major responsibilities are divided into three categories: initiating proposals for legislation, watching over the Union's treaties, and managing and executing Union policies and international trade relationships.[51] A Commission recommendation does not bind member states or their citizens.[52]

The Commission of the European Union proposes and later implements European legislation in line with the treaties.[53]

The Commission enjoys a great deal of independence in performing its duties.[54] It represents the Community interest and takes no instructions from individual Member States.[55] The members of the Commission must operate independently of their national

governments and act only in the interests of the EU.[56] As guardians of the Treaties it ensures that regulations and directives adopted by the Council are properly implemented.[57] It can bring a case before the Court of Justice to ensure that Community law is enforced.[58] The Commission has sole right of initiative and can intervene at any state in the legislative process to facilitate agreement within the Council or between the Council and Parliament.[59] It also has an executive function in that it implements decisions taken by the Council under the common agricultural policy, for instance.[60]

The Council and the European Parliament need a proposal from the Commission before they can pass legislation and EU laws are mainly upheld by the Commission action.[61] Thus the integrity of the single market is preserved by the Commission policing with agricultural and regional development policies which are sustained, managed and developed by the Commission, as is development cooperation with the countries of Central and Eastern Europe, Africa, the Caribbean and Pacific.[62] Research and technological development programs, vital for the future of the Europe, are also orchestrated by the Commission.[63]

The Commission is backed by a civil service, mainly located in Brussels and Luxembourg. It comprises 26 departments, called Directorates-General, each responsible for implementation of common policies and general administration in a specific area. The work of the Commission is carried out by the different Directorate-General offices.[64] There are twenty-four different Directorate-General offices; each headed by a Director-General, and each with a different mission.[65] Examples of a few of the Directorate-General's are External Relations (DG I), Competition (DG IV), and Customs and Indirect Taxation (DGXI).[66] More specifically, DG I is responsible for international trade policy such; as the EU's trade policy with respect to the WTO, (World Trade Organization), external political and economic relations with other regional trade groups such as NAFTA and APEC, and external relations in the area of nuclear energy.[67]

The Commission is composed of twenty men and women who provide the political leadership and direction of the EU.[68] The number of Commissioners was increased to 20 on January 5, 1995 (two each from France, Germany, Italy, Spain and the United Kingdom).[69] The other members of the Commission are nominated by the 15 member governments in consultation with the incoming President.[70] The terms of office is five years and their appointment has to be approved by Parliament.[71] The President is chosen by the Heads of State or Government meeting I the European Council after consulting the European Parliament.[72]

C. The European Parliament

The Parliament has become significantly stronger since its inception.[73] Its members are directly elected by the people of the EU, and its responsibilities have been widened through the Single European Act and Treaty of the European Union of 1993.[74] Members are elected by political parties in their own countries through direct popular elections.[75]

The three major responsibilities of the Parliament are legislative power, power over the budget, and supervision of executive decisions.[76] Community legislation is presented to parliament by the Commission, and Parliament must approve the legislation before it can be submitted to the Council for adoption.[77] Parliament may approve legislation, amend it, or reject it outright.[78] The Parliament also approves the EU's budget each year and monitors spending.[79]

The parliament now has what is called a "c-decision" procedure that amounts to a legislative veto in the significant areas of the EU single market, education, culture, health, consumer protection, environmental protection, transportation, and research affairs. Thus, the Parliament now has consultative, cooperative, and co-decisional roles in the legislative process of the European Union.[80]

D. The Court of Justice of the European Communities

The Court of Justice ensures consistent interpretation and application of EU treaties.[81] Cases may be brought to the Court by member states, community institutions, or individuals and companies.[82] The Court of Justice is an appeals Court for individuals, firms and organizations fined by the Commission for infringing Treaty Law.[83]

National Courts are required to take Commission recommendations into account when deciding disputes submitted to them.[84]

The Court of Justice of the EU consists of fifteen judges, one from each Member State of the Union, appointed for six-year terms.[85] This court has supranational authority to interpret the trade obligations contained in the treaties and regulations of the three segments of the European Union: the EEC, ECSC, and EURATOM.[86]

In 1989, the Court of First Instance was created to relieve the Court of Justice of some of its caseload. The Court of First Instance has fifteen judges who usually sit in panels of five.[87] The court's jurisdiction is limited to direct actions or proceedings by individuals or legal persons except those regarding antidumping complaints.[88] There is a right of appeal from the Court of First Instance to the Court of Justice.[89] The rulings of the Court of Justice set legal precedents that become part of the legal framework of each Member State.[90]

THE LAW

A. Historical Perspective

Most legal systems throughout the world are either Civil law or common law. Table 1 outlines the various nations that adhere to either Civil law or Common law legal systems.

Table 1. LEGAL SYSTEMS OF THE WORLD

Civil Law	**Common Law**
Argentina	Australia
Austria	Bangladesh
Brazil	Canada
Chile	Ghana
Czechoslovakia	India
Egypt	Ireland
Finland	Israel
France	Jamaica
Germany	Kenya
Greece	Malaysia
Hungary	New Zealand
Indonesia	Nigeria
Iran	Singapore
Italy	United Kingdom
Japan	United States
Mexico	Zambia
Poland	
South Korea	
Sweden	
Switzerland	
The Netherlands	
Tunisia	
Turkey	
Venezuela	
Yugoslavia	

Most of nations in the European Union have Civil law legal systems. Table 2 outlines those nations in the EU which follow Civil law versus Common Law systems.

Table 2. THE LEGAL SYSTEMS OF THE EUROPEAN UNION

Civil Law	Common Law
Austria Finland France Germany Greece Italy Portugal Sweden Spain The Netherlands	United Kingdom

The United States legal system is a common law system. It relies heavily on the judiciary as a source of law and on the adversary system for settling disputes.[91] The Courts independently develop the rules governing certain areas of law, such as torts and contracts.[92] These common law rules apply to all areas not covered by statutory law.[93] Although the common law doctrine of stare decisis obligates judges to follow precedential decisions in their jurisdictions, courts may modify or even overturn

precedents when deemed necessary.[94] Additionally, if there is no case law to guide the court, the court may create a new rule of law.[95] In an adversary system, the parties, not the court, must initiate and conduct litigation.[96] This approach is based on the belief that the truth is more likely to emerge from the investigation and presentation of evidence by two opposing parties, both motivated by self-interest, than from judicial investigation motivated only by official duty.[97] In addition to the United Sates and England, the common law system is used in other English-speaking countries, including Canada and Australia.[98]

In distinct contrast to the common law system are civil law systems, which are based on Roman law.[99] Civil law systems depend on comprehensive legislative enactments (called codes) and an inquisitorial system of determining disputes.[100] In the inquisitorial system, the judiciary initiates litigation, investigates pertinent facts, and conducts the presentation of evidence.[101]

The civil law system prevails in most of Europe Scotland, the state of Louisiana, the province of Quebec Latin America, and parts of Africa and Asia.[102] In civil law systems, the only official source of law is a statutory code.[103] Courts are required to interpret the code and apply the rules to individual cases, but courts may not depart from the code ad develop their own laws.[104]

The oldest and most influential of the legal families is the Romano-Germanic legal system, commonly called the civil law.

Historically, the civil law dates to 450 B.C., the traditional date when Tome adopt its Twelve Tables.[105] The most significant historical event in the development of the civil law, however, was the compilation and codification (i.e., the selection, arrangement, and simplification) of all Roman law done under the direction of Byzantine Emperor Justinian (A.D. 483-565).[106] This Code, known as the Corpus Juris Civilis, was compiled between A.D. 528 and 534.[107] It was important because it preserved the ancient legal system in written form.[108] The Roman law was displaced to some extent by the rules of Germanic tribes when they overran the Western Empire.[109] Germanic tribal law, however, recognized the principle of personal (as opposed to territorial) law, so the former Roman subjects and their descendants were allowed to follow the Roman law.[110]

Two national codes have had such widespread and lasting influence that they are now regarded as the very bases of the German Civil Code of 1896[111]

In comparative law, the legal systems of the Nordic or Scandinavian countries (Denmark, Sweden, Norway, Finland and type of legal system, distinct from the common law ad the civil law.[112] Table 3 outlines those countries in the EU that fall within this category. For historical and political reasons, they share a great many rules and principles, and they have a common style of legal reasoning.[113] They were not influenced by Roman law or the common law of England.[114]

Interestingly, however, Belgium and Portugal are known to be nations which follow the French Code.[115]

Table 3. LEGAL SYSTEMS OF NORDIC/SCANDINAVIAN NATIONS

NORDIC/SCANDINAVIAN LAW
Denmark, Iceland, Portugal, Belgium, Luxembourg

The EU has gone far toward creating a new body of law to govern all of the member nations, although some of the EU's efforts to create uniform laws have been confounded by national ism.[116] All member states in the European Union encountered constitutional nightmares regarding the compatibility of the Maastricht Treaty with their national constitutions.[117] In Germany, for instance, there was great concern about democracy, especially whether democracy would be practiced by the European Union.[118] In Great Britain, the predominant concern was the effect of the Treaty on parliamentary sovereignty. In Denmark, where the Maastreicht Treaty was first voted upon, the concern was about the rights of the citizens.[119]

Additionally, in France, because of its constitutional traditions, because of what the French people have been fighting for since the French Revolution in 1789, the concern was national sovereignty.[120] In France for example, the Constitutional Council found that there were three provisions in the Maastricht Treaty that were unconstitutional: The first was the provision relating to the monetary union because it was a transfer of monetary sovereignty.[121] The second was the provisions enabling non-French citizens to participate in local European elections.[122] In France, there is not yet dual citizenship as it exists in the United States. Community citizenship exists under community law.[123] This means that community citizens may vote in the European and local elections, but not in the national elections.[124] For example, a German citizen living in France may exercise voting privileges as a community citizen.[125] As a community citizen, this German citizen may vote for the European Parliament, and may also vote for the district; however, this German citizen may not vote for the French national constitutional body.[126] The Constitutional Council found this provision unconstitutional.

A. Comparative Law Discussion

Because the European Community is a federal supra-government of limited powers, its lawmaking must be justified with reference to foundational principles.[127] No general power enables the Community to carry out tasks that lie outside the objectives stated in the founding treaties.[128]

1. Product Liability

Strict product liability is designed to promote both safety and fairness.[129] In fact, the original purpose for adopting strict product liability was to relieve the injured consumer from the enormous burdens of proving either negligence or the overly technical

requirements of warranty.[130] The primary rationale behind this doctrine is that, since the manufacturer profits from product sales, he or she should pay for any damage caused by that product.[131] The threshold issue in American product liability litigation is whether the product was defective at the time it left the manufacturer's control.[132] Traditionally, courts and scholars define "defect" in three functional categories: manufacturing defects, design defects and marketing defects.[133]

A manufacturing defect is an abnormality of a condition that was unintended, and makes the product more dangerous than it would have been as intended.[134] A design defect occurs when the product is manufactured according to the intended design, but the design poses unintended, unreasonable dangers.[135] A marketing defect is usually described in terms of failure to warn: a manufacture or other seller is subject to liability for failing to warn or adequately warn about a risk or hazard inherent in the way a product is designed.[136] If the manufacturer pays for the damages caused by his or her product, he or she can pass the costs on to the consuming public through higher prices.[137] The original purpose for adopting strict product liability was to relieve the injured consumer from the enormous burdens of proving either negligence or the overly technical requirements of warranty.[138]

In Sperry-New Holland v. Prestage,[139] the Supreme Court of Mississippi compared the two tests as follows: [I]n a "consumer expectations" analysis, for a plaintiff to recover, the defect in a product which causes his injuries must not be one which the plaintiff, as an ordinary consumer, would know to be unreasonably dangerous to him. In other words, if the plaintiff, applying the knowledge an ordinary consumer, sees a danger and can appreciate that danger, then he cannot recover for any injury resulting from that appreciated danger. . . In a "risk-utility analysis, a product is "unreasonably dangerous" if a reasonable person would conclude that the danger-in-fact, whether foreseeable or not, outweighs the utility of the product"

American product liability doctrine employs two major tests to determine whether a "defect" exists: the seller-oriented risk utility test and the buyer-oriented consumer expectations test.[140] The draft of the Restatement Third of Torts: Products Liability, like some American jurisdictions, rejects the "consumer expectations" test as an independent standard in defective warning and design cases.[141] Ironically, this limitation of the use of the consumer expectations test in American products liability doctrine coincides with the European Community's adoption of the consumer-oriented test for European strict products liability cases.[142] Ironically, as the EU is moving forward towards implementation of strict liability for defective products, American product liability law is reevaluating its legal and social significance[143]

On July 25, 1985, the EU adopted a uniform product liability directive.[144] In part, the European Directive resulted from the demand for product safety following the thalidomide tragedy in Europe during the 1960's[145] An additional reason for its implementation was the need to harmonize the differing national rules for product liability for economic reasons.[146] A single strict liability regime would place all twelve Member States on an equal footing, eliminating the risk that consumers would receive

differing amounts of protection or that producers in Member States having stricter regimes would be financially disadvantaged.[147]

Before the European Directive, the products liability laws of the individual Member States varied greatly[148] Greece, Italy, Portugal and Spain maintained traditional negligence systems with the plaintiff retaining the traditional proof.[149] Denmark, Germany, the Netherlands, Ireland and the United Kingdom had a presumption of liability shifting the burden of proof to the defendant, which resembled strict liability. Belgium, Greece and Luxembourg had absolute strict liability regimes.[150]

Basically, the consumer expectations test asks whether the product's safety conforms to what a reasonable consumer expects.[151] If the product does not so conform, it is defective.[152]

The American debate is centered on whether our law has gone too far to protect consumers and the European debate is centered on greater consumer protection and not going far enough. In my opinion, the EU has modeled the American Product Liability laws and will intelligently continue to enhance greater consumer protection.

The European Directive seeks to promote integration of Member State markets by providing a uniform standard of product liability safety: strict liability. Although the European Directive mandates that strict liability form the basis for producer (manufacturer) liability; it is unlikely that this will result in the development of products liability law similar to the American experience. Most EU Member States are civil law countries, without a strong tradition of case law creating substantial legal change. However, it is clear that the EU is moving in the direction of legitimate product liability goals by its directive.

The following chart illustrates both the similarities and differences between American law and European Union law.

American Law	**European Union Law**
Product liability law is rooted in the law of contracts. A contract of sale was a pre-requisite to a successful claim to recover for injuries sustained as a result of a defective product. As products liability law developed, the courts applied a negligence theory in order to permit a recovery, without privity of contract to those who were injured. See, McPherson v. Buick Motor Co., 217 N.Y. 382 (1916). The Courts have consistently recognized that a party injured by a defective product may have several causes of actions or	Article 6 The defect must exist at the time the product was placed onto commerce by the producer. In addition, a product may be defective in its "presentations," which includes packaging, labeling and directions for use. Therefore, the failure to warn of potential dangers will be actionable. A product is defective when it does not provide the safety which a person is entitled to expect, taking all circumstances into account, including:

theories of liability upon which recovery could be obtained: (1) warranty or contract-expressed or implied, (2) negligence and/or (3) strict products liability. RESTATEMENT (SECOND) OF TORTS @ 402A comment I (1964) provides that "the article sold must be dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics."	(a) the presentation of the product; (b) the use to which it could reasonably be expected that the product would be put; and (c) the time when the product was put into circulation. 2. A product shall not be considered defective for the sole reason that a better product is subsequently put into circulation.
Defect – the basis of the consumer expectation test by stating that a product is defective if it is "dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics. @402A comment I to the Restatement (Second) of Torts	Article6 (1)'s definition is the same.
State of the Art Defense Available	Article 7 (e) "State of the Art" generally refers to scientific knowledge at a particular time.

B. Bankruptcy

The Convention on Insolvency Proceedings of the European Union (EU) has developed from a history of false starts since 1960.[153] Both a long debated and never accepted proposal by the Commission of the European Economic Community (EEC) and a Council of Europe convention failed to establish a minimum standard f cooperation in insolvency matters for Europe – the former because it was too ambitious and the latter because it was not ambitious enough.[154]

It was a very ambitious objective for the EEC Commission to prepare, starting in 1960, a Convention which would guarantee that bankruptcies would be mutually recognized by Member States (principle of universality) and that a bankruptcy proceeding opened in one State would bar all other states form opening proceedings (principle of unity). The proposals produced a first proposal in 1980 (EEC Draft) and revised proposals in 1982 and 1984. Given the diverse laws regarding security interests and priorities in EEC countries, the principle of unity had serious loopholes; for the

purpose of paying secured and priority creditors, local assets were to be treated as a separate estate. The EEC draft lingered until 1984, before it became obvious that it was unrealistic. Later, there was an Istanbul convention, which also failed.

The EEC Council of Ministers, in a quite singular procedure, set up a working group on Bankruptcy. By 1995, the Working Group had produced a Convention on Insolvency Proceedings (Convention). The philosophy of the Convention is influenced more by the civil law of the continent of Europe than by the common law systems of England and Ireland.[155] The Convention covers "collective insolvency proceedings which entail the partial or total divestment of the debtor and the appointment of a liquidator.[156] It refers national laws of Member States and into a common understanding, which includes elements both of illiquidity, and of insufficiency of assets, the latter to be established by a balance sheet test.[157]

C. Sex Discrimination

While Americans see the problem of sexual harassment s wither wrongful private conduct between two people or as sex discrimination, Europeans have shaped it as a problem of workers, and sited the problem in the workplace.[158] In the United States, sexual harassment is a legal wrong; in Europe – with the exception of extreme situations that amount to blackmail or physical violence – sexual harassment does not give rise to an illegal act.[159]

In America, in one landmark case, a federal court held that propositions followed by retaliation against a woman employee constituted sex discrimination.[160] In 1980, the Equal Employment Opportunity Commission promulgated rules that prohibited sexual harassment in the workplace.[161]

In European and American workplaces, women of color are more vulnerable than white women to sexual harassment.[162] In most EC countries, sexual harassment cannot be the basis for criminal prosecution or private civil actions for damages.[163] The Idea that sexual harassment constitutes a legal wrong is not widely shared in Europe.[164] In sum, naming and recognizing sexual harassment must be credited to Americans, who have given the world unequaled leadership in this area[165]

Hostile environment theory was introduced to American case law in a context distinct from sexual harassment.[166] It originated I a challenge to the practice of segregating patients in an optometrist's office on the basis of their national origin and ethnicity.[167] The plaintiff, a Spanish surnamed worker in the office, claimed that this practice was offensive and a violation of Title VII.[168] The Fifth Circuit agreed, condemning work environments that are heavily charged with discrimination even where a challenged practice is not aimed directly art the employee.[169] Sexual harassment claims based on this theory received recognition by the United States Supreme Court in 1986.[170]

American Law	European Law
Unwelcome sexual advances, requests for	The Code of Practice stresses prevention

sexual favors, and other verbal or physical conduct of a sexual nature constitute sexual harassment when (1) submission to such conduct is made either explicitly or implicitly a term or condition of n individual's employment, (2) submission to or rejection of such conduct by an individual is used as the basis for employment decisions affecting such individual, or (3) such conduct has the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile, or offensive working environment.	over the formal resolution of disputes. In mild language, the Code recommends that employers act to prevent sexual harassment in several ways. Employers are urged to issue a policy statement condemning sexual harassment and to communicate this policy to all employees. Employees should also be told that they have an enforceable right to be treated with dignity; managers should receive special training in the subject. Because preventive measures will not always work, employers should designate someone to provide advice and assistance to employees who complain about sexual harassment. In addition to informal harassment. In addition to informal methods for dispute resolution, a formal grievance procedure should exist, and it should provide an alternative in case circumstances make formal grievance proceedings unsuitable. Employers are expected to view violation of their sexual harassment policies as a disciplinary offense. [171]

There are many other legal theories which can be commenced as a separate and distinct cause of action which are a direct result of a sexual harassment incident/cause of action which are available under American law, but not under European Union law to date. Interestingly, it is germane to note that there is one separate cause of action "wrongful discharge" which is available under European Union law and not readily available under current American law to the same extent.

American Law	European Union Law
WRONGFUL DISCHARGE In addition to dignitary torts, some American states recognize a tort of wrongful discharge, which could be applied when the harassed plaintiff's employment was actually or constructively terminated. See Hale v. Ladd, 826 S.W.2d 244, 245-46 (Ark. 1992) (allowing a cause of action for wrongful discharge wen the plaintiff was dismissed after rebuffing the defendant employer's sexual advances); Foster v. Albertsons, Inc., 835 P.2d 720, 726-27 (Mont. 1992) (recognizing a cause of action of retaliatory discharge relating to sexual harassment). [172]	**WRONGFUL DISCHARGE** In Europe, where workers' rights enjoy greater protection, wrongful discharge law is a more important weapon against sexual harassment. See, e.g., International Labour Office, Combating Sexual Harassment at Work, 11 Conditions Work Dig. 65-175 (1992) describing the use of unjust dismissal law for sexual harassment cases in Denmark, France, Germany, Greece, Italy, the Netherlands, Spain, and Portugal). [173]
TORTIOUS INTERFERENCE WITH CONTRACT Another non-dignitary tort possibility, rarely used in sexual harassment cases, is tortuous interference with contract. [174] See, Kyriazi v. Western Elec. Co., 476 F. Supp 335, 336 (D.N.J. 1979) (noting that the harassment suffered by plaintiff interfered with her ability to fulfill contractual responsibilities).	**TORTIOUS INTERFERENCE WITH CONTRACT** No applicable rule or case.
BATTERY When sexual harassers touch their victims in a harmful or offensive manner, claims of battery may arise. American courts have accepted battery as a proper theory of recovery in sexual harassment cases, particularly those involving sexual touching. [175]	**BATTERY** No applicable statute or case.
FALSE IMPRISONMENT A California court found one defendant-harasser liable for false imprisonment: he had clamped the plaintiff, a waitress who worked in his restaurant, between his legs, refusing to release her. [176]	**FALSE INPRISONMENT** No applicable statute or case.

INTENTIONAL INFLICTION OF EMOTIONAL STRESS	INTENTIONAL INFLICTION OF EMOTIONAL STRESS
Intentional infliction of emotional distress is the major theory of redress in tort cases alleging sexual harassment. Using this tort, the plaintiff must prove that the defendant intentionally or recklessly engaged in extreme and outrageous conduct that caused her severe emotional distress. To many judges and observers, this is the tort that best fits the actual experience and injury of sexual harassment, although the technical requirements of other torts might be met as well. [177]	No applicable statute or case.

Although the Code of Practice offers great potential to unify and advance European Community law, it also demonstrates the ways in which EC law remains unequal to that of the United States.[178] In most EC countries, sexual harassment cannot be the bases for criminal prosecution or private civil actions for damages.[179] Neither the Community-wide law making sex discrimination illegal nor the Code of Practice contains any mention of sanctions.

D. Antitrust Law

The European Economic Community (EEC) has several provisions (especially Articles 85 and 86 of the Treaty of Rome, which established the EEC) that forbid anti-competitive business practices, Article 85 is similar to section 1 of the Sherman Act. [180]

CONCLUSION

The European Union is the most exciting international regional organization in the world today. There appears to be a trend in the European Union in adopting laws similar to those in the United States. The hostile environment as a cause of action in sexual discrimination cases and the consumer expectation test in product liability cases are good examples. It is clear that the European Union is becoming quite pro-active in legislating to develop a common body of law for the court sin all member states to follow. There is no question in my mind that within the next ten to fifteen years the result will eventually be a "United States of Europe" It will be truly wonderful to see the continued economic, social and political integration necessary to make it work.

ENDNOTES

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[125] Id.

[126] Id.

[127] Anita Bernstein, *Law, Culture, and Harassment,* 142 U. Pa. L. Rev. 1227, 1252 (1994).

[128] Id.

[129] Rebecca Korzec, *Dashing Consumer Hopes: Strict Products Liability and the Demise of the Consumer Expectations Test*, 20 B.C. Int'l & Comp. L. Rev. 227 (1997).

[130] Id., at 230.

[131] Id.

[132] Id.

[133] Id.

[134] Id., at 229, n.2.

[135] Id.

[136] Id.

[137] Id., at 229.

[138] Id., at 230.

[139] 617 So. 2d 248, 252 (Miss. 1993).

[140] Id.

[141] Id., at 228.

[142] Id.

[143] Id., at 229.

[144] See Council Directive 85/374 of 25 July 1985 on the Approximation of the Laws, Regulations and Administrative Provisions of the Member States Concerning Liability for Defective Products, arts. 1, 6(1), 28 O.J. (L210) 29, 30-31. Article 6 of the European Directive provides in part: 1. A product is defective when it does not provide the safety which a person is entitled to expect, taking all circumstances into account, including: (a) the presentation of the product; (b) the use to which it could reasonably be expected that the product would be put; and (c) the time when the product was put into circulation.

[145] Rebecca Korzec, *Dashing Consumer Hopes: Strict Products Liability and the Demise of the Consumer Expectations Test*, 20 B.C. Int'l & Comp. L. Rev. 227, 232 (1997).

[146] Id.

[147] Id.

[148] Id., at 233.

[149] Id.

[150] Id.

[151] Id., at 245.

[152] Id.

[153] Id.

[154] Id.

[155] Manfred Balz, *The European Union Convention on Insolvency Proceedings*, 70 Am. Bank L.J. 485 (1996).

[156] Id.

[157] Id.

[158] Anita Bernstein, *Law, Culture, and Harassment*, 142 U. Pa. L. Rev. 1227, 1233 (1994).

[159] Id.

[160] Id., at 1235, citing Williams v. Saxbe, 413 F. Supp. 654, 657 (D.D.C. 1976), rev'd on other grounds sub nom. Williams v. Bell, 587 F.2d 1240 (D.C. Cir. 1978).

[161] See Equal Employment Opportunity Commission's Guidelines on Discrimination Because of Sex, 45 Fed. Reg. 74, 677 (1980).

[162] Anita Bernstein, *Law, Culture, and Harassment*, 142 U. Pa. L. Rev. 1227, 1233 (1994).

[163] Id., at 1238.

[164] Id.

[165] Id.

[166] Id., at 1239.

[167] Id.

[168] Id.

[169] See, Rogers v. EEOC, 454 F. 2d 234, 237 (5th Cir. 1971), cert. Denied, 406 U.S. 957 (1972).

[170] See, Meritor Sav. Bank v. Vinson, 477 U.S. 57, 63-68 (1986).

[171] Anita Bernstein, *Law, Culture, and Harassment,* 142 U. Pa. L. Rev. 1227, 1285 (1994).

[172] Id., at 1246, n.99.

[173] Id.

[174] Id., at 1246.

[175] Id.

[176] Id.

[177] Id.

[178] Id., at 1239.

[179] Id.

[180] The Legal, Ethical, and Regulatory Environment of Business, Bruce D. Fisher and Michael J. Phillips, 247, 6bth Edition, West Publishing Company (1988).

STATE OIL CO. V. KHAN: A REVERSAL ON MAXIMUM RESALE PRICE MAINTENANCE

by

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INTRODUCTION

On November 4, 1997, the Supreme Court in a unanimous decision ruled that a manufacturer or supplier does not necessarily violate federal antitrust law by placing a ceiling on the retail price a dealer can charge for its products. In State Oil Co. v Khan[1], the Court reversed nearly thirty years of legal precedent set by the decision in Albrecht v. The Herald Co.[2], altering the standard from one of a *per se* violation to one governed by the Rule of Reason.

Rationale for Resale Price Maintenance

Resale Price Maintenance (RPM) is controlled by Section 1 of the Sherman Act[3] which states "every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal." Most RPM agreements require the setting of minimum rather than maximum resale prices. Empirical studies show that , except in rare cases, these RPM agreements result in higher retail prices and, therefore, lower sales for the manufacturer.[4] It is somewhat surprising that manufacturers would ever want to set minimum resale prices: once a manufacturer sets the product's wholesale price, it would normally be in the manufacturer's best interest to increase sales by having the product sold at the lowest possible retail price. If RPM generally does not benefit manufacturers, why has it been so commonly used? There are four major arguments that explain the adoption of RPM.

First, RPM may be the result of "retailer cartel", i.e. collusion among retailers, to keep prices high. According to this argument, the most important reason for RPMs popularity has been the desire of small retailers to compete with large discount stores.

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Historically, small retailers put pressure on Congress, and Congress responded by legalizing RPM with the passage of the Miller-Tydings Act in 1937.[5]

Second, it is suggested that RPM might make tacit collusion among manufacturers easier to maintain, but little empirical evidence supports this theory.[6] According to this theory, if retail prices are fixed, a retailer will have little incentive to cheat on the agreement and reduce prices. Because the price reductions cannot be passed on to customers, the cuts are likely to have a limited effect on the cheater's market share.[7]

Third, RPM might prevent retailers from selling high-quality products at low prices or as "loss leaders". According to this theory, if a high-quality product is consistently sold at a low price, consumers will begin to think of the product as a low quality product, and this will hurt the manufacturer in the long run. Both Levi jeans and Izod alligator shirts may have been victims of this phenomenon when they moved away from RPM.[8] Levi-Strauss was persuaded by the FTC to abandon RPM in 1977. Initially Levi's sales increased, but during the early 1980s it lost significant market share to designer jeans such as Gloria Vanderbilt, Ralph Lauren and Calvin Klein. Similarly, Izod's image and appeal declined as the shirts became more widely available.

Finally, RPM has been justified by the argument that some products require high quality pre-sale service from retailers, and only RPM or vertical integration can ensure the provision of such services. For example, by imposing RPM on their retailers, manufacturers could ensure that the dealers do not compete on price, but instead, would compete by attempting to provide better service. In the absence of RPM, some retailers, for example, computer dealers would provide good, but costly, service and charge high prices while other dealers would provide little or no service and charge low prices. Consumers could then shop around at the high priced, good service dealers, but ultimately purchase their computers at the low priced dealers. The low priced dealers would then obtain a "free ride" on the services provided by the high priced, good service dealers who might then be eliminated from the market. The prevention of a significant free rider problem is the most convincing economic justification for RPM. However, this argument may make sense only for a small number of items such as automobiles, computers, audio and video equipment, and bicycles, for which in-store pre-sale services are important.

The Rule of Reason

The first major interpretation of this statute came with the decision in Standard Oil Company of New Jersey v. United States[9]. In his opinion, Chief Justice Edward White said,

> It is obvious that judgment must in every case be called into play in order to determine whether a particular act is embraced within the statutory classes, and whether, if the act is within such classes, its nature or effect causes it to be a restraint of trade within the intendment of the act. If the criterion by which it is determined in all cases whether every contract, combination, etc., is a restraint of

> trade within the intendment of the law, is the direct or indirect effect of the acts involved, then of course the rule of reason becomes the guide[10]...

In his dissent to the decision[11], Justice Harlan maintained a Rule of Reason Approach had been rejected in the earlier case of United States v. Trans-Missouri Freight Assn.[12]. In that decision, Justice Peckham, speaking for the majority said,

> What is the meaning of the language as used in the statute, that 'every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce among the several States or with foreign nations, is hereby declared to be illegal?'. Is it confined to a contract or combination which is only in unreasonable restraint of trade or commerce, or does it include what the3 language of the act plainly and in terms covers, all contracts of that nature?...The arguments which have been addressed to us against the inclusion of all contracts in restraint of trade, as provided for by the language of the act, have been based upon the alleged presumption that Congress, notwithstanding the language of the act, could not have intended to embrace all contracts, but only such contracts as were in unreasonable restraint of trade...In other words, we are asked to read into the act by way of judicial legislation a exception that is not placed there by the law-making branch of the government, and this is done upon the theory that the impolicy of such legislation is so clear that it cannot be supposed Congress intended the natural import of the language it used. This we cannot and ought not to do.[13]

Henceforth, most antitrust claims are handled under the Rule of Reason under which the court reviews a number of relevant factors, however, some types of restraints on trade have such predictable and pernicious anti-competitive effect, and such limited potential for pro-competitive benefit, that they are deemed unlawful *per se*[14]. According to one scholar,

> Antitrust reflects the never-ending conflict between the desire for certainty and the desire for flexibility that is as old as the processes of the law itself. Whereas a *per se* rule immediately brands the operative facts embraced by it as unreasonable, the Rule of Reason opens the way to reliance upon a broad range discretion in weighing the evidence of defenses of justification compatible with the purposes of the antitrust statutes. The Rule of Reason operates through a process of inclusion and exclusion in a case-by-case consideration of all the facts. The *per se* illegality doctrine operates by converting predetermined single-fact categories into fixed rules of law.[15]

To be *per se* unreasonable, a practice must be inherently harmful to competition and should be readily recognized as unreasonable and, hence, illegal without further economic inquiry.[16] An inquiry into the relevant economic product market and geographic market as well as the defendant's economic power within those markets would be pertinent and necessary.[17]

The *Albrecht* Case

The case of Albrecht v. The Herald Company[18] was decided by the Supreme Court in 1968. Albrecht was an exclusive distributor for *The Herald* in a portion of the city of St. Louis. When Albrecht began selling newspapers at a price above *The Herald's* suggested retail price, the newspaper ceased selling to him. Albrecht brought a lawsuit alleging a *per se* violation of the Sherman Act[19]. This case was unusual in that the alleged violation was not the setting of a minimum price but rather a maximum price at which the distributor could effectively sell the product without losing his distributorship. The courts had long recognized setting of a minimum price as a *per se* violation[20]. However, the issue of maximum price setting had not arisen until the case of Kiefer-Stewert Company v. Joseph E. Seagram & Sons, Inc., et al[21] in 1951. In Kiefer, the Court held "agreements, no less than those to fix minimum prices, cripple the freedom of traders and thereby restrain their ability to sell in accordance with their own judgment"[22]. Therefore, such agreements were ruled to be *per se* violations of the Sherman Act.

The positions of the parties in Albrecht indicate the different goals of the parties to the contract. The distributor was interested in maximizing his profits per unit sold while the newspaper was interested in keeping the prices low in order to sell a greater volume of papers. A greater volume of papers sold at lower prices might not maximize sales profits but would support higher advertising rates. In the opinion for the majority, Justice Byron White wrote, "Schemes to fix maximum prices by substituting the perhaps erroneous judgment of a seller for the forces of the competitive market, may severely intrude upon the ability of buyers to compete and survive in that market"[23]. The Court held the setting of maximum prices to be a *per se* violation of the Sherman Act. In a dissenting opinion, Justice Harlan argued for the application of a Rule of Reason.

> In the present case the Court uses again the fallacious argument that price ceilings and price floors must be equally unreasonable because both cripple the freedom of traders and thereby restrain their liberty to sell in accordance with their own judgment ...It has long been recognized that one of the objectives of the Sherman Act was to preserve, for social rather than economic reasons, a high degree of independence, multiplicity, and variety in the economic system. Recognition of this objective does not, however, require this Court to hold that every commercial act that fetters the freedom of some trader is a proper subject for a *per se* rule in not whether the dictation of maximum prices is ever illegal, but whether it is always illegal.[24]

It would be nearly thirty years before Justice Harlan's words would become prophetic.

The *Khan* Case

In State Oil Company v. Khan[25], Khan leased a gas station and a convenience store from supplier State Oil Company. Under the lease, State Oil sold its gasoline to Khan at State Oil's suggested retail price, less a margin of 3.25 cents per gallon, representing Khan's profit margin on the sale of the gasoline. While Khan could charge any retail price he wanted, if the price were above State Oil's retail price, any excess

would be rebated to State Oil. This arrangement effectively set a ceiling on Khan's retail price of gasoline. Khan's business did not prosper and when State Oil sought to evict him, Khan filed a complaint alleging in part that, by preventing him from raising or lowering retail gasoline prices, State Oil had violated the antitrust laws.

At the Federal District Court level, the court ruled that Khan had failed to make out a case for a *per se* violation of Section 1 of the Sherman Act because he had shown no "manifestly anti-competitive implications or pernicious effect on competition" that would justify *per se* prohibition of State Oil Company's conduct.[26] On appeal, the Circuit Court of Appeals reversed.[27] In the Seventh Circuit's opinion, Judge Posner cited the Albrecht case[28] as "unsound when decided" and "inconsistent with later decisions" of the Supreme Court but determined that the Seventh Circuit was bound to follow the stare decisis of Albrecht case and find a *per se* violation of the Sherman Act. State Oil appealed and oral argument was had before the Supreme Court on October 7, 1997.

As an interesting aside, the Justice Department and the Federal Trade Commission joined in an amicus curiae brief in favor of a reversal of the Albrecht decision. Acting Assistant Attorney General Joel I. Klein argued that the ruling in Albrecht had done "considerably more harm than good" and that the ceilings on prices are "likely to be pro-competitive"[29]. On the retailers' side, organizations of automobile and gasoline dealers as well as the Attorney Generals of thirty-three states filed briefs urging the Court to uphold Albrecht.

In its ruling, the Supreme Court explicitly overruled Albrecht[30]. In a unanimous decision of the Court, Justice Sandra Day O'Connor stated in her opinion,

> ...guided by the general view that the antitrust laws' primary purpose is to protect inter-brand competition, and that condemnation of practices resulting in lower consumer prices is disfavored, this Court finds it difficult to maintain that vertically imposed maximum prices could harm consumers or competition to the extent necessary to justify their *per se* invalidation of *Albrecht's* theoretical justifications for its *per se* rule- that vertical maximum price fixing could interfere with dealer freedom, restrict dealers' ability to offer consumers essential or desired services, channel distribution through large or specially advantaged dealers, or disguise minimum price fixing schemes- have been abundantly criticized and can be appropriately recognized and punished under the Rule of Reason....In overruling *Albrecht*, the Court does not hold that all vertical maximum price fixing is *per se* lawful, but simply that it should be evaluated under the Rule of Reason, which can effectively identify those situations in which it amounts to anti-competitive conduct[31].

CONCLUSION

The authors concur in the reasoning of the Supreme Court in State Oil Company v. Khan[32]. In the past manufacturers have avoided direct legal confrontation with antitrust regulators by alternate mechanisms such as franchise fees, whereby a manufacturer

requires retailers to pay a fixed fee for the right to sell the product, volume discounts disguised in the form of manufacturer rebates and minimum purchase requirements. The authors conclude that a great deal of existing RPM agreements have a positive or neutral effect on economic efficiency and welfare and each antitrust case over RPM should be analyzed in detail to determine whether there is a positive or negative effect on economic efficiency. The Supreme Court's decision to alter the standards of antitrust violation from *per se* to one governed by the Rule of Reason is a step in the right direction.

ENDNOTES

[1] __U.S.__, 1997 WL 679424 (Nov. 4, 1997)

[2] 390 U.S. 145 (1968)

[3] 15 USC Section 1

[4] S.C. Hollander, in B.S. Yamey(ed.), *Resale Price Maintenance* Chicago: Aldine, 1966) pp. 67-100: Marvin Frankel, "The Effects of Fair Trade: Fact and Fiction in Statistical Findings", *Journal of Business* (July 1955); and J.F. Pickering, "The Abolition of Resale Price Maintenance in Great Britain", *Oxford Economic Papers* (March, 1975).

[5] The Miller-Tydings Act amended the Sherman Act to permit states to pass laws to exempt "agreements prescribing minimum prices for the resale of a branded commodity which...is in free and open competition with commodities of the same general class produced or distributed by others". The Act also prevented the FTC from taking action against RPM as an "unfair method of competition". By 1941, forty-five of the forty-eight states had passed so-called fair trade laws permitting RPM. Only Texas, Missouri, Vermont and the District of Columbia stood as exceptions. The courts have generally been together on RPM than has Congress. In 1976, however, even Congress turned against RPM and repealed the remaining "fair trade laws" that permitted resale price maintenance.

[6] Waldman and Jensen, *Industrial Organization* (Reading, MA, Addison Wesley, 1998) p.422

[7] Thomas R. Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence* (Washington: FTC Bureau of Economics staff report, November 1983) pp. 13-19, 80, 140-4, 161-3; and Stanley I. Ornstein, "Resale Price Maintenance and Cartels", *Antitrust Bulletin* 30 (1985), 401-32.

[8] Robert L. Steiner, "Jeans: Vertical Restraints and Efficiency", in Larry L. Duetsch(ed.) *Industry Studies* (Englewood Cliffs, NJ: Prentice-Hall, 1993), pp. 182-205; and "Has Izod's Alligator Peaked?" *New York Times* (September 8, 1983): D1.

[9] 221 U.S. 1 (1911)

[10] Id

[11] Id

[12] 166 U.S. 290 (1896)

[13] Id

[14] *Northern Pacific Railroad Company v. United States*, 356 U.S. 1

[15] S.C. Oppenheim, "Federal Antitrust Legislation: Guideposts to a Revised National Antitrust Policy", *Michigan Law Review,* Vol. L (June, 1952), 1149

[16] *Carlson Machine Tools, Inc. v. American Tool, Inc.* (1982, C.A. 5 Tex), 678 F. 2d 1253

[17] *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447 (1993). *See also, Brooke Group Ltd. v. Brown and Williamson Tobacco Corp.* 509 U.S. 209

[18] 390 U.S. 145 (1968)

[19] Id

[20] *Dr. Miles Medical Co. v. John D. Park & Sons Co.,* 220 U.S. 373 (1911)

[21] 340 U.S. 211 (1951)

[22] Id

[23] See Supra note 11

[24] Id

[25] See Supra note 1

[26] Id

[27] 93 F. 3d 1358 (7th Cur. 1996)

[28] See Supra note 11

[29] Brief for the United States and the Federal Trade Commission's Amici Curiae Supporting Reversal

[30] See Supra note 1

[31] Id

[32] Id

CONSERVATION EASEMENTS: BOON TO THE ENVIRONMENT OR POTENTIALSOURCE OF LITIGATION?

by

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INTRODUCTION

Many people are not aware that there is a land use device that preserves environmentally valuable land and offers tax benefits to the donor of land both during and after life. This device is called a conservation easement or conservation restriction. There are many advantages and disadvantages to these easements and this paper will discuss its benefits and drawbacks for property owners.

A conservation easement is a legally-enforceable document that is recorded on the land records and restricts or removes the right to develop all or a portion of a piece of property.[1] The document creating easement can provide not only for the removal of the right to build on, dump on, pave or mine the property but require that it be used for certain purposes.

The definition of a conservation easement is:

> A non possessory interest of a holder in real property imposing limitations or affirmative obligations for the purposes of which include retaining or protecting natural, scenic or open-space values of real property, assuring the availability for agricultural, forest, recreational or open space use, protecting natural resources, maintaining or enhancing air or water quality, or preserving historical architectural aspects of real property.[2]

Creating a conservation easement involves the creation of a contract between a landowner and a conservation organization restricting the kind of development permitted. While the purpose is to preserve some natural feature of the land, the effect is to limit ownership rights.

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Once the contract has been properly drawn, signed and recorded, the conservation easement (or restriction) in favor of an organization or public agency is binding on present and future owners of the property with regard to the restrictions.[3] Under the easement, a landowner retains all rights in the property but the land must be used in a way consistent with the restrictions. The easement can also be drafted to protect only certain sections of the property.

In addition, the easement can be written to last forever or for a specified period of time. The landowner is also required to allow the grantee-organization or agency to go on the property regularly to determine that the restrictions are not being violated.[4] The grantee may require the owner to correct any violations and restore the property to its condition prior to the infraction.[5]

Conservation easements differ from another land use device called a restrictive covenant which is also a means to control the use of property. In the latter, the right to develop a property in a certain way is restricted without the involvement of a third party such as a government entity or land trust organization . All that the landowner needs to do is to execute a deed to the property which includes the covenants.

Under a restrictive covenant, development rights are not being donated to a charitable organization, there are no tax advantages, nor is there a "watchdog" to make sure that the restrictions are honored. Enforcement of restrictive covenants is by a private lawsuit between similarly-situated parties.[6] Restrictive covenants do not guarantee that land will remain undeveloped.[7]

If a conservation easement is placed on the property, the land cannot be developed and the local government must tax the property to reflect this fact.

There are drawbacks to using a conservation easement. First, to achieve a tax reduction, the land must be permanently placed under the easement. Second, an additional requirement of a conservation easement is that the landowner grant it to a qualified organization. Among the qualified groups for tax purposes are local governments or non-profit organizations. According to the nomenclature of the easement, the "grantee" of the restriction agrees to "hold" and enforce the easement.[8]

ENFORCEMENT

How is a conservation easement enforced? The grantee-government or organization is required to monitor the restricted property to assure that the provisions of the conservation easement are obeyed. Monitoring "normally involves a periodic walk by a person from the organization or agency through the property and a subsequent written report listing the current uses."[9]

When the easement is created, photographs of the site should be taken to document the condition of the property. This careful documentation of the property assures that the landowner will comply with the terms of the easement. The purpose of such a survey is to determine what is on and not on the property at the time the grant is made. This protects the grantor-landowner from a subsequent claim that there has been a change on the property that compromises the income tax deduction and property tax assessment.[10]

The initial inspection however should not be the last because the land trust or government grantee of the easement has the obligation to inspect the property to determine compliance with the provisions of the easements. The grantee is responsible to monitor the land annually by walking the property and preparing a written report noting any changes in the use of the property from the previous visit. The walk should also be verified by photographs noting the date of the visit.

If no changes have occurred such fact should be noted. If there have been changes such as a road, a building or other evidence of non-compliance, a copy of the report should be sent to the landowner to verify the condition of the property.[11]

Can the grantee be held liable for failure to enforce the easement? While case law is unclear, there are incentives for the grantee to enforce the easement. Any land trust group that has been granted tax exempt status by the IRS risks losing that status if it does not operate in a manner consistent with the stated charitable purposes of the organization.[12] If a local government is the grantee, it would not be subject to this proscription.

Second, organizations who undertake monitoring activities are or should be proponents of the environment and should take their watchdog obligations seriously. Therefore grantees who undertake the enforcement of such easements should be drawn from directories maintained by the state Departments of Environmental Protection.[13]

TAX CONSEQUENCES

An important advantage of the conservation easement to a landowner is the tax consequences. The conservation easement provides for the reduction of property taxes and estate taxes for landowners and their heirs.

The 1997 Taxpayer Relief Act[14] provided the impetus for the creation of the conservation easement. This law which became effective on January 1, 1998 relieves the pressure on heirs to sell land to developers to pay estate taxes.[15] It comes at a time when the generation which came of age during the Depression and World War II, and accumulated much wealth in the form of real property, is passing away and leaving the property to its "Baby Boomer" children. The latter need to mitigate the tax implications of the passing of the property as well as to satisfy a desire to reserve some land in its natural state.

The key provisions of the 1997 Act are:

- It cuts estate taxes up to 40% on land that is left undeveloped under a conservation easement.
- It gives heirs nine months after the death of the property owner to create a conservation easement.
- Land eligible for the easement must be within 25 miles of a national park, metropolitan area or wilderness area, or within 10 miles of an urban national forest.
- The exclusion is subject to a cap of $100,000 in 1997 but increases incrementally to $500,000 by 2002.

- Permits tax-deductible conservation easements on the land if mineral or surface rights are separately owned as long as the possibility of extraction is low which may encourage land conservation in the Western states.[16]

While there is no minimum amount of acreage required to create an easement, IRS regulations mandate that an easement protect land that "provides a significant public benefit." Property with "significant public benefit" includes historic sites, animal or plant habitat, or land dedicated to preserving natural resources.

CHANGING THE CONSERVATION EASEMENT

As with any document involving real property, careful attention should be given to the drafting of a conservation easement. Under the Statute of Frauds, any grant of land must be in writing in order to be enforced in court. Because it is a deed, it must be recorded on the land records just as any other transfer of an interest in land.

Amending the contents of the conservation easement may be difficult since both the grantor and grantee must agree to any changes. There is the additional consideration of the role of the owners of the land if the grantor of the easement no longer owns it. The IRS would closely examine any change in an easement on which a tax deduction was based. The only changes that would likely be acceptable to the grantor, the grantee and the IRS would be those that would make the easement stricter by providing more protections for the restricted land. Any amendment to the easement that provides more protection for the land could result in more tax savings.

Can the easement be changed to lessen the restrictions? A change in the easement cannot be done unilaterally by the grantee-organization because the latter must abide by its terms. There are however circumstances in which an easement can be changed, and that can occur when the issue is litigated, and a court determines that due to a change in circumstances related to neighboring properties the easement no longer applies.[17]

DISADVANTAGES

While the conservation easement device has a positive impact on the environment and favorable tax implications, there are some drawbacks. First, placing a conservation easement on a property reduces its value because the use of the land is limited. In addition, a lender that has made a loan secured by a mortgage on the property will have to agree "to subordinate its lien to the easement."[18] Therefore, there must be a mortgage subordination agreement which gives the easement priority over the mortgage. The IRS is a factor because it will not approve an easement that is subject to a mortgage.[19]

There is a second negative feature. To obtain tax benefits there may have to be public access -- physical or visual -- to the easement. Public access is an issue because the "conservation purposes" test must be satisfied.[20]

The "conservation purposes" test can be satisfied in one of four ways. The property preserved:

1. Will provide public recreation or educational opportunities.

2. Contains a valuable plant or animal habitat.

3. Will result in the preservation of significant open space in an area where the public can enjoy it or where a published government policy of some kind has mandated that property in a particular geographical area should be preserved.

4. Will result in the preservation of some historically significant buildings or property.[21]

Under the first and second tests listed above and for the first part of the third, physical access must be granted.

In addition to benefits of the federal Taxpayer Relief Act, there are potential local property tax abatements. Since many municipalities assess property taxes according to the "best and highest use of the property" property may be assessed at a higher value as a potential building lot rather than as forest land.[22]

The grantee-organization or agency benefits from the conservation easement because it protects land without the groups' having to purchase it. The desire of towns and municipalities for open space can be achieved by the easement device without a locality having to spend taxpayer dollars and suffer the expense of maintaining the land. A city or town's cost is confined to the cost of inspection. A conservation easement allows property to remain in private hands subject to property taxes,[23] which also benefits local governments.

The trend toward creating easements has also been encouraged by the fact that many state legislatures have passed the Uniform Conservation Easement Act[24] (UCEA). There are a few states that have not yet passed this law so common law principles of contract law and easement law must be relied upon in deciding issues that may arise in court.[25]

LITIGATION AND THE CONSERVATION EASEMENT

While there have been few cases in which the issue of conservation easements have been litigated, the case that is cited as establishing the validity of the device is Parkinson v. Board of Assessors of Medfield.[26]

The facts of the case were that a property owner created a conservation easement with the Medfield Trustees of Reservations as the grantee. The goal of the easement was to prohibit the building of more structures on the land and to prevent any use of the property which was inconsistent with its preservation in a natural state. The easement however did permit the construction of a single family residence. A dispute arose over the property tax assessment which denied a discount to the owner. The assessors argued that the easement was invalid because it applied to buildings as well as land.[27]

The Supreme Judicial Court of Massachusetts held the easement invalid but not because it included buildings and land, but because the terms of the easement were so vague that "It preclude(d) any meaningful identification of the servient estate.[28] There the upshot of Parkinson is that the drafters must take care to be specific as to the size and location of the land subject to the easement.[29]

The drafter should take care to write the easement in such a way as to adequately describe the property, to indicate how it will be protected, and to delineate the responsibilities of grantee and property owner.[30]

There are other concerns which relate to monitoring and enforcing the easement. Both are vital to the continuation of the easement as originally granted.

The easement must be guarded against violations forever and this can be a financial burden on the grantee organizations and agencies. The groups that accept easements must actively monitor them and be prepared to go to court to enforce them to prevent violations if necessary.

In addition to regular and systematic monitoring, there must be education of future owners of the land as to what the easement means. This can be done by advising the real estate community so that it can alert the buyers of the land about the existence of, and responsibility for, observing easement provisions prior to the purchase. Real estate brokers, agents and lawyers have an obligation to advise a potential buyer of the land restrictions and to ask if he or she can live with the fact that the land cannot be used as fully as property which is not so encumbered.

If an easement violation occurs, then enforcement must follow. If persuasion in the form of a letter from the grantee fails to gain compliance, there must be litigation which can be expensive especially if the grantee of the easement is conservation organization which relies on donations for sustenance. Litigation can also be a burden to municipalities who are faced with expensive legal fees to enforce the easement. There is sure to be litigation as land changes hands and second generation owners acquire property subject to easements.

Who would begin such a lawsuit? The grantee or holder of the easement would certainly have standing to bring an enforcement action. The U.C.E.A. states that a land owner whose real property is burdened by the easement would also have standing to bring such an action.[31]

In a recent Connecticut case, a conservation easement was the subject of an enforcement action after a "second generation landowner" refused to comply with a ruling by the Town's Planning Commission regarding the erection of a fence and subsequent letters to the violator by the Town's Zoning Enforcement Officer went unheeded. The Town brought an enforcement action nearly two years after the violation was first reported.[32]

The easement called "conservation restriction" was placed on land that formed the border of three lots on a subdivision called Sunrise Estates in Woodbury. The granting of the easement to the Town protected a wetland area, a habitat containing peepers or tree frogs and spotted turtles which are a threatened species. The easement provided that the land was to be kept in a "wild, natural, and open" condition which was interpreted by the Planning Commission to mean that no fences could be placed in the protected area. Two of the property owners had placed fences in the easement zone and allowed the grazing of sheep and horses which threatened the degradation of the protected area with animal waste and the destruction of the habitat.

While one property owner acquiesced and removed his fence, the other owners, Joseph and Catherine Sajda insisted on retaining theirs. The portion of a 3.3 acre parcel of land owned by the Sajdas that was limited under the easement was a 60 foot wide area on the westernmost border.[33] The conservation easement was granted by the Sajdas' predecessor in the title who had subdivided the property into six lots. The conservation easement was granted on June 11, 1993 and recorded on the Town's land records on October 8, 1993. In October, 1996, the Sajdas obtained some sheep and placed a fence in the protected area. Thus within three years of its creation, the easement was violated.

The Town of Woodbury sought temporary and permanent injunctions to prevent the Sajdas from continuing this activity, and sought its attorney's fees[34] and costs.

Under section 22a-19 of the Connecticut General Statutes, a neighbor whose land was also subject to the easement intervened in the zoning enforcement action "to enforce the terms and conditions of a conservation restriction easement. . . encumbering the subject property that requires an undisturbed vegetative buffer for the purpose of maintaining the area of the conservation restriction easement in its natural, scenic, and open condition."[35]

The litigation to enforce the easement cost the Town and intervenor several thousand dollars, an indication of how expensive it can be to enforce an easement against a defiant property owner.

THE VALUE OF A CONSERVATION EASEMENT

The value of a conservation easement is an important issue because of its effect on the market value of the property. Once the easement is effective, the portion of the land subject to the easement is limited to the specific uses.

Because easements are perpetual, there can be no changes in the use of the land and subsequent land owners may chafe at the restrictions, because it limits what they can do.

Can an easement then be terminated? Usually a conservation easement is designed to be perpetual. But some extraordinary circumstances will end it. Eminent domain occurs when the government takes land for public use, so such a taking would terminate the easement. So too would an easement end if the property were sold in a foreclosure sale which means the purchaser takes title to the property free of encumbrances.[36]

Perhaps the most common way for an easement to end, and this will become clear as more easements are created, are changed circumstances or non-enforce- ment. If the situation were such that the land was being used for a purpose other than that contemplated by the original grant due to changed conditions, the easement would end. There might also be a situation in which there have been numerous violations of the easement by second and third generation owners of the property or the grantee organization has become defunct or has been lax in enforcement. If there is non-enforcement for a period of years and the grantee then decided to enforce the easement, the landowner would have grounds to object to the renewed enforcement.[37]

CONCLUSION

Conservation easements have been touted as a valuable device for protecting the environment and preserving natural resources. They are seen as a panacea to preserving land especially in an era when suburban sprawl and overbuilding threatens the land and habitats. Certainly the move for environmental protection and federal and local tax incentives are a potent incentive for their creation.

But there is a downside. Conservation easements can stymie future economic development, depress the value of land, and lower tax revenues for local governments which rely heavily on them to support education, recreation and other local services. Moreover, zoning regulations are a more appropriate device for controlling land use because there is an opportunity for public input. With a conservation restriction, a single landowner can dictate the use of land without community participation or public hearings.

For example, actor/director Robert Redford dedicated 860 acres near his Sundance, Utah resort as a nature and wildlife preserve. The Redford family donated a permanent conservation easement to a private group, the Utah Open Lands Conservation Association, so the land can never be developed. Undoubtedly Redford, a dedicated environmentalist, has the goal of protecting a scenic habitat and watershed but there is also a private gain under the IRS regulation. Perhaps Redford's land might have had its highest and best use as a park that could be enjoyed by the public or used for economic development.[38]

Since these easements have only been used for a short period, there is little case law to indicate how they will be enforced. As the Connecticut case discussed in this paper indicates, the process of enforcement can be a lengthy and expensive one, especially if one is dealing with a recalcitrant enforcement agency and obdurate land owners. More time will have to pass before the true efficacy of the conservation easement as an effective protector of the land can be conclusively determined.

Yet creation of such easements does have a desirable purpose as society becomes increasingly concerned about the degradation of the environment, open space and habitats. Since most desirable ecosystems are in the hands of private parties, there is a need to protect habitats which, once lost, can never be reclaimed.[39]

ENDNOTES

[1] Ray Lyons, "Conservation Easement: A Primer," Timberline, New England Forestry Foundation, Spring, 1996 at 16. (hereinafter "Conservation Easements: A Primer").

[2] Melissa Waller Baldwin "Conservation Easements: A Viable Tool for Land Preservation," Land and Water Law Review, Vol. XXXII 1997 at 105 quoting UNIF. Conservation Easement Act 1 (1) (Supp. 1995) (hereinafter Conservation Easements: A Viable Tool).

[3] Id. at 106, quoting The Nature Conservancy, Conservation Easements (1992).

[4] Id. quoting Janet Diehl and Thomas S. Barrett, The Conservation Easement Handbook at T. (hereinafter the Conservation Easement Handbook).

[5] Id.

[6] Southern New England Forest Consortium, Inc. "Your Family Lands: Legacy or Memory," SNEFCI, Chepachet, R.I., 1991, at 2 (hereinafter "Your Family Lands,").

[7] "Conservation Easements: A Primer" supra note 1.

[8] Id. at 17.

[9] Id.

[10] Id.

[11] Id.

[12] "Your Family Lands," supra note 6 at 3.

[13] Id. at 4.

[14] Common Ground, TM Conservation News from the Conservation Fund. Vol 8, No. 6 Sept/Oct 1997.

[15] Paul C. Judge, "A Tax Break The Deer Will Love," Business Week, Jan. 29, 1998.

[16] "Land Protection Thru Tax Reform." Common Ground, Conservation News from the Conservation Fund, Vol. 8, No. 6 Sept/Oct, 1997.

[17] Your Family Lands, supra note 6 at 4-5.

[18] Id. at 5.

[19] Id.

[20] Id. at 8.

[21] Id. at 8.

[22] Conservation Easements: A Primer, supra note 1.

[23] The Conservation Easement Handbook, supra, note 4 at 108.

[24] The Connecticut law says: "Conservation restriction" means a limitation, whether or not stated in the form of a restriction easement, covenant or condition, in any deed, will or other instrument executed by or on behalf of the owner of the land described therein or in any order of taking such land whose purpose is to retain land or water areas predominantly in their natural, scenic or open condition or in agricultural, farming, forest or open space use. CGs.47-42 a West, 1995) Acquisition of restrictions such conservation and preservation restrictions are interests in land and may be acquired by any governmental body or any charitable corporation in trust which has the power to acquire interests in land in the same manner as it may acquire other interests in land. Such restrictions may be enforced by injunctions or proceedings in equity (47-42c.)

[25] Pennsylvania, Wyoming, Alabama and Oklahoma have not adopted the U.C.E.A.

[26] 481 N.E. 2d 491 (Mass 1985).

[27] Id. at 492.

[28] Id. at 493.

[29] "Conservation Easements: A Viable Tool," supra note 2 at 110-111.

[30] Id. at 111 fn. 179.

[31] Id. at 115 fn. 209, quoting The Conservation Easement Handbook at 92.

[32] Complaint, Town of Woodbury, Peter Hughes, Zoning Enforcement Officer v. Sajda Superior Court J.D. of Waterbury, June 23, 1998.

[33] CV-98-0146931-S. Verified Complaint First Count. #5-8 at 2.

[34] Id.

[35] Verified Pledging Filed Pursuant to Sect. 221- 19 of Conn. Gen. Statutes CV -98-0146931-S, para 3.

[36] "Conservation Easements: A Viable Tool," supra note 2 at 117.

[37] Id. at 119-120.

[38] Redford is not the only environmentally-conscious member of the entertainment industry. Singer James Taylor created an easement on 100 acres of farm lands and meadows he sold in 1998. T. Colleen Morgan, "James Taylor's Cornwall , Connecticut Farm Gets New Owners Not New Use," Litchfield County Times, Oct. 16, 1998 at 1 and 3.

[39] Note, "The Endangered Species Act Under Attack: Could Conservation Easements Help Save the ESA," 13 No. Ill. Univ. L. Rev. 37 at 389.

PUNITIVE DAMAGES AND THE BMW CASE

by

Robert Wiener*

INTRODUCTION

Dr. Ira Gore Jr. sued BMW for nondisclosure of acid rain damage to his car. The jury awarded him $4 million in punitive damages.[1] Is there something wrong with this picture?

Do marketing law suits such as this one (decided by the U.S. Supreme Court this past term) and the McDonald's coffee case[2] make any sense? Do punitive damages serve a legitimate purpose? If so, how should they be calculated? Are there constitutional caps? Should the matter be left to Congress?

THE STORY

Dr. Ira Gore Jr. went to German Auto, Inc., a BMW dealer in Birmingham, Alabama, to buy a new car. He selected a 1990 BMW 535i which he purchased for $40,750.88. Dr. Gore, a Harvard College and Duke Medical School alumnus, signed a "Retail Buyers Order" and an "Acknowledgement of Disclosure" stating that the automobile might have suffered undisclosed damage and he had inspected and agreed to accept the car.

After using the car for about nine months, still unaware of any problem with the car's finish, Gore took it to an automobile detailing shop, "Slick Finish," to make it look "snazzier than it normally would appear."[3]

Slick Finish discovered that the car had been repainted in places.[4] Further investigation revealed that the car had sustained acid rain damage to its finish in transit from BMW AG's manufacturing plant in Germany to the vehicle preparation center of BMW NA, the American distributor of BMW automobiles, in Brunswick, Georgia (both companies with whom Gore had no direct dealings).

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BMW NA company policy was not to disclose any damage costing less than three percent of the manufacturer's suggested retail price (MSRP) to repair to a dealer or to a customer. Gore's automobile cost $601 to refinish, about 1 1/2 percent of the MSRP, so BMW NA told neither Gore nor the dealer about the refinishing.

Gore found out what had happened and sued German Auto, BMW AG, and BMW NA, arguing that their failure to disclose the car's paint history to him was fraud, suppression of a material fact, and breach of contract. As to BMW AG and BMW NA, the trial judge only submitted the suppression claim to the jury. The jury determined that the damage reduced the car's value by about 10 percent or $4,000 and therefore decided for $4,000 in compensatory damages against all three defendants. In addition, it judged that the BMW defendants were liable jointly for $4,000,000 in punitive damages, based on their gross, malicious, intentional, and wanton fraud. The trial court entered the jury's verdict as its judgment. Upon review of the verdict under the standards of Hammond and Green Oil, the judge also denied the BMW defendants' post-judgment motions. The BMW defendants appealed the punitive damages award.

The Alabama Supreme Court reduced the punitive damages award to $2 million.[5] The BMW defendants once again appealed, this time to the United States Supreme Court

FRAUD

Gore's cause of action was suppression, Alabama's equivalent, in such a case, to the common law intentional tort of fraud in the inducement. Gore proved, by a preponderance of the evidence that BMW made false material representations with scienter as to the nature of the car it sold to him. In addition, Gore established that he justifiably relied on these representations to his detriment. Fore had to satisfy the jury as to all of these elements or he would have lost the case.

A. False Representation

The jury concluded that when BMW sold a repainted car as new without notifying its buyer of this fact, BMW was representing that there had been no damage to the car. In other words, by painting over the car, the information as to the acid rain damage was suppressed.

B. Material

Is the fact that the car needed to be partially repainted material, that is, would this fact be relevant to the ordinary consumer? If the answer is no, there is no fraud.

The idea that a fact may be so inconsequential as to be immaterial is not new. The concept of de minimus injury dates back at least to the Hebrew Scriptures.[6] A principle of insignificant shortcomings concerning car sales has been codified by various states in their laws.[7] Indeed, in 1993, Alabama passed a law that nondisclosure was immaterial

unless the loss of value exceeded the greater of the two following amounts: $500 or 3% of the Manufacturer's Suggested Retail Price (MSRP).[8]

In this case, had Gore purchased his car after the passing of the Alabama law, he would have recovered no compensatory damages, not to mention punitive damages, because he simply would not have been able to prove the materiality of his fraud cause of action.[9]

C. Fact

Apparently cars sold as new, even the best models, typically have defects.[10] But the jury here decided that, as a result of the touch-up repainting, car was not new.

D. Scienter

The scienter requirement is satisfied if the party charged with fraud acted intentionally, that is, it either knew of the falsehood of its misrepresentations or acted in reckless disregard of the truth. Scienter is proved here because BMW actually knew[11] of the repainting.

E. Justifiable

Is a consumer justified in relying on an automobile dealer to tell the truth as to whether the paint of a car sold as new is the original coat? The court decided here that the answer was yes. Even if the consumer is highly educated,[12] consumers are not expected to do an extensive inspection.[13] Nor are they, apparently, expected to get an expert to inspect the painting of a car for them.[14]

F. Detrimental

The detriment Gore suffered is not made clear from the reported opinion. After all, the car had already been repainted. Perhaps the jury identified with Gore as a consumer making a major investment in a car, only to discover that it is not what he expected. But Gore did not quite get a pig in a poke. Maybe the jury felt that a repainted car is simply not as good as new.

G. Reliance

It seems clear that Gore did rely on the dealer and was unaware that his car had been repainted until he brought it in for detailing.

DAMAGES

A. Introduction

Perhaps from the birth of what anthropologists might call society, the concept of action against someone for wrongdoing has been recognized as a right of the injured.[15] In civil law,[16] the typical form of compensation is monetary and the term used is damages.[17] How should compensation for wrongdoing be determined? Since the Hebrew Scriptures became part of the canon of most of the Western World, it has largely looked to a principle based on a hypothetical in the Mosaic law.

> When men fight, and one of them pushes a pregnant woman and a miscarriage results, but no other damage ensues, the one responsible shall be fined according as the woman's husband may exact from him, the payment to be based on reckoning. But if other damage ensues, the penalty shall be life for life, eye for eye, tooth for tooth, hand for hand, foot for foot, burn for burn, wound for wound, bruise for bruise.[18]

In our common law it goes by the name of lex talionis and is defined as "The law of retaliation; which requires the infliction upon a wrongdoer of the same injury which he has caused to another."[19]

This concept has become a fundamental part of our vocabulary. You can find it in Shakespeare[20] and in Gilbert and Sullivan.[21] In fact, it was widely reported that "An eye for an eye" was spray-painted outside the Australian hospital where the alleged perpetrator of last week's Tasmanian massacre was held.[22]

It seems clear that, especially in the last incident, the notion of interpretation of retaliation is fundamental to many people's understanding of "an eye for an eye." Yet, many if not most contemporary Bible scholars,[23] as well as the rabbis of the Talmud, understood this passage to refer exclusively to monetary damages.[24]

In any case, the concept is one of proportional punishment, as is made abundantly clear from the words of the text. The rhetorical technique of comparative repetition evokes the more contemporary image of scales of justice. Perhaps the idea of the writer of the passage is that an action has put the world out of kilter and now, to make things right again, things must be put back in balance.[25]

B. Proportionate

It is even more clear from the Hebrew Scriptures that compensation for acts of negligence, that is, unintentional civil wrongs, was monetary.

When a man opens a pit, or digs a pit and does not cover it, and an ox or an ass falls into it, the one responsible for the pit must make restitution; he shall pay the price to the owner, but shall keep the dead animal.[26]

This notion, and the objective of the compensation, was developed in English common law. "Civil Suits. -- ... [T]he penalties are at times not as severe as under the

criminal law, being designed to furnish compensation to the plaintiff for some injury done him, rather than to punish the defendant."[27]

The proportionality of compensatory damages is emphasized in the following definition, "... are such as will compensate the injured party for the injury sustained, and nothing more; such as will simply make good or replace the loss caused by the wrong or injury.[28]

C. Disproportionate

1. Multiple Damages

The earliest record of damages, however, were not of proportionate damages. In the Ancient Near East, The Code of Hammurabi, who ruled from 1728 to 1686 B.C.E., specified multiple damages.[29]

> The Laws 8. If a seignior stole either an ox or a sheep or an ass or a pig or a boat, if it belonged to the church (or) if it belonged to the state, he shall make thirtyfold restitution; if it belonged to a private citizen, he shall make good tenfold. If the thief does not have sufficient to make restitution, he shall be put to death.[30]

The Hebrew Scriptures also provided for multiple damages in certain cases.[31] "When a man steals an ox or a sheep, and slaughters it or sells it, he shall pay five oxen for the ox, and four sheep for the sheep."[32] Later Biblical commentators discuss the rationale for disproportionate, including concepts of deterrence.[33]

English statutes between 1275 and 1753 provided for double, treble, or quadruple damages.[34] Multiple damages appear in American law in statutory law most commonly as treble damages. "In practice. Damages given by statute in certain cases, consisting of the single damages found by the jury, actually tripled in amount. The usual practice has been for the jury to find the single amount of the damages, and for the court, on motion, to order that amount to be trebled."[35]

Current federal law includes several prominent examples of multiple damages: the Racketeer Influenced and Corrupt Organizations Act of 1970 (RICO)[36] and antitrust law such as the Sherman Act.[37]

2. Punitive Damages

Under the common law there are exemplary or, as they are more often called today, punitive damages in addition to any compensatory damages.[38] Examples of such common law awards in England go back at least to 1763.[39]

"Exemplary damages are damages on an increased scale, awarded to the plaintiff over and above what will barely compensate him for his property loss, where the wrong done to him was aggravated by circumstances of violence, oppression, malice, fraud, or

wanton and wicked conduct on the part of the defendant, and are intended to solace the plaintiff for mental anguish, laceration of his feelings, shame, degradation, or other aggravations of the original wrong, or else to punish the defendant for his evil behavior or to make an example of him, for which reason they are also called 'punitive' or 'punitory' damages or 'vindictive' damages and (vulgarly) 'smart-money.'"[40]

The term punitive damages implies punishment. This seems odd for a basic principle in the law is that defendants are only punished in criminal and not in civil cases.[41] The deterrence effect of making an example of the defendant is often presented by the sole intent of punitive damages. But Justice Stevens, in his majority opinion in the BMW case, stated clearly that "Punitive damages may properly be imposed to further a State's legitimate interests in punishing unlawful conduct..."[42]

In Alabama, the punitive damages requirement is statutorily limited to those "consciously or deliberately engaged in oppression, fraud, wantonness or malice with regard to the plaintiff."[43] Therefore in Alabama, as in other states, in business fraud cases, punitive monetary damages may be awarded to the plaintiff in addition to damages for actual injury.

D. Philosophy

Inasmuch as a primary function of punitive damages is punishment, I will take a brief look at the philosophy of punishment. The utilitarian philosopher, Jeremy Bentham,[44] argued that "All punishment is mischief: all punishment in itself is evil."[45] Why then do other philosophers argue in favor of punishment? The two most common reasons are retribution and deterrence.

1. Retribution

Those who are in favor of retribution often contend that it is just, that one action elicits another in return.[46] But this philosophy is not referred to in punitive damages cases.

2. Deterrence

The objective of deterrence is to prevent similar action in the future. Specific deterrence is intended to deter the specific defendant, whereas general deterrence is intended to make an example of defendant to deter others. Probably the general deterrence notion is closer to the idea of exemplary damages, although both are argued in cases involving punitive damages.

But can punishment be effective? Keep in mind that Aristotle[47] was probably not thinking of punitive damages. He said, "The generality of men are naturally apt to be swayed by fear rather than by reverence, and to refrain from evil rather because of the punishment that it brings, than because of its own foulness."[48]

Note that although deterrence seems to be forward looking whereas retribution seems to be backward looking, neither kind of deterrence uses the vocabulary of correction (as in "correctional" institutions). But Horace Mann,[49] a philosopher of education, argued that its effect is its sole objective. "The object of punishment is, prevention from evil; it never can be made impulsive to good."[50] The German philosopher Friedrich Wilhelm Nietzsche[51] agreed. "The broad effects which can be obtained by punishment in man and beast, are the increase of fear, the sharpening of the sense of cunning, the mastery of the desires; so it is that punishment tames man, but does not make him 'better.'"[52]

3. Other Arguments

Other arguments are raised less frequently. The psychological justification argues in favor of the psychological need to even the score, get back, get pay back. The claim is also made that punishment acknowledges that a person is a human being, responsible for their actions. Not to punish would be to treat them as something less than human.

E. Economics

Even if punitive damages make sense philosophically, can they at some point, be excessive? Are they economic?[53] In other words, do punitive damages, especially in concealment cases, promote economic behavior?

F. Calculation

If punitive damages are seen as appropriate, how are they to be calculated? Alabama case law gives some guidance.[54] The following factors are to be considered:

1. Reprehensibility of Defendant's Conduct

For example, if the defendant engaged in a "cover-up" of its conduct, the punitive damages should be greater. In this case, the defendant literally covered-up its conduct.

2. Profitable to Defendant

What amount would be necessary to eliminate profit from such conduct? Here BMW continued its behavior largely because it was cost effective. How much in punitive damages would be necessary to take out the profit motive? See factor 6.

3. Financial Position of Defendant

Would the damages have a substantial impact on the defendant? This factor suggests that wealthier defendants should be assessed greater punitive damages. Here BMW, the manufacturer and other companies, is quite wealthy.

4. Costs of Litigation

Punitive damages may be used to encourage plaintiffs to bring suit in similar cases. The incentive of hefty punitive damages awards apparently encouraged quite a few plaintiffs to bring similar lawsuits against BMW, most argued by the same attorneys.

5. Other Civil Actions

Punitive damages should not duplicate other punishment of the same action. This factor may consider if there has already been criminal action taken against the defendant for the same conduct. It also tends to reward the plaintiff from a group of similarly injured plaintiffs who wins the race to the courthouse.[55] Here there was no separate criminal action against BMW. And Gore was one of the first to the courthouse, certainly the first to win such a sizable punitive damages award.

6. Reasonable Relationship Factor

Do the punitive damages assessed have a reasonable relationship to harm likely to occur or harm that had occurred.[56] An issue raised by this case is whether it is appropriate for a state court to consider harm in other states.

7. Other Criminal Actions

Has the defendant already been criminally punished for its behavior. Here the answer was no.

G. Civil Process

1. Trial

Our civil process may yield surprising results as a result of different trials before different juries.

Here the same lawyers, on both sides, had argued the Yates[57] case. The facts were virtually identical in terms of the car, the acid rain, the doctor plaintiff, and the jurisdiction. But, whereas Yates also won and the compensatory damages were nearly identical,[58] Yates's punitive damages award was $0.[59] "How does Gore get $2,000,000 [$4,000,000] in punitive damages and Yates get nothing in punitive damages? Different juries."[60]

2. Appeal

In cases such as these, the juries often do not have the last say. In Stella Liebeck's case, the jury punitive damages award of $2.7 million was reduced to $640,000 by the appellate court. And in this case, the jury's $4 million judgment was changed to $2 million by the Alabama Supreme Court.[61]

3. Settlements

Many, probably most, cases are settled out of court, even after a jury award. Plaintiffs facing repeated appeals often feel that justice deferred is justice denied. The potential expense in time and money of repeated appeals often results in settlements for far less that the trial judgment.

CONSTITUTIONAL REVIEW

A. Excessive Fines

The United States Constitution has been appealed to by defendants who claim that punitive damages are excessive. Punitive damages, like fines, are intended partly to punish and largely to deter the defendant, but whereas fines go to the government, punitive damages go to the plaintiff. Therefore, the excessive fines clause of the Eighth Amendment does not apply to punitive damages because they are not fines.[62]

B. Substantive Due Process

Constitutional review of punitive damages under the Due Process Clause,[63] particularly its substantive component has also been argued. Substantive due process concerns the substance of legislation and the legislative process.

Do punitive damages violate substantive due process? They may. The Court has stated that the Due Process Clause imposes substantive limits "beyond which penalties may not go." In the 1991 insurance fraud case of Pacific Mutual Life Insurance Company v. Haslip,[64] the trial court assessed damages of $4,000 for medical expenses, $196,000 for emotional distress, and $840,000 for punitive damages, four times the amount of all other damages. Although the Supreme Court affirmed, it observed that the due process clause would be violated by "extreme results that jar one's constitutional sensibilities"[65] and that this award "may be close to the line."[66] The Court acknowledged that it is difficult to determine whether a particular award is so "grossly excessive" as to violate substantive due process. "We need not, and indeed we cannot, draw a mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case. We can say, however, that [a] general concern of reasonableness ... properly enters into the constitutional calculus."[67]

In the 1993 case of TXO Production Corp. v. Alliance Resources Corp.,[68] TXO tried to cut Alliance out of its share of a West Virginia oil and gas deal. Alliance sued and was awarded $19,000 in damages for legal fees and 526 times that amount, $10 million, in punitive damages. TXO argued that the punitive damages award was so excessive that it was an unconstitutional arbitrary deprivation of property without due process of law. The Court decided for Alliance, saying that these punitive damages were a reasonable punishment for TXO's reprehensible conduct and a proper deterrent of potential harm.

The TXO decision was extraordinarily complicated. A majority of the court, comprising Justices Stevens, Rehnquist, and Blackmun, applied the Haslip test and determined that the punitive damages award in this case passed. First, they decided that there was a reasonable relationship between the punitive damage and the actual damages and potential damages (reasonableness test) and that the financial position of the defendant was a question of fact and, therefore, a jury question not reasonably subject to judicial review. (In general courts defer to the jury on questions of fact.) Concurring in the judgment, but disagreeing with the analysis were Justices Kennedy, Scalia, and Thomas. Justice Kennedy argued for a substantive due process review that would change the Haslip test to a rationality test with judicial review of the jury's purpose, deterrence (permitted) or retribution (not), and absence of bias, passion, and prejudice. Justices Scalia and Thomas argued against substantive due process review since such review, they argued, would make the eighth amendment's excessive fines clause superfluous. They noted that this case did pass procedural due process review. Dissenting were Justices O'Connor, White (in part), and Souter (in part) who applied the Haslip standard, but found that the punitive damage awarded failed substantive due process review and that the court's procedure failed procedural due process review. Such a split decision promised an exciting finish in the Gore case, and that is, indeed, what happened.

The BMW case came down to a 5-4 decision with four opinions filed. Justice Stevens wrote the opinion for the majority of the court, joined by Justices O'Connor, Kennedy, Souter, and Breyer. Justice Breyer also filed a concurring opinion in which Justices O'Connor and Souter joined. Justices Scalia, Thomas, Ginsburg, and Rehnquist all dissented with two separate dissenting opinions filed; Thomas joined Scalia's opinion and Rehnquist joined Ginsburg's opinion.[69]

A central theme in Stevens's opinion is "principles of state sovereignty and comity."[70] It seems clear that the jury awarded Gore $4 million based on a multiplication of the $4,000 compensatory damages award by the approximately 1,000 times BMW had failed to disclose similar repairs to other customers throughout the United States. But, observed Stevens, it is not the prerogative of a jury in Alabama to punish BMW for its actions in other states.[71]

Stevens next stated that punitive damages should be proportionate to a defendant's act,[72] comparable to "the enormity of his offense."[73] But Stevens and the rest of the majority did not think that BMW's offense was such a big deal, lacking all of "the aggravating factors associated with particularly reprehensible conduct",[74]perhaps not warranting punitive damages at all?

Even if a defendant's behavior is reprehensible, punitive damages may be deemed unreasonable in light of their ratio to actual damages. Here the punitive damages awarded by the jury were 1,000 times the compensatory damages. The award as modified by the Alabama Supreme Court was 500 times the calculated actual harm, less than the TXO case. But Stevens here calls the ratio a "breathtaking 500 to 1"[75] and

quotes with approval Justice O'Connor's dissent in the TXO case that such an award must "raise a suspicious judicial eyebrow."[76]

Moreover, as Stevens noted, "35 times greater than the total damages of all 14 Alabama consumers who purchased repainted BMW's."[77] We can see here the principle of state sovereignty arising once more.

BMW changed its disclosure policy during this case, but, insofar as deterrence is concerned, Steven wonders whether a lesser sanction would have been adequate to change BMW's behavior.[78] In fact, the Alabama Legislature chose a significantly lower amount, $2,000, as its maximum civil penalty for violation of its Deceptive Trade Practices Act.[79]

Justice Kennedy, in his concurring opinion, quoted himself in the TXO case that "a strong presumption of validity"[80] is appropriate for punitive damages awards resulting from fair procedures. Here, Kennedy asserts that the Alabama statute does not adequately distinguish been serious and less serious conduct resulting in punitive damages awards.[81] Secondly, Kennedy argues that the Alabama courts did not adequately apply their own seven factor test. First, under the reasonable relationship, reprehensibility, and profit factor tests Kennedy asks why $56,000 economic harm in Alabama should result in a $2 million award. In short, Kennedy finds that the Alabama Supreme Court exercised inadequate constraint over the jury's punitive damages award. In addition, Kennedy, through some extensive economic analysis of the history of the common law, finds no precedent for a award of such relative magnitude.

Justice Scalia, again joined by Justice Thomas, repeats his position that punitive damages is not a Constitutional issue and, therefore, none of the Supreme Court's business beyond procedural due process review.[82] And here, he says, there was adequate due process.

Interestingly, Justice Ginsburg, joined by Chief Justice Rehnquist, and not a former state court judge on the court, argues most forcefully that punitive damages is a matter for the states. Having given some guidance in its earlier cases, guidance followed, she feels, by the Alabama Supreme Court, the United States Supreme Court should simply stay out of the way.[83] She also seems to feel that the majority is acting perhaps to preempt legislative action. Ginsburg notes that, despite BMW's failure to raise the issue of out-of state defendant activities in its post-verdict arguments, the Alabama Supreme Court clearly excluded them from proper review in this and future cases. Therefore, she says that Justice Stevens's comments on this issue are moot. She also considers it unwise for the United States Supreme Court to take on alone the task of review of punitive damage awards in the state courts.[84]

RESPONSE

Is there a problem here in need of correction? Or is the Congressional action on tort reform an overreaction to isolated cases? There is a legal saying that "bad cases

make bad law." Perhaps the reaction to punitive damages is largely an example of the validity of this saying.

Despite the impression one might get from the media, the widely trumpeted massive jury verdicts rarely bear a close relationship to the plaintiff's eventual recovery. As explained above, large damage awards are often reduced by appeal and/or out of court settlements. In fact, of the top ten judgments of 1995, ranging from $400 to $40 million, only three had been collected as of February 1996. The three judgments collected were settled. In two of these settled cases the amounts were undisclosed. In the third case, a $50.1 million verdict was settled for $2 million. The other seven judgments are either being appealed or are probably not collectible.[85]

Moreover, although large awards as in the BMW case gain a great deal of notoriety, they are quite rare. Justice Stevens referred to the BMW case as "an extraordinary case" noting that "this is the first case in decades in which we have found that a punitive damages award exceeds the constitutional limit."[86]

Even so, it is clear that punitive damages may exceed all other damages combined. Businesses that pay these sizable, hard to predict costs, argue that fairness compels tort reform by Congress or the courts. Is it fair for individual plaintiffs to get a windfall judgment often as a result not merely of the special merit of their claim, but on having been early to trial and due to the vagaries of the jury system?

Possible solutions to these problems include legislative and judicial. Legislatively, Congress has set punitive damage caps in a bill just vetoed by President Clinton.[87] States may also consider putting a substantial portion of punitive damages (after attorney fees and expenses) to the state general fund.[88]

If a large class of persons is injured by a single company, plaintiffs should be encouraged to bring legitimate claims. But often a slew of similar cases seems to follow a large award.[89]

Or a judicial solution, such as clearer guidelines for judicial review of punitive damages, for example, a multiplier of possible damages to plaintiffs, might be in the offing. It will be interesting to see what the Supreme Court does.

In conclusion, punitive damages remain an effective tool in fraud cases such as this one. Without additional damages of some sort, the market would not function economically. Companies would not take into consideration injury costs to customers if they were likely to get away with them and would continue to commit business fraud. In other words, there would neither be specific nor general deterrence of such behavior. This would not be just. On the other hand, it also seems unjust to reward a single plaintiff because many plaintiffs have been injured. Perhaps some sort of ex post fact class action, whereby similarly injured plaintiffs would share such an award, would be both economically efficient and just.

ENDNOTES

[1] BMW of N. Am., Gore v. Bayerische Motoren Werke A.G., No. CV-90-9658 (Jefferson Cir. Ct., Dec. 17, 1990).

[2] In Stella Liebeck's case against McDonald's a New Mexico jury awarded her $2.9 million, later reduced to $640,000, for a scalding she suffered when she spilt hot coffee in her lap.

[3] BMW of N. Am., Inc. v. Gore, 646 So.2d 619, 621 (Ala. 1994).

[4] The top, hood, trunk, and quarter panels. BMW of N. Am., Inc. v. Gore, 1996 U.S. LEXIS 3390, n.1 (1996).

[5] BMW of N. Am., Inc. v. Gore, 656 So.2d 619 (Ala. 1994)

[6] If in the matter of t'rumah (an offering consisting of produce) one-sixtieth or less (batel b'shishim) is not acceptable, it is immaterial. A similar concept exists in the Talmud as to the matter of the kashrut (eating acceptability) of meat into which milk has fallen. Also, the small possibility of an abandoned child not being of the same status as the majority of the community in which it is found is ignored for determining the orphan's status.

[7] BMW argued that "most" or 60% of the states have auto disclosure laws under which it would not have had to disclose the damage to Dr. Gore's car.

[8] Ala. Code Section 8-19-5(22) (1993).

[9] A student of mine, and my own experience, contend that a repainted car is not as good as new. The repainted areas are far more likely to peel and need future repainting. Therefore, the cost of the originally repainting is not, perhaps, the best guide to the materiality of a misrepresentation.

[10] If the Consumer Reports magazine is a valid guide. Even the highly rated Honda Civic EX "arrived with three sample defects..." Consumer Reports, May 1996, at 52. Of course, under the Uniform Commercial Code, a consumer would be entitled to have defects cured. Uniform Commercial Code.

[11] Certainly, at least, the regional distributor which was responsible for the painting.

[12] In this case, medical doctor.

[13] It seems that in this case, the ordinary consumer would not have discovered evidence of the repainting.

[14] Although with cases like this one and those dealing with rolled back odometers on "new" cars, it might not be a bad idea.

[15] With some exceptions such as sovereign immunity.

[16] That is, not criminal law.

[17] Damages: A pecuniary compensation or indemnity which may be recovered in the courts by any person who has suffered loss, detriment, or injury, whether to his person, property, or rights, through the unlawful act or omission or negligence of another. Black's Law Dictionary.

[18] Exodus 21:22-24 (Mishpatim). New JPS.

[19] Black's Law Dictionary (rev. 4th ed. 1968).

[20] Haste still pays haste, and leisure answers leisure;
Like doth quit like, and Measure still for Measure.
William Shakespeare, Measure for Measure, Act V, Scene 1, Line 440 (1604-05).

[21] My object all sublime
I shall achieve in time --
To make the punishment fit the crime
William Schwenck Gilbert, The Mikado, Act II (1885).

[22] Fury grew in Australia Tuesday at 28-year-old Martin Bryant as he was charged at his hospital bedside over the weekend's Tasmania massacre, and a 35th victim was discovered.
"An eye for an eye" proclaimed a message sprayed across an outside wall of the Royal Hobart Hospital where Bryant was kept under close police guard, recovering from burns and expected to stay ten days. "Eye for an eye" - fury grows as Tasmania massacre man is charged, Deutsche Presse-Agentur, April 30, 1996. See also, Man charged over Tasmanian massacre as hunt continues for 35th victim, Agence France Presse, April 30, 1996; Australia massacre suspect facing 1 charge, The Commercial Appeal (Memphis), April 30, 1996, at 2A; Christian Gysin/Mark Dowdney, Hero of massacre; Brit shot in bid to protect teenage girl from maniac gunman; heroic Briton shot in the face during Tasmanian massacre, Daily Mirror, May 1, 1996, at 4, 5; Garry West, Australian charged in mass murder case, 35 dead, Reuters, Limited, April 30, 1996; Mark Bendeich, Tight security on accused after Australian massacre, Reuters, Limited, April 30, 1996.

[23] From the context of the passage.

[24] Even if the passage did not mean monetary damages when written, it is clear that it did mean that to the rabbis of the Talmud. This is derived from the Talmudic hermeneutic technique of melitza.

[25] Of course this does not necessarily solve the dilemma of what to do with a mass-murderer who has killed many times, but can only die once.

[26] Exodus 21:33-34.

[27] Charles Herman Kinnane, A First Book on Anglo-American Law 552 (2d ed. 1952).

[28] Black's Law Dictionary. See, McKnight v. Denny, 198 Pa. 323, 47 A. 970, Wade v. Power Co., 51 S.C. 296,

[29] In the Code of Hammurabi, class distinctions of victim and criminal would affect the punishment, economic injury might result in capital punishment, and vicarious punishment existed (that is, a child might be punished for its parent's crime). None of these elements exist in the Hebrew Scriptures.

[30] ANET (Ancient Near Eastern Texts), translated by Theophile J. Meek, at 140.

[31] Note that, under the common law, the following would be categorized as an intentional tort of conversion.

[32] Exodus 21:37. Taking of other property results in double damages. Elsewhere, supplementary damages are provided for, such as adding 20% to the value of an offering as a maaser sheni if money is given as an offering instead of fruit or to replace a cow (hamishito yosef alav).

[33] See Moshe Greenberg, Some Postulates on Jewish Criminal Law. Rabbinic authorities include the Talmud (Baba...), Rashi, the Mekhilta, and Ibn Ezra's Yeshulah HaKarai and the Rambam's Mora Nevuchim (ease of theft of ox is harder than the others and, therefore, theft of the others is punished more severely as a deterrence because it would tend to be more common).

[34] Sixty-five separate statutes have been identified. Owen, A Punitive Damages Overview: Functions, Problems and Reform, 39 Vill. L.Rev. 363, 368 (1994).

[35] 2 Tidd, Pr. 893, 894. Treble (and double and quadruple) damages seem to originate in English statutory law. See Owen. Note that there seem to be no such examples in The Code of Hammurabi or the Hebrew Scriptures. It may be related to the Christian concept of the Holy Trinity.

[36] See 18 U.S.C. Section 1964(c) civil RICO: person whose business or property has been injured as a result of a Section 1962 violation allowed to collect treble damages, court costs, and attorney's fees.

[37] See Section 4 of the Clayton Act, 38 Stat. 731, as amended, 15 U.S.C. Section 15. Although note that if the damages assessed are nominal, trebling them still won't amount to much. See USFL v. NFL, in which the USFL won an award of $3 ($1 x 3).

[38] The doctrine as to "punitive damages" in some cases of flagrant injury, under which double or triple or other damages in excess of the amount necessary to compensate for the

actual injury may be assessed, is an exception to this rule [that damages only compensate]. Charles Herman Kinnane, A First Book on Anglo-American Law 552, n.36 (2d ed. 1952).

[39] BMW of N. Am., Inc. v. Gore, 1996 U.S. LEXIS 3390, at *62 (May 21, 1996). See Brief for James D. A. Boyle et al. as Amici Curiae 4-5.

[40] Black's Law Dictionary. See Springer v. Fuel, Co., 196 Pa.St. 156, 47 A. 370, Scott v. Donald, 165 U.S. 58, Gillingham v. Railroad Co., 35 W.Va. 588, 14 S.E. 243, Murphy v. Hobbs, 7 Colo 541, 5 P. 119. Punitive damages are also sometimes colloquially called "punies".

[41] According to some cases, the idea of punishment does not enter into the definition of punitive damages; the term being employed to mean an increased award in view of supposed aggravation of the injury to the feelings of plaintiff by the wanton or reckless act of defendant. Brause v. Brause, 190 Iowa 329, 177 N.W. 65, 70.

[42] BMW of N. Am. v. Gore, 1996 U.S. LEXIS 3390, at *17.

[43] Ala. Code 1975, Sec. 6-11-20.

[44] Who lived from 1748 to 1832.

[45] Jeremy Bentham, Principles of Morals and Legislation, ch. 13, 2.

[46] Retribution (from Latin retribuere, to pay back) (retributive justice)
1. Something justly deserved; recompense.
2. Something given or demanded in repayment, especially punishment.
3. Theology. Punishment or reward distributed in a future life based on performance in this one.
American Heritage Dictionary of the English Language (3rd ed. 1992).

[47] Who lived from 384 to 322 B.C.E..

[48] Aristotle, Nicomachean Ethics X.

[49] Who lived from 1796 to 1859.

[50] Horace Mann, Lectures and Reports on Education (1845), 1867 edition, lecture.

[51] Who lived from 1844-1900.

[52] Friedrich Wilhelm Nietzsche, Genealogy of Morals Second Essay, Aphorism 15 (translated by Horace B. Samuel) (1887).

[53] See Richard A. Posner, Economic Analysis of Law (2d ed. 1977).

[54] Green Oil Co. v. Hornsby, 539 So. 2d 218 (Ala. 1989).

[55] See Yates.

[56] The court seems to have felt that the $4,000 awarded as compensatory damages was just. Because it was likely that 1000 cars had been similarly affected and therefore 1000 prospective plaintiffs similarly injured, $4 million would have passed the reasonable relationship factor. Note that this calculation includes potential out of state plaintiffs. Is the mere amount, $4 million, reasonable? Prior Alabama auto cases included punitive damage awards as great as $162,637 when adjusted for inflation. (The actual awarded amount was $11,800.)

[57] Yates v. BMW (Alabama).

[58] Yates was awarded $4,400 in compensatory damages.

[59] Id.

[60] Gore v. BMW. Apparently Gore got the Gilbert and Sullivan jury.
Jury (shaking fists at Defendant):
Monster, monster, dread our fury --
There's the Judge, and we're the Jury!
Come! Substantial damages,
Dam-
Gilbert (& Sullivan): Trial By Jury

[61] Id.

[62] Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted. U.S. Constitution, Amendment VIII (1791).

[63] Similar due process clauses exist in both the fifth and fourteenth amendments.
No person shall be deprived of life, liberty, or property, without due process of law.... Amendment V (1791); ... nor shall any State deprive any person of life, liberty, or property, without due process of law.... Amendment XIV (1868) Section 1.

[64] Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1 (1991).

[65] Id.

[66] Id.

[67] Id.

[68] TXO Prod. Corp. v. Alliance Resources Corp., 509 U.S. 443 (1993).

[69] BMW of N. Am., Inc. v. Gore, 1996 U.S. LEXIS 3390.

[70] Id. at *23.

[71] Id. at *25.

[72] Id. at *28.

[73] Day v. Woodworth, 54 U.S. 363 (1852).

[74] BMW of N. Am., Inc. v. Gore, 1996 U.S. LEXIS 3390 , at *30.

[75] Id. at *41.

[76] TXO, at 482.

[77] BMW of N. Am., Inc. v. Gore, 1996 U.S. LEXIS 3390, at *40, n.35. That total injury to Alabama consumers would be $56,000.

[78] Id. at *45.

[79] Ala. Code Section 8-19-11(b) (1993).

[80] TXO at 453-54.

[81] BMW of N. Am., Inc. v. Gore, 1996 U.S. LEXIS 3390 , at *51-52. See Ala. Code Section 6-11-20(a) (1993).

[82] Id. at *68-69.

[83] Id. at *84-85.

[84] Id. at *94.

[85] THE REST OF THE STORY
It's the McDonald's Coffee Syndrome: Little old lady spills scalding coffee on lap, sues McDonald's, wins $2.7 million, lawyers take a beating. But she never sees the money, because McDonald's appeals and settles for a small fraction of that amount.
So it's time to revisit an item that appeared here two weeks ago, the top five verdicts of 1995 as compiled by Lawyers Weekly USA. Sure, they were shockingly high, but what's happened to them since?
Well, the deadline has passed for appealing the biggest one -- $500 million against the William Recht Co., whose toxic dump caused a young boy's death in Florida. But the money may never be collected, because the company no longer exists.
A trial court cut the No. 2 award -- $350 million for a helicopter crash -- to $77.5 million, and that's on appeal.

At No. 3, a $98.5 million judgment against a hospital for malpractice is also on appeal, and the parties are reportedly talking settlement for about $4.5 million.

In fourth place, the $90 million award against Suzuki for a truck that rolled over has been slashed to $40 million by the trial court and is being appealed.

No. 5 -- a $70 million verdict in a second case involving the helicopter crash -- is on appeal.

Rounding out the top 10 are judgments ranging from $ 50.4 million down to $40 million. All have been appealed, settled or reduced by trial courts to $ 5 million or less. Even more telling: Of the top 10 verdicts of 1994, only three have been collected. The third highest -- $50.1 million -- settled for $2 million and two others settled for undisclosed amounts. The rest are either uncollectible or on appeal.

So the awards are a lot less than advertised, meaning the jury system may not be as out of control as critics think. But there's another problem, says Alan Shapey, a lawyer whose $58.5 million win for his client was cut by a trial judge to $15 million and appealed.

"People lose confidence in the judiciary when something like this happens," he told Lawyers Weekly USA.

Reynolds Holding, Office Affairs Can Spell Trouble, The San Francisco Chronicle, February 5, 1996, B1.

[86] BMW of N.Am., Inc. v. Gore, 1996 U.S. LEXIS 3390, at *47, n.41.

[87] The New York Times, May 3, 1996.

[88] Gore, concurring opinion. Fuller v. Preferred Risk Life Ins. Co., 577 So.2d 878, 886 (Ala. 1991), Justice Shores, special concurrence.

[89] See the numerous coffee spill cases brought after Stella Liebeck's victory.

THE RECOVERY OF BANKRUPTCY ESTATE ASSETS FROM NON-DEBTOR ENTITIES

by

Robert C. Bird*

Picture this: you are a creditor. Having a once productive relationship with a company that has fallen into bankruptcy, you now have the unpleasant task of recouping your losses from the bankrupt. Armed with your enforceable debt, and reinforced by a valid security interest, you participate in the bankruptcy proceedings with confidence that you will receive at least some portion of your money back.

Unfortunately for you, the debtor has other ideas. The debtor is a company held in sole ownership by its president, who is doing everything she can to siphon assets out of the reaches of creditors and into her own pockets. Complex stock transfers, mergers, and other transactions that skirt the law slowly drain the estate, and various legal bills pile up from your efforts.

After some time, you achieve a success, the court has ruled that the creditors have access to the president's assets which were deftly removed from the estate. The court has used a well-known theory for the task, termed "piercing the corporate veil." The phrase describes the act of disregarding the legal difference between a company and its controller or a parent and its subsidiary. The theory holds, in short, that if a person or entity holds such great domination over a corporate entity that it has no will of its own, the corporate separateness between the two is discarded. Naturally, after hearing of the unbridled access the court's ruling offers, your confidence is renewed that the unscrupulous president will not be able to escape the rightful obligations of her creditors.

However, the president of the debtor corporation has more tricks up her proverbial sleeve. After your attorneys comb her finances for remains of the corporate assets, you realize that most of the funds have been shuttled to friends, relatives, shell companies and various non-debtor entities. The result is a complicated web of corporate relationships, agreements, stock purchases, and strawpersons that will prove difficult and costly to untangle. What was once a simple secured debt in bankruptcy has turned into a costly exercise from which most creditors will never be able to recover.[1]

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This paper will examine some of the options available for creditors faced with such a problem. Traditional piercing the corporate veil doctrine, as embedded in state law, only goes so far. Many states authorize the disregarding of dominating corporate or individual forms, but do not authorize further efforts to reach assets belonging to the bankrupt estate. Arguments on policy grounds or to make new law in the state are possible, but represent a risky effort at best, particularly in states where corporate identity is a bedrock legal principle rarely disregarded by its judiciary. As a result, assets properly belonging within the bankruptcy estate that have undergone multiple transfers may fall beyond the reach of creditors under traditional state law.

This paper examines the issue and offers solutions for the beleaguered creditor. Part I will examine traditional piercing the corporate veil under state law, using Connecticut state law as a sample because it presents aspects of corporate veil law common to many states. This part will briefly address choice of law issues, examine Connecticut's corporate veil law, and through this jurisprudence show the uses, benefits, and limitations of traditional corporate veil doctrine.

Part II examines remedies beyond state corporate veil law. This part details the existence of federal common law regarding piercing the corporate veil. Federal common law is not only available but must be used when federal policies are thwarted by the limitations of state corporate veil law. Using such federal doctrine should be followed by creditors whenever possible because federal law tends to be less deferential of corporate forms and holds tools that could be used to reach well-dissipated assets of the estate.

Part III looks at additional tools available. Federal common law offers various methods with which to reach dissipated assets beyond state corporate veil doctrine. Two such methods will be highlighted here. First, the doctrine of substantive consolidation will be examined. Substantive consolidation joins separate but related bankrupt debtors into one unified estate. However, substantive consolidation may also be used to join *non-debtor* assets into a debtor estate. Although there is some controversy over the measure, this paper concludes that substantive consolidation of non-debtor assets is affirmed by implication by the Supreme Court, and presents a valuable tool for reaching non-debtor entities who hold dissipated corporate assets.

Part III also examines using piercing the corporate veil doctrine to reach estate assets of individual relatives and associates of the debtor's controller. Caselaw has been slowly developing that authorizes reaching such individuals who may have no direct relation to the debtor, but through the debtor's owner or controller now hold assets so that they may fall beyond the reach of the creditors. This line of cases will be examined and a conclusion reached that such cases should be supported as a useful legal tool to reach hidden assets.

PART I: THE BENEFITS AND LIMITATIONS OF PIERCING THE CORPORATE VEIL: AN EXAMINATION OF CONNECTICUT LAW AS A SAMPLE

A. Choice of Law

For a federal bankruptcy court faced with a corporate veil issue, deciding which state law to apply is not always an automatic process. Traditional doctrine dictates that a federal court sitting in diversity applies the choice of law rules of the state in which it sits to determine which state's law is appropriate.[2]

Although an important first step of analysis, choice of law does not normally raise lengthy debate. However, complexities can raise the question into a significant issue when the debtor has shifted states of incorporation. For example, Connecticut law holds that a Connecticut corporation that reincorporates in another state cannot escape liability for conduct that occurred while the corporation was previously incorporated in Connecticut.[3] As a result, a Connecticut corporation that moves to another state and incorporates there while the bankruptcy is pending (or any other suit for that matter) will still face Connecticut law as the applicable law at issue.[4] Other conflicts issues do exist, and creditors must be aware that choice of law doctrine may raise itself as a possible concern.

B. Piercing the Corporate Veil Under Connecticut Law

Like other states, Connecticut deems a corporation a discrete entity in which stockholders are not liable for its acts or obligations.[5] Corporations receive this protection so that entities working on their behalf can function without fear of personal reprisal for the actions or liabilities of the corporate entity. Indeed, Connecticut law grants significant protection to the corporate form and will only pierce that form in extraordinary situations. As Connecticut jurisprudence states, "[o]rdinarily the corporate veil is pierced only under exceptional circumstances, for example, where the corporation is a mere shell, serving no legitimate purpose, and used primarily as an intermediary to perpetuate fraud or promote injustice."[6]

However, a corporate veil is not an impenetrable shield. If a corporate entity is dominated by another, courts will generally disregard the corporation as a fiction and strip the protection of immunity.[7] In determining whether such a threshold of domination exists, a bright line rule does not exist, and the court makes the determination according to the particular facts of each case.[8]

Under Connecticut law, two theories exist for disregarding the corporate form: the instrumentality rule and the identity rule.[9] To satisfy the instrumentality rule, plaintiff must provide three elements:

(1) Control, not mere majority or complete stock control, but complete domination, not only of finances but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; (2) that such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of plaintiff's legal rights; and (3) that the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.[10]

The second theory that Connecticut offers to disregard a corporate form is the identity rule. Rather than requiring control or injury, the identity rule applies "when the plaintiff shows such a unity of interest and ownership that the independence of the corporation had in effect ceased or had never begun, and that an adherence to the fiction of separate identity would serve only to defeat justice and equity[.]"[11] The identity rule is most commonly applied where two corporations are controlled by one entity because of the presence of common shareholders or owners and the lack of corporate formalities.[12] However, individual stockholders have also been found liable under identity theory.[13] Although many factors may be taken in consideration when determining whether to disregard a corporate form, the overriding consideration addresses the level of dominion exerted by the entity at issue.[14] Piercing the corporate veil doctrine in Connecticut also holds flexibility in its execution as well as its methods of determination. If a corporate veil must be penetrated, it can be pierced only partially and does not compel disregarding the entire corporate form.[15]

Since the doctrine of disregarding the corporate form is equitable in nature, it may also be disregarded on general principles of equity.[16] Where equity demands piercing the corporate form, no requirement of actual fraud need be proven.[17] Although some Connecticut decisions suggest a fraud requirement,[18] proof of actual deceit does not always need to be shown to disregard a corporate form.[19]

Connecticut offers a corporate veil law that resonates with many other states. The instrumentality rule focuses on the use of the corporation as a mere tool for the dominating entity's ends. The identity rule addresses a separate though related concept -- the existence of the individuality of the corporation compared with its stockholders. These rules provide a number of factors as guidance. Resolution of the issue is ultimately a fact sensitive matter, and ultimately rests upon equitable principles.

PART II: PIERCING THE CORPORATE VEIL UNDER FEDERAL COMMON LAW: AN OPPORTUNITY FOR EXPANDED REACH BY CREDITORS

A. Piercing the Corporate Veil Under Federal Common Law

Federal common law also articulates its own corporate veil doctrine. This doctrine parallels state law in some respects. For example, considerations such as

dominance and identity are important to both doctrines. However, federal law offers some distinctive characteristics to its veil doctrine that may prove useful for the creditor. This section examines corporate veil doctrine in federal common law, focusing on the law of the Second Circuit in which the state of Connecticut sits, and reveals that federal law offers better opportunities for piercing a corporation's veil that its Connecticut counterpart.

Federal common law regarding disregarding the corporate form holds many similar requirements to its Connecticut counterpart. "Federal common law allows piercing of the corporate veil where (1) a corporation uses its alter ego to perpetrate a fraud or (2) where it so dominates and disregards its alter ego's corporate form that the alter ego was actually carrying on the controlling corporation's business instead of its own."[20]

However, unlike Connecticut law, piercing analysis must not necessarily fall neatly into the instrumentality or identity doctrine. Accordingly, federal common law offers a list of considerations for a court to apply for disregarding the corporate form. Fifteen factors have been articulated, particularly useful here since they address parent/subsidiary relations, to provide guidance on piercing corporate veil issues:

(1) common or overlapping stock ownership between parent and subsidiary; (2) common or overlapping directors and officers; (3) use of same corporate office; (4) inadequate capitalization of subsidiary; (5) financing of subsidiary by parent; (6) parent exists solely as holding company of subsidiaries; (7) parent's use of subsidiaries property and assets as its own; (8) informal intercorporate loan transactions; (9) incorporation of subsidiary caused by parent; (10) parent and subsidiary's filing of consolidated income tax returns; (11) decision-making for subsidiary by parent and principals; (12) subsidiary's directors do not act independently in interest of subsidiary but in interest of parent; (13) contracts between parent and subsidiary that are more favorable to parent; (14) non-observance of formal legal requirements; (15) existence of fraud, wrongdoing or injustice to third parties.[21]

Like Connecticut law, the determination of whether to pierce a corporate veil is an equitable one and rests on the facts of each case.[22]

Federal law also offers relaxed requirements to which other states may not subscribe. For example, the absence of stock ownership by an entity does not necessarily preclude disregarding a corporate form to reach that entity's assets.[23] With reference to persons, individuals may be named equitable owner of a company based on their control even if they exhibit no formal criteria of ownership.[24]

Since a multitude of considerations exist for determining whether to pierce the corporate veil, more grounds are available from which to do so. Unlike Connecticut

which channels such questions through two theories, federal law provides far more factors which are equal in weight. A combination of any of these may trigger the necessary domination or control required to disregard a corporate form. Accordingly, federal common law favors the creditor who would be faced with such an issue, who can bring a more diverse range of facts to show veil that piercing is necessary in their circumstance.[25]

PART III: BEYOND PIERCING THE CORPORATE VEIL: AN EXAMINATION OF THEORIES UNDER FEDERAL LAW TO REACH ASSETS DISPERSED BY THE DEBTOR'S CONTROLLER

Traditional veil piercing theory under federal law requires less indicia of control to permit disregarding of a corporate form. When a veil is pierced, the entity dominating the corporation becomes liable for the same obligations as the company. In a bankruptcy context the company at issue usually means the debtor.

However, traditional veil piercing can be an incomplete remedy. Piercing the corporate veil can only reach the dominating entity's assets. When the dominating entity has dissipated the debtor's assets through itself to other associates and shell companies, veil piercing may prove ineffective and thus the creditor's interest in receiving its full due under bankruptcy laws remain unfulfilled.

This part first shows the requirements necessary for accessing federal corporate veil piercing law. In most situations, choosing federal corporate veil theory cannot merely be a selection over state law by personal preference. Parties must fulfill specific requirements to use federal doctrine. Once these requirements are described, this part will then examine two legal theories available and recommend them as opportunities for action.

A. Articulating Necessity for Federal Law

The application of federal law for disregarding the corporate form is not an automatic one. As noted, *supra*, under most circumstances the federal court applies the law of the state in which it sits to determine whether to disregard a corporate form.[26] For example, Connecticut law would apply to a federal court sitting in Connecticut. However, federal common law can be applied in addition to or overriding of state law where a court finds that it must protect a substantial federal interest or policy.[27] In other words, if the application of state corporate veil law doctrine alone does not sufficiently fulfill federal policies or interests, a federal court may apply whatever federal jurisprudential tools are available to achieve those ends.[28] Such policies are prevalent in bankruptcy, and may be thwarted when a dominating entity shuttles assets away from the debtor and to allied associates or firms.

For example, bankruptcy law establishes as a fundamental tenet the breadth of the available "property of the estate." The term encompasses "all legal or equitable interests

of the debtor in property as of the commencement of the case."[29] The phrase is interpreted in a very broad fashion, encompassing any property of the debtor no matter where it may be located.[30] The broad interpretation of the phrase, as interpreted by *United States v. Whiting Pools, Inc.*,[31] furthers the goals of Congress: "[b]oth the congressional goal of encouraging reorganizations and Congress' choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate."[32]

The Congressional and Judicial policy of broadly determining 'property of the estate' will be partially thwarted if disregarding a firm's corporate form is the only action taken. If a debtor, through its owner, has transferred assets away from the estate into various allied entities, traditional corporate veil law will not reach such organizations and thus not fulfill the Congressional mandate for a broad reading of the property of the estate. Accordingly, the thwarting of such an interest can represent a useful articulated policy for a creditor with which to contend that the court should take the reins of the more invasive federal common law and leave state corporate veil law behind.

A second policy existing for an estate in bankruptcy is the protection of tort creditors. The distinction between tort and contract creditors is a significant one, which arises out of the nature of the relationship between the creditor with the debtor. Contract creditors enter into agreements voluntarily for an exchange of goods and services and presumably self-beneficial gain. Tort creditors are involuntary creditors, and do not choose a relationship with the debtor. The creditor relationship is forced upon them just as suddenly as the injury inflicted.[33] Tort creditors often do not enter the creditor/debtor relationship on equal footing, and may suffer from unequal bargaining power compared to their contract creditor brethren. Appropriately, where tort creditors are concerned, less reluctance exists to disregard corporate forms than when faced with their contract counterparts.[34] The federal policy of protecting these creditors, particularly vulnerable because of their lack of sophistication and involuntary participation in the suit, would be thwarted if measures are not taken to ensure compensation for their injuries.

Accordingly, to the extent that state law (here Connecticut law) does not permit disregarding the corporate form beyond the original dominator into associate entities, a creditor may contend that state law thwarts important federal policies favoring a broad view of the bankruptcy estate and the protection of involuntary tort creditors. When these goals are thwarted, federal common law may be used to further these goals.

B. Substantive Consolidation Examined

Substantive consolidation, in short, is a process whereby the assets and liabilities of different entities are merged together and treated as though they are one unit.[35] It results not only in the pooling of assets of the related entities, but satisfies liabilities from the common fund that results.[36] The common fund eliminates inter-entity claims; and combines the creditors of the multiple entities for purposes of voting on reorganization plans.[37] Substantive consolidation permits what may not be possible when a debtor's

assets have been widely dispersed -- a comprehensive inventory of the assets available to creditors prior to submission of a bankruptcy plan.[38]

Substantive consolidation is not merely an alternative phrase for piercing the corporate veil.[39] Rather, substantive consolidation achieves a different result and effectuates a different goal. Piercing the corporate veil sheds the limited liability afforded to a corporation, which rests on the determination that some domination by the corporation's owner has harmed third parties.[40] Substantive consolidation, on the other hand, merges the two entities into one and sees as its goal the equitable treatment of all creditors.[41] The primary focus of substantive consolidation is not deception or domination, but rather whether the affairs of various entities have become so entangled (i.e. financially, in business practice) that consolidation of these entities would benefit all creditors involved.[42]

The power of substantive consolidation does not find its explicit origins in the Bankruptcy Code. Rather, substantive consolidation primarily traces its origins to the development of common law. The only statutory-based allusion to the concept rests in section 1015 of the Federal Bankruptcy Rules.[43] Section 1015 provides for joint administration of the estates of two debtors.[44] Joint administration differs from substantive consolidation because it does not join multiple entities. Rather, it combines two cases by using a single docket to hear claims involving common issues.[45]

Although 1015 authorizes a distinct mechanism from substantive consolidation, the concept is explicitly addressed in the Advisory Committee Note ("Committee Note") for section 1015. The Committee Note states that "[c]onsolidation of the estates of separate debtors may sometimes be appropriate, as when affairs of an individual and a corporation owned or controlled by that individual are so intermingled that the court cannot separate their assets and liabilities."[46] However, the Committee took a neutral stance towards the doctrine, noting that substantive consolidation is "neither authorized nor prohibited" by section 1015.[47] In short, as some courts have aptly noted, substantive consolidation is mainly the "product of judicial gloss," and does not derive explicit authority from the Bankruptcy Code.[48]

Merely because substantive consolidation does not stem from statutory command does not necessarily mean that the doctrine stands on uncertain legal ground. Far from it -- courts have consistently found the authority for substantive consolidation in the bankruptcy code's general equitable powers pursuant to 11 U.S.C. § 105.[49] Section 105 states, in pertinent part, that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."[50] These powers, although quite broad, must be exercised within the confines of the Bankruptcy Code and cannot be used in a manner inconsistent with the Code's mandates.[51]

Although no single indicia exists to determine whether substantive consolidation is appropriate, several factors have been raised by various courts to determine its appropriateness.[52] One such test rests on a showing of need or the avoidance of harm and

that the benefit of consolidation will outweigh its harm to any objecting creditors.[53] Others focus the harm/benefit analysis to creditors and look to the past behavior of the debtors towards the creditors and the debtors' present financial status. Specifically, this test considers whether the debtor entities share a substantial identity or have financial affairs that are so entangled that consolidation will benefit all creditors.[54] Another addresses similar considerations but adds specific consideration of creditors who relied on the separate credit of one of the entities and will be prejudiced by the consolidation.[55] The fourth and final set of considerations articulated focus on the unity between the two entities, factors similar to veil piercing doctrine.[56]

Although specifics differ, the decision of whether to substantively consolidate entities rests on two key considerations: the effect on creditors and the status of the entities to be consolidated. And between the two, the paramount consideration is likely the benefit or harm to creditors when substantive consolidation occurs. It is questionable whether a court faced with harming creditors if two entities merged would enact substantive consolidation of similar entities. Substantive consolidation of two debtors ultimately rests on the benefit or harm to the creditors, and has been widely used and accepted for the task.

C. Substantive Consolidation of Non-Debtors

Substantive consolidation has been widely applied for the merging of separate debtors. It has certainly been useful for merging debtors that have acted as one unit, or have their finances so entangled that the creditors would benefit from the combination. Such doctrine, though useful for multiple debtors, leaves creditors stranded who witness the property of the bankruptcy estate siphoned away to non-debtor entities. Consolidation of the debtor with non-debtor entities would allow creditors to reach these debtor havens and bring lost assets back into the estate. However, the measure is a controversial and unsettled one, leaving the bankruptcy bench and commentators alike disagreeing as to whether substantive consolidation can be used in such a manner at all.

Primary authority for the proposition that substantive consolidation may be ordered with non-debtor as well as debtor entities stems from the Supreme Court itself. In *Sampsell v. Imperial Paper Corp.*,[57] the Supreme Court affirmed a consolidation of a non-debtor corporation into the estate of a debtor.[58] The Supreme Court reached this conclusion where the affairs of the non-debtor corporation were so closely associated with the debtor dominant shareholder that the non-debtor corporation was little more than a corporate pocket to place assets beyond the reach of creditors.[59] In upholding consolidation, the Court stated, in passing, that the "power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete."[60]

Some bankruptcy courts have followed *Sampsell* and approved substantive consolidation involving non-creditors.[61] However, the application of substantive consolidation to non-debtor entities remains a controversial one. In many circuits no

cases explicitly affirm such a proposition, and caselaw exists rejecting the concept.[62] Thus, although it is not entirely settled that merging with a non-debtor estate is an accepted practice, substantive consolidation presents a useful vehicle with which to retrieve assets which have been diverted away from the estate.

D. Reaching Non-debtor Associates and Relatives

In certain situations, equity and justice may permit piercing the corporate form beyond the sham organizations to recover funds from non-owner entities who may have helped perpetrate corporate frauds. When various relatives or close friends operate in conjunction to shuttle funds out of reach of bankruptcy creditors, equity demands reaching beyond the corporate form and attributing property held by various family members to the estate.[63]

For example, in *In re Daily*,[64] the court addressed the issue of whether three entities owned by the debtor's relatives could be attributed to the debtor. In spite of the fact that the debtor did not have ownership or officer status within the corporations,[65] the court concluded that the debtor controlled three corporate entities which were legally owned by the debtor's wife, son, and daughter.[66]

The court reasoned that the debtor's behavior towards the firms, in spite of his lack of formal relationship, proved telling. The debtor organized them as a means of carrying on his business and was the "moving and controlling force behind all of their actions."[67] The court found that state corporation law as well as federal bankruptcy court cases supported the decision to attribute property to nonowners in order to prevent injustice.[68]

This method of reaching non-debtor assets presents an alternative method to substantive consolidation theory. Cases like *In re Daily* apply federal and state common law to apply a kind of equitable ownership to the non-debtor entities. The reasoning is based on equitable corporate veil principles, with the goal to do justice on behalf of the creditors.

Reaching non-debtors in this way has a clear advantage – it applies traditional piercing the corporate veil doctrine and does not require applying the more controversial issue of substantively consolidating non-creditors. However, such doctrine promoting an equitable ownership to another may not be developed under many state's common law. Where it is developed, action may only be based in equity, a doctrine that can prove unhelpful since it rests so much on the facts of an individual case. Reaching non-debtors through piercing the corporate veil is an effective method of reaching dispersed assets, but may not be available in all cases.

CONCLUSIONS

Retrieving funds from a bankrupt estate represents a most uncertain task for a

creditor to perform. Competing creditors seek recovery from similar assets and the debtor often does not have the money available to repay everyone. The problem is made even more difficult when the debtor looks to place funds outside the reach of creditors. Piercing the corporate veil may help when debtors disperse the funds to themselves from the estate. However, when debtors take the additional step of passing assets to relatives and allied entities, the task of recovery becomes more difficult.

The concepts offered here provide additional opportunities for beleaguered creditors. By seeking to apply federal common law to pierce the corporate veil, creditors may tap into a more flexible doctrine that is generally less respectful of corporate forms than its state law counterpart. Further, the doctrine of substantive consolidation provides a more drastic remedy than piercing the corporate veil. Substantive consolidation, in merging the assets of the debtor and non-debtor party, treat the two entities as one unit. However, applying substantive consolidation against a non-debtor remains a controversial and unsettled issue of law which has been rejected in some districts. Finally, the creditor may apply an equitable ownership doctrine and contend that the debtor's dominant control over an entity should constitute ownership for purposes of the bankruptcy.

No one theory may prove dispositive all of the time, for these remedies merely present various alternatives for the creditor. However, reaching beyond traditional state corporate veil alter ego theory into the doctrines discussed here will likely increase the likelihood of creditors retrieving assets dispersed from the debtor estate.

ENDNOTES

[1]This scenario is loosely based on the facts stated in In re MacDonald, 114 B.R. 326 (D. Mass. 1990) and In re Daily, 107 B.R. 996 (Bankr. D. Haw. 1989), *rev'd*, 940 F.2d 1306 (9th Cir. 1991).

[2]*E.g.*, Klaxon Co. v. Stentor Electric Mfg., 313 U.S. 487, 496 (1941); Valley Juice Ltd. v. Evian Waters of France, Inc., 87 F.3d 604, 607 (2d Cir. 1996); In re Carterhouse, Inc., 94 B.R. 271, 276 (Bankr. D. Conn. 1988). Connecticut has traditionally applied the doctrine of lex loci delicti -- the place where the injury occurred determines which state's law applies. Pollack v. Bridgestone/Firestone, Inc., 939 F. Supp. 151, 152 (D. Conn. 1996). However, Connecticut abandons the lex loci delicti doctrine when "strict application of the lex loci delicti rule frustrates the legitimate expectations of the parties and undermines an important policy of the state." O'Connor v. O'Connor, 201 Conn. 632, 637, 519 A.2d 13, 15 (1986). In these cases, Connecticut follows the 'most significant relationship' test articulated in section 145 of the Restatement (Second) Conflict of Laws. Pollack, 939 F. Supp. at 152. Under this test, the law of the state applies which has the most significant relationship to the occurrence and the parties. *Id.*

[3] Mackay v. New York, N.H. & H.R. Co., 82 Conn. 73, 85 (1909) ("That . . . a merger was effected between . . . a purely Connecticut corporation, and [a Massachusetts

corporation] certainly cannot detract from the power of the courts of this state to regulate the conduct of the corporation now bearing the latter name by compelling it to fulfill its obligations, here assumed, to do acts here to be performed. To a suit against it as a Connecticut corporation it must respond as a Connecticut corporation."). *See also* CONN. GEN. STAT. § 33-820 (1997) ("A proceeding pending against any corporation party to the merger may be continued as if the merger did not occur[.]").

[4] *Id.*

[5] Kmart Corp. v. First Hartford Realty Corp., 810 F. Supp. 1316, 1327 (D. Conn. 1993) ("[A] corporation is a distinct legal entity and the stockholders or other related corporations are not personally liable for the acts or obligations of the corporation.").

[6] Angelo Tomasso, Inc. v. Armor Construction & Paving, Inc., 187 Conn. 544, 557, 447 A.2d 406, 412 (1982). See also Carterhouse, 94 B.R. at 276; Hoffman Wall Paper Co. v. Hartford, 114 Conn. 531, 535, 159 A. 346, 348 (1932).

[7] Kmart Corp., 810 F. Supp. at 1327 ("Courts will disregard the fiction of a separate legal entity to pierce the shield of immunity afforded by the corporate structure in a situation in which the corporate entity has been so controlled and dominated that justice requires liability to be imposed on the real actor.").

[8] Angelo Tomasso, 187 Conn. at 554-55, 447 A.2d at 411 ("No hard and fast rule, however, as to the conditions under which an entity may be disregarded can be stated as they vary according to the circumstances of each case.").

[9] Connecticut courts also frequently use the phrase "alter ego" as a means of describing when a corporate veil should be pierced. The term does not arise as a term of art meaning a separate theory from instrumentality or identity doctrine. Rather, it commonly appears as a method to describe the overall goal of veil piercing theory: to determine whether another individual or entity lies behind a corporation such that the corporate veil should be ignored. *E.g.,* De Leonardis v. Subway Sandwich Shops, Inc., 35 Conn. App. 353, 358, 646 A.2d 230, 233 (1994) ("When the corporation is the mere alter ego, or business conduit of a person, it may be disregarded."). The phrase is also used as a synonym for the identity doctrine used in Connecticut, Klopp v. Thermal-Sash, 13 Conn. App. 87, 89 n.3, 534 A.2d 907, 908 (1987), or a phrase that could encompass both identity and instrumentality doctrine. Saphir v. Neustadt, 177 Conn. 191, 209-10, 413 A.2d 843, 853-54 (1979).

[10] Angelo Tomasso, 187 Conn. at 553, 447 A.2d at 410 (emphasis omitted); Zaist v. Olson, 154 Conn. 563, 575, 227 A.2d 552, 558 (1967). *See also* Campisano v. Nardi, 212 Conn. 282, 291-94, 562 A.2d 1, 5-7 (1989).

[11] United Electrical Contractors, Inc. v. Progress Builders, Inc., 26 Conn. App. 749, 755, 603 A.2d 1190, 1194 (1992).

[12] *Id.*

[13] Saphir v. Neustadt, 177 Conn. 191, 211, 413 A.2d 843, 854 (1979).

[14] In re Carterhouse, Inc., 94 B.R. 271, 276 (Bankr. D. Conn. 1988) ("[T]he key factor in any decision to disregard the separate corporate entity is the element of control or influence exercised by the entity sought to be held liable over corporate affairs.").

[15] Angelo Tomasso, 187 Conn. at 559, 447 A.2d at 413 ("The fact that the corporate veil could be disregarded for some purposes does not mean that it must be disregarded for all purposes.")

[16] Connecticut Co. v. New York, N.H. & H.R.R., 94 Conn. 13, 27, 107 A. 646, 651 (1919) (A corporate entity "will be disregarded where, as here, the interests of the justice and righteous dealing so demand.").

[17] International Union v. Bristol Brass Co., 1988 WL 235669 at *3 (D. Conn. 1988) (construing Connecticut law). *See also* Bergesen d.y. A/S v. Lindholm, 760 F. Supp. 976, 988 (D. Conn. 1991) (agreeing with this conclusion) (citing Brunswick Corp. v. Waxman, 599 F.2d 34, 36 (2d Cir. 1979) (equity considerations paramount)).

[18] *E.g.,* Tishman Equip. Leasing, Inc. v. Levin, 152 Conn. 23, 28, 202 A.2d 504, 507 (1964); Humphrey v. Argraves, 145 Conn. 350, 354, 143 A.2d 432, 433-34 (1958).

[19] DeMartino v. Monroe Little League, Inc., 192 Conn. 271, 275, 471 A.2d 638, 641 (1984) ("Fraud need not be shown in order to disregard the corporate entity where one corporation is used as an adjunct to another corporation.").

[20] Status International S.A. v. M & D Maritime Ltd., 1998 WL 54263 (S.D.N.Y. Feb. 4, 1998). *See also* Dow Chemical Pacific Ltd. v. Rascator Maritime S.A., 782 F.2d 329, 342 (2d Cir. 1986); Kirno Hill Corp. v. Holt, 618 F.2d 982, 984-85 (2d Cir. 1980).

[21] Bergesen d.y. A/S v. Lindholm, 760 F. Supp. 976, 987 (D. Conn. 1991).

[22] Kregos v. Latest Line, Inc. 929 F. Supp. 600, 602 (D. Conn. 1996).

[23] Shades Ridge Holding Co., Inc., v. United States, 888 F.2d 725, 729 (11th Cir. 1989); Baker v. Raymond International, Inc., 656 F.2d 173, 181 (5th Cir. 1981), *cert. denied,* 456 U.S. 983 (1982); Krivo Industrial Supply Co. v. National Distillers & Chemical Corp., 483 F.2d 1098, 1104 (5th Cir. 1973), *modified per curiam on other grounds,* 490 F.2d 916 (5th Cir. 1974).

[24] Freeman v. Complex Computing Company, Inc., 119 F.3d 1044, 1057 (2d Cir. 1997) (applying New York law, finding individual equitable owner of company who was neither a shareholder, officer, director, or employee).

[25] Indeed, this has been noted in practice. *See* Town of Brookline v. Gorsuch, 667 F.2d 215, 221 (1st Cir. 1981) ("In applying [the pierce the corporate veil rule] federal courts will look closely at the purpose of the federal statute to determine whether the statute places importance on the corporate form, an inquiry that usually gives less respect to the corporate form than does the strict common law alter ego doctrine.") (citations omitted).

[26] *E.g.,* Klaxon Co. v. Stentor Electric Mfg., 313 U.S. 487, 496 (1941); Valley Juice Ltd. v. Evian Waters of France, Inc., 87 F.3d 604, 607 (2d Cir. 1996). However, certain areas of the law apply only federal common law when deciding whether to pierce a corporation's veil and do not consider state doctrine. *E.g.,* Chan v. Society Expedition, Inc., 123 F.3d 1287, 1294 (9th Cir. 1997) (case in admiralty). These applications of veil piercing law fall outside of bankruptcy and are outside the scope of this paper.

[27] *E.g.,* In re Carterhouse, Inc., 94 B.R. 271, 276 (Bankr. D. Conn. 1988).

[28] United Paperworkers Int'l Union v. Penntech Papers, Inc., 439 F. Supp. 610, 620 (D. Me. 1977) ("[A] federal court may pierce the corporate veil for any reason acceptable under the common law of the state in question or if disregarding the corporate entities is the only way to protect a substantial federal policy or interest."), *aff'd sub nom,* United Paperworkers Int'l Union v. T.P. Property Corp., 583 F.2d 33 (1st Cir. 1978).

[29] Official Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines Inc.), 928 F.2d 565, 569 (2d Cir. 1991) (quoting 11 U.S.C. § 541(a)(1)).

[30] *See e.g.,* Straton v. New, 283 U.S. 318, 320-21 (1931) (purpose of bankruptcy law is "to place the property of the bankrupt, wherever found, under the control of the court, for equal distribution among the creditors.").

[31] 462 U.S. 198 (1983).

[32] *Id.* at 203.

[33] *See* United States v. Jon-T Chemicals, 768 F.2d 686, 693 (5th Cir. 1985) (highlighting this distinction on related grounds).

[34] In re Matter of Clark Pipe & Supply, 870 F.2d 1022, 1029 (5th Cir. 1989) ("Courts are more likely to find that one corporation has used another as an instrumentality in aid of a tort creditor who unwillingly and without choice became a creditor of that corporation."), *withdrawn and superseded on other grounds,* 893 F.2d 693 (5th Cir. 1990); In re Chateaugay Corp., 139 B.R. 598, 604 (Bankr. S.D.N.Y. 1992) (courts more reluctant to pierce veil for contract creditor than for tort creditor).

[35] Federal Deposit Insurance Corp. v. Colonial Realty Co., 966 F.2d 57, 58 (2d Cir. 1992) ("The substantive consolidation of estates in bankruptcy effects the combination of the assets and liabilities of distinct, bankrupt entities and their treatment as if they belonged

to a single entity.") (citing 5 COLLIER ON BANKRUPTCY § 1100.06 (Lawrence P. King ed., 15th ed. 1991)).

[36] In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515, 518 (2d Cir. 1988).

[37] *Id.*

[38] Chemical Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966).

[39] However, early courts did just that -- confusing substantive consolidation and corporate veil doctrine as interchangeable theories. *See e.g.,* In re Tito Castro Construction, Inc., 14 B.R. 569, 571 (Bankr. D.P.R. 1981); In re 1438 Meridian Place, N.W., Inc., 15 B.R. 89, 89 (Bankr. D.C. 1981).

[40] Wm. Passalacqua Builders v. Resnick Developers South, Inc., 933 F.2d 131, 136 (2d Cir. 1991).

[41] In re Augie/Restivo Baking, 860 F.2d at 518.

[42] *Id.*

[43] FED. R. BANKR. P. 1015.

[44] *Id.*

[45] FED R. BANKR. P. 1015(b) ("[If] a joint petition or two or more petitions are pending in the same court by or against (1) a husband and wife, or (2) a partnership and one or more of its general partners, or (3) two or more general partners, or (4) a debtor and an affiliate, [the court may order joint administrations of estates].").

[46] FED R. BANKR. P. 1015 advisory committee's note.

[47] *Id.* ("Consolidation, as distinguished from joint administration, is neither authorized nor prohibited by this rule since the propriety of consolidation depends on substantive considerations and affects the substantive rights of the creditors of the different estates.") (citing Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941) and Chemical Bank N.Y. Trust Co., v. Kheel, 369 F.2d 845 (2d Cir. 1966)).

[48] In re Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988).

[49] Federal Deposit Insurance Corp. v. Colonial Realty Co., 966 F.2d 57, 59 (2d Cir. 1992).

[50] 11 U.S.C. § 105(a) (1998).

[51] Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988); In re Plaza de Diego

Shopping Ctr., Inc., 911 F.2d 820, 830-31 (1st Cir. 1990).

[52] Underlying these considerations is the everpresent concern that substantive consolidation is no mere procedural mechanism, but rather affects substantive rights of the parties. In re Food Fair, Inc., 10 B.R. 123, 124 (Bankr. S.D.N.Y. 1981). Accordingly, consolidation is used "sparingly." Chemical Bank N.Y. Trust Co., v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966); In re Lewellyn, 26 B.R. 246, 251 (S.D. Iowa 1982).

[53] In re F.A. Potts & Co., 23 B.R. 569, 571 (Bankr. E.D. Pa. 1992); In re Snider Bros., Inc., 18 B.R. 230, 138 (Bankr. D. Mass. 1982).

[54] Federal Deposit Insurance Corp., v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992); In re Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988).

[55] In re Auto-Train Corp., 810 F.2d 270, 276 (D.C. Cir. 1987).

[56] The seven factors articulated are:

> (1) The presence or absence of consolidated financial statements; (2) The unity of interests and ownership between various corporate entities; (3) The existence of parent and intercorporate guarantees on loans; (4) The degree of difficulty in segregating and ascertaining individual assets and liabilities; (5) The existence of transfers of assets without formal observance of corporate formalities; (6) The commingling of assets and business functions; (7) The profitability of consolidation at a single physical location.

Holywell Corp. v. Bank of New York, 59 B.R. 340, 347 (S.D. Fla. 1986) (citing In re Donut Queen, 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984)).

[57] 313 U.S. 215 (1941).

[58] *Id.* at 216.

[59] *Id.*

[60] *Id.* at 219.

[61] *E.g.,* In re Trueaud, 45 B.R. 658, 662 (Bankr. N.D. Okla. 1985) ("Under its general equitable powers, 11 U.S.C. § 105(a), a bankruptcy court may substantively consolidate affiliate corporations within a pending case when the assets and liabilities of different entities are dealt with as if the assets were held by, and the liabilities were incurred by a single entity."), *aff'd*, 59 B.R. 973 (N.D. Okla. 1986).

[62] *E.g.,* In re Circle Land & Cattle Corp., 213 B.R. 870, 876-77 (Bankr. M.D. Fla. 1997) (rejecting substantive consolidation involving non-debtor party); *In re Alpha & Omega*

Realty, 36 B.R. 416, 417 (Bankr. D. Idaho 1984) (similar). *See also* Christopher J. Predko, Note, *Substantive Consolidation Involving Non-Debtors: Conceptual and Jurisdictional Difficulties in Bankruptcy*, 41 WAYNE L. REV. 741 (1995) (rejecting substantive consolidation of non-debtor estates).

[63] In re Gary G. MacDonald, 114 B.R. 326, 330 (Bankr. D. Mass. 1990) (court found debtor had beneficial interest in stock ostensibly owned by debtor's father); In re Landbank Equity Corp., 83 B.R. 362, 373 (E.D. Va. 1987) (bankruptcy court could reach behind corporate veil and recover from relatives related to the debtor various funds where corporations were owned and operated by members of one family and used to remove funds from the corporation to various family members); In re Tureaud, 45 B.R. at 662-663 (existence of non-debtor corporation entities disregarded and subsumed in the debtor's estate).

[64] 107 B.R. 996 (D. Haw. 1989), *rev'd*, 940 F.2d 1306 (9th Cir. 1991). Although the opinion was ultimately overturned, its factual underpinnings are still instructive.

[65] *Id.* at 1008.

[66] *Id.* at 999.

[67] *Id.* at 1008.

[68] *Id.* at 1007.

ESTATE TAX AGGREGATION THEORY:
IRS CONTINUES ITS LOSING WAYS[*]

by

Martin H. Zern[†]

INTRODUCTION

The *cutting edge* of estate planning in recent years has been the promotion of stratagems to transfer property (e.g., marketable securities, real estate, a closely held business) at a reduced valuation, and consequently a reduced gift and/or estate tax burden. In general, the procedure used to realize this goal is to transfer fractional parts of the property, and/or to die owning only a fractional part. In some planning situations, a family limited partnership ("FLP") or, more currently, a family limited liability company ("FLLC") is formed to facilitate the transfer of fractional parts.[1] When utilizing a FLP, typically property will be transferred, usually be a parent or parents, in exchange for a small general partnership interest and larger limited partnership interests. When utilizing a FLLC, property is transferred for membership interests. Limited partnership interests in the FLP, or membership interests in the FLLC, are then gifted, perhaps over time, to family members, or trusts for their benefit.[2] The partnership or membership interests being gifted are valued independently of one another utilizing various discount valuation theories that have been advanced over the years. The basic concept is that , die to discounts, the sum of the value of the separate interests being transferred is less than the value of the entity as a whole (or the property held by such entity). The discount theories that have gained credibility are: lack of marketability, lack of control (minority interest), blockage (the inherent difficulty in selling large blocks of stock in one fell swoop), transferability restrictions, discount for dependence of the business on a key person and, recently, a discount for built-in capital gains tax.[3] Moreover, the mere exchange of assets for partnership or membership interests arguably results I a reduction in value (i.e., the interests received are worth less than the transferred property) where restrictions are placed on the assignment of the interests. The concept that an *assignee* interest should be discounted will be considered later in this article.

In addition to valuation discounts that may be applicable in a gift situation, it is *important to be aware* that valuation discounting may be relevant where the property interest being valued is included in a person's gross estate. For instance, it would be appropriate to apply a minority discount (and perhaps an additional marketability discount) to a minority interest owned at death, even where the deceased had given away the majority interest during lifetime. Furthermore, as two new Tax Court cases discussed hereafter will illustrate, despite the fact that a controlling interest winds up being included in a person's gross estate, fractionalization and thus discounting of the overall interest is not precluded. As one of the new cases also illustrates, additional discounting may be appropriate at death where property interests have been converted into interests in a FLP or FLLC.

Although the Internal Revenue Service ("IRS") has challenged discounting, overall it has fared rather badly in the courts. As a result, the IRS seems to have accepted the concept of valuation discounting , albeit reluctantly, at least for the time being.[4] Accordingly, when an estate or gift tax return is audited, the taxpayer is fairly well assured that some type of discount(s) will be allowed for factional interests that have been transferred or that are help at death; it will be just a matter of negotiating the appropriate discount percentage to apply. If a settlement cannot be reached and the matter is litigated, it seems that the courts have a tendency to *cut the baby in half* or close thereto, frequently coming up with a valuation somewhere between the valuation proposed by the taxpayer's expert and that proposed by the IRS's expert. The writer of this article has heard that a shortage of trained IRS personnel in the estate and gift tax area due to budget cutbacks and turnover, and insufficient litigators adequately versed in the arcane estate and gift tax area, are the reasons for the IRS willingness to often compromise estate and gift tax cases involving discounts. Moreover, remedial legislation presently does not seem to be in the cards especially since there is a significant Congressional block advocating the complete repeal of the estate and gift tax laws. Accordingly, reducing estate and gift tax values through discounting in general, and in particular utilizing FLPs and FLLCs, seems to be an estate planning technique – the IRS might argue a scheme – that is alive and doing quite well.

While the IRS seems to have warily accepted the concept of discounting for the time being, it has from time-to-time attempted to limit its applicability by claiming that separate interests should be *aggregated* in determining value. It seems pretty clear now, however, that in determining the appropriate discounts, family attribution will not be considered. After losing numerous court battles, the IRS seems to have conceded that family attribution, although applicable in many areas of the income tax laws,[5] is not relevant in the estate and gift tax area.[6] The IRS, however, seems to have left open the door on family attribution by way of a *swing-vote* theory. For example, if the owner of 100% of thee stock of a corporation gives away 30% to each of his three children, it could be argued that each 30% minority interest enhances the otherwise discounted value of the other 30% minority interests due to the fact that any sibling could join forces with another to control the corporation.[7] In other words, the discount for each minority interest arguably should be reduced – but not eliminated – because each minority interest is a swing vote.

Despite conceding the family attribution issue, the IRS apparently has not given up on the aggregation theory, as two recent Tax Court decisions filed in 1999 demonstrate: Estate *of Mellinger*[8] and *Estate of Nowell.*[9]

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ESTATE OF MELLINGER

Factual Background

Harriet R. Mellinger (the "deceased") died testate on April 18, 1993 (the "valuation date"). She was the widow of Frederick N. Mellinger, the founder of Frederick's of Hollywood ("FOH"), a primarily California chain of specialty stores selling women's lingerie FOH was established in 1946 and had a reputation of being "slightly naughty," but not offensive. In later years its lines became more conventional. At the time of the death of the deceased, FLH operated 206 stores in 39 states and conducted a mail order business through a subsidiary in all 50 states. Prior to Mr. Mellinger's death, the decedent and he were husband and wife and owned, as community property, 4,921,160 of FOH. Such shares were held in a revocable *inter vivos* family trust managed by institutional trustees.

Upon Mr. Mellinger's death, and pursuant to the terms of the family trust, one half of the stock was transmitted to an irrevocable marital trust for the benefit of the deceased during her lifetime. This trust met the qualifications for a Qualified Terminable Interest Property ("QTIP") trust, the necessary election to treat it as such was made by the institutional co-trustees, and a marital deduction was claimed.[10] The institutional trustees remained co-trustees of the QTIP trust. The terms of the QTIP trust provided for the decedent to receive a *qualified income interest for life.*[11] Upon her death, certain periodic and lump sum payments were to be made to the adult children of Mr. Mellinger and the deceased until age 65, certain periodic and lump sum payments were to be made to their grandchildren until age 30, and thereafter the balance in the trust was to be distributed to certain tax exempt charitable organizations. On the date of death of the deceased, the QTIP trust held 2,460,580 shares of FOH, which was 27.8671% of its issued and outstanding stock.

After Mr. Mellinger's death, the deceased removed her on-half community share of the FOH stock from the family trust (i.e., 2,460,580 shares) and transferred it to a revocable trust she had established (the "Harriet Trust"). Consequently, this trust, with the same institutional co-trustees, also held 27.8671% of the issued and outstanding stock of FOH. Under the terms of this trust, upon the death of the decedent, the co-trustees were to sell the decedent's residence and distribute the proceeds to her children. The balance of the assets were to be held by the trust and periodic distributions were to be made to her children and certain grandchildren. Upon the death of the children and grandchildren, the ultimate beneficiaries were certain charitable organizations.

The FOH stock held in both the QTIP trust and the Harriet Trust was included in the deceased's gross estate[12] and was valued at $4.79 per share. At the valuation date, the deceased also owned 50 shares of FOH outright. The institutional co-trustees hired two separate appraisal firms to value the stock and each firm valued the shares as *separate* 27.8671% interests in FOH. Both appraisers concluded that because of the size of each 27.8671% block relative to the trading volume of the stock, neither block could be sold in the public market without incurring a blockage discount. One appraiser felt the blockage

discount was 30% and valued the stock at $4.85 per share, whereas the other appraiser felt a 31% blockage discount was appropriate and valued the stock at $4.79 per share. The latter value was used for the estate tax return.

At the valuation date, FOH had one class of stock outstanding (unregistered) that traded on the New York Stock Exchange ("NYSE") at an average price of $6.9375 per share.

In October 1993, roughly six months after the death of the deceased, there was a recapitalization of FOH. The effect of the recapitalization was to convert each three existing shares of FOH stock into one share of Common A (fully voting) and two shares of Common B (non-voting except as to limited issues). Further, the trusts were prohibited from selling the FOH stick for less than $7.00 per share. In order to pay estate taxes, however some of the FOH stock was sold in January of 1994. Pursuant to a stock purchase plan, 357,143 Class A shares were sold by the Harriet Trust to an Employee Stock Ownership Plan (ESOP) established by FOH at $4.20 per share. This was a 30% discount from the price of the stock on the NYSE. The ESOP relied on an appraiser for establishing the discount. In February of 1994, 29,500 Class B shares were sold on the NYSE at $4.875 per share.

After negotiations spanning over a year, all of the stock of both trusts was sold in September of 1997, pursuant to a tender offer, at a price of $6.90 per share. Stock held by other shareholders was also acquired at a price of $7.75 per share.

IRS Position

Upon an audit of the estate a tax return of the deceased, the IRS determined that the stock held by the QTIP trust and the Harriet Trust should be *aggregated* in determining the overall value of the stock. In other words, the IRS asserted that the two blocks of stock together constituted over 55% of the issued and outstanding stock of the corporation, which was a controlling interest, and as such should be valued at a premium. Consequently, the IRS argued that the value for estate tax purposes was $8.46 per share, and it determined a deficiency of $10,574,983.

Tax Court's Holding

The Tax Court disagreed with the IRS position that the stock held by the two trusts should be aggregated, and thereby valued at a premium as a majority interest. The Tax Court, however, did not blindly accept the 30-31% discount advocated by the taxpayer's experts. It concluded that the FOH shares included in the deceased's gross estate should reflect a discount of 25% for lack of marketability, thus valuing the stock in FOH at $5.2031 per share.

Tax Court's Analysis

1. The Issue of Aggregation

In general, the value of a decedent's gross estate is determined by including property owned and property over which the decedent had certain control. [13] Ownership includes property that is beneficially owned[14] as well as property with respect to which the decedent owned, at time of death, a general power of appointment. [15] Also included in the estate of a decedent is the value of property in which the decedent had a qualifying income interest for life and for which the decedent's predeceased spouse's estate took a marital deduction under the QTIP provisions. [16] Consequently, property that is, so to speak, QTIP'd winds up being taxed in the estate of the Property included in the gross estate is included at its fair market value on the date of the decedent's death. In this context, fair market value is "the price that a willing buyer would pay to a willing seller, both persons having reasonable knowledge of all of the relevant facts and neither party being under a compulsion to buy or sell."[17] The willing buyer or seller are hypothetical persons whose characteristics are not necessarily the same as the actual persons involved.[18]

Despite IRS challenges, for some time now, courts have allowed discounts to reflect lack of marketability and/or lack of control (minority interest) for fractional property interests gifted, or held at death, even where in the aggregate family members held overall control.[19] The essence of the IRS argument that interests held by family members should be aggregated in determining values was founded on the theory that family cooperation would negate the fact that each interest held by family members was a minority interest, and that all of the interests of sold would be sold together. After losing numerous cases involving the family attribution issue, notably *Estate of Bright,*[20] a 1981 decision of the Fifth Circuit, and *Propstra,*[21] a 1982 decision of the Ninth Circuit, the IRS ultimately conceded that for *both* estate and gift tax purposes it would not contest discounts solely because an entity is controlled by members of a family.[22]

In *Propstra,* the decedent and his wife had owned real estate as community property. State law provided that death of a spouse dissolved the community, that upon death the community is divided equally, that each spouse can exercise testamentary disposition over his or her half, and that as a consequence only the decedent's half is included in his or her gross estate. Nevertheless, the IRS argued that the decedent's interest in the property should be valued together with the interest of his surviving spouse on the theory that the interest held by the estate would most likely be sold together with the interest of the survivor so that "the market value of the whole would be realized."[23] The executor though valued the decedent's share at a 15% discount.[24] The Court noted that Congress explicitly made family attribution applicable in other areas of the tax law.[25] Thus it reasoned that since Congress had not enacted explicit family attribution rules in the estate and gift tax arena, it was not up to the Court to apply such rules.

The IRS, however, argued that the facts in *Mellinger* were distinguishable because all of the property to be valued was included in the decedent's gross estate,

whereas only the one-half community interest was includable in *Propstra*. The FOH shares in the revocable Harriet trust were included in the gross estate of the decedent under I.R.C. § 2033 and the FOH shares in the QTIP trust were included under I.R.C. § 2044. [26] Consequently, since the decedent wound up with all of the FOH shares being included in her estate, which amounted to over 55% of the issued and outstanding stock, a clear majority interest, the IRS argued that the "shares should be valued at a premium rather than at a discount." [27]

The Tax Court then went on to analyze I.R.C. § 2044, which requires property in a QTIP trust to be included in the estate of the surviving spouse. The section was added to the Internal Revenue Code, together with I.R.C. § 2056(b)(7), in 1982.[28] The sections operate in tandem. The Congressional intent was to allow a marital deduction for property passing from the first spouse to die to the surviving spouse despite the fact that the property passing to the survivor was a *terminal interest* – i.e., the survivor's interest in the property ended upon his or her death and it passed to whomever was designated to receive the remainder interest by the first spouse to die.[29] The *quid pro quo* of allowing a marital deduction for this type of terminal interest is the requirement that the property in the QTIP trust to be included in the gross estate of the surviving spouse, and that inclusion would be at the property value determined at the date of death of the survivor, or six months thereafter if the alternate valuation date were elected.[30] Thus the estate tax on the property placed in the QTIP trust, plus any growth in value less what has been consumed during the lifetime of the surviving spouse, is deferred until the death of the survivor.

Importantly, the Tax Court observed that although I.R.C. § 2044 requires QTIP property to be included in the estate of the survivor, "at no time did the decedent possess, control or have any power of disposition over the FOH shares in the QTIP trust."[31] Consequently, although the QTIP property had to be included in the deceased's gross estate, se was not actually the owner of the property at her death. "Neither section 2044 nor the legislative history indicates that decedent should be treated as the owner of QTIP property...."[32] "Section 2044 was designed to prevent QTIP property from escaping taxation by including it in the estate of the second spouse to die. There is, however, no indication that section 2044 mandated identical tax consequences as an outright transfer to thee surviving spouse."[33]

The Tax Court also referred to *Estate of Bonner,*[34] a 1996 decision of the Fifth Circuit, which came to the same conclusion on similar facts. *Estate of Bonner* had followed thee earlier decision of the Fifth Circuit in *Estate of Bright,* noted above. In *Bonner,* the Ninth Circuit opined that a "decedent should be required to pay taxes on those assets whose disposition that decedent directs and controls, in spite of the labyrinth of federal tax fictions"[35]

As a final argument, which seems to have been a last gasp by the IRS, it asserted that I.R.C.§ 2044 is a valuation section, rather than an inclusion section, comparing it to I.R.C. § 2040. This latter section mandates that the value of the gross estate shall include the value of *all* property held jointly with right of survivorship upon the death of the first

joint tenant to die except for the proportionate value of the property corresponding to the proportionate contribution, if any, to its acquisition by the survivor.[36] Thus despite the fractional interest owned by the deceased, the full value of the property is included in his or her gross estate, excluding only an amount proportionate to what the survivor contributed, if anything.[37] The court made short shrift of this contention, simply noting that I.R.C. § 2040 is applicable only to joint tenancy property, and that I.R.C. § 2044 contains no such directive. Since both sections were enacted as part of the same tax act, the court inferred there was no Congressional intention to apply a special valuation rule for property included in the estate of a decedent under I.R.C. § 2044.[38]

2. The Issue of Valuation

Valuation has always been problematical for the courts: "[V]aluation is necessarily an approximation of judgement rather than mathematics."[39] Although the regulations under the Internal Revenue Code and court decisions provide broad guidance, valuation is a question of fact requiring weighing all relevant evidence in each particular situation.[40] The fair market value of stock listed on an exchange is the mean between the highest and lowest selling prices on the valuation date.[41] When a block of stock is so large, however, that it cannot be liquidated in a reasonable time without depressing its market value, a blockage discount may be applied.[42] When a blockage discount is asserted, the burden of proving the correctness and amount of the discount is on the taxpayer.[43] The burden is one of persuasion requiring the taxpayer to prove its claim y a preponderance of the evidence.[44]

When valuation is in issue, the IRS and the taxpayer must necessarily rely on expert testimony to determine the amount of the discount. Highly relevant is the qualification of the expert.[45] Nevertheless, the courts are not bound by an expert's opinion of not in accord with the court's judgment.[46] Where experts offer conflicting estimates, the court can evaluate the factors used by the experts t com to its own conclusion,[47] accept one opinion entirely,[48] use part of an opinion[49] or determine its own valuation based on the record.[50]

In *Mellinger*, the parties stipulated that the undiscounted fair market value of the sock was $6.9375 per share, the price at which it was trading on the NYSE on the valuation date. It was also stipulated that a marketability discount was to be applied if the court concluded, which it did, that the shares in the two trusts were not to be aggregated. The taxpayer was arguing for a 31% discount in this event, while the IRS contended that the discount should be only 15%. The intent of this article is not to explore the minutia involved in the art of apprising stock, but to simply present broadly the approaches that are sometimes taken.

A. Synthetic Put Option Analysis

When a block of stock represents several weeks of trading volume, the seller is exposed to a greater amount of market fluctuation. A way to reduce such risk is to buy put option contracts giving the seller the right to sell the shares at a fixed price over a set

period of time. This is called a *synthetic* analysis since FOH had no actual public market for any options in existence on the valuation date. One of the taxpayer's experts ("Kimball") in *Mellinger* originally estimated the expense of entering into such options for blocks of FOH stock using certain theoretical option pricing models, and came up with a 35% discount, or $4.50 per share. On cross-examination, however, he admitted certain errors and readjusted his valuation to a discount range of 14.4% to 18%, or $5.689 to $5.9372 per share.[51]

B. Public Secondary Offering

Under this approach, Kimball reviewed various studies analyzing the costs of a secondary offering. Relevant in this regard was the risks of an unsuccessful secondary offering. Under this approach, he came up with a discount of about 26.5%, or $5.10 per share. The court criticized this analysis noting that the expert did not compare the present case to transactions within the secondary offering studies that have similar characteristics, such as where the stock is traded, revenues, sales and similar factors. Instead he simply relied on the mean and median discounts of each study.[52] The taxpayer asserted, however, that the expert relied very little on this approach and most heavily on the private placement analysis.[53]

C. Private Placement Analysis

This analysis involves studies of restricted stock to analyze the private placement market. Kimball testified that various surveys reviewed by him indicated that for a publicly traded company an average discount was 35%. After considering other relevant facts under this approach, he concluded that in this case a discount of 32% was warranted, for a value of $4.72 per share.

The taxpayer also offered the testimony of another expert ("Cotlier") to establish the appropriate discount. He testified that his review of studies showed there was a mean discount of 34.73% for lack of marketability, the discount being most sensitive to block size – the larger the black the larger the discount.

D. Operational and Market Analysis

Cotler also testified that to value the FOH stock properly, there must be an analysis of the company's operations and markets. In this regard he testified that tat the valuation date, in 1992, FOH was experiencing negative financial performance, he testified that it would be difficult to sell a large block of the stock in the public market within a reasonable time at a price equal to the publicly traded common. He finally valued the FOH stock at a 31% discount, or $4.79 per share.

E. IRS's Expert

The IRS's expert ("Fuller") testified that the proper marketability discount was between 10% and 17%. He asserted that there were three viable approaches to valuation:

(i) a registered secondary offering, (ii) a private placement, or (iii) a periodic sale subject to volume restrictions under SEC rule 144.[54] He testified that under the first approach, the discount should be between 10% and 13% and that under the third approach between 13% and 17%. He ultimately concluded, however, that the private placement analysis was the exclusive means to value the FOH stock since this was the most likely means of disposition. He testified that holding period restrictions were the primary reason for the discount. Fuller reviewed various studies on private placement offers. In contrast to the taxpayer's expert who considered only private placement block sales of restricted stock. He noted that private placement resulted in an average discount of 13.5%. Fuller then fine-tuned his analysis by selecting companies with market capitalization's similar to that of FOH. He ultimately concluded that the blockage discount should be 15%, or $5.8969 per share.[55]

The Tax Court rejected the IRS's and Fuller's approach noting that by relying on only one type of analysis "he rejected an entire body of restricted stock studies covering an extensive time span."[56] These other studies showed that the discount for restricted stock compared with freely tradable stock averaged 42%.

The taxpayer also asserted that comparable sales should be taken into account referring to the sale to the ESOP none months after the valuation date at a 30% discount and the sale by the Harriet Trust ten months after the valuation date at the market value at which the stock was trading on the NYSE on that day, $4.875 per share. In this regard, the Tax Court observed that the sale to the ESOP was not a sale to an arms-length party. Furthermore, the sale took place after a re-capitalization and neither of the parties had presented any information as to how the re-capitalization affected value. The sale by the Harriet Trust was also quickly disregarded since that simply reflected the undiscounted value at that time.[57] The Tax Court did not consider the ultimate sale in September of 1997; apparently feeling it was too far removed from the valuation date.

Overall, however, the Tax Court was satisfied that "the respective discounts as determined by experts set the appropriate range from which we may determine the marketability discount," but took a swipe at the experts observing that "each expert excluded information that contradicted his result."[58] Cotler was patted on the back, the Court noting that he was the only one who addressed the specifics of FOH's financial situation in detail.

The Tax Court concluded that the discount claimed by the taxpayer was overstated while that claimed by the IRS was understated. Based on the entire record, the Court determined that the proper discount was 25%. Since the IRS had argued for a 15% discount and the taxpayer for 31%, the Tax Court did not quite split the baby in half.

ESTATE OF NOWELL

Factual Background

Ethel Nowell (the "deceased") died on December 22, 1992. The IRS determined a deficiency of $342,688 in the estate tax due with respect to her estate. The decedent

was survived by Nancy Prechel ("Nancy"), David Prechel ("David") and Diane Prechel ("Diane"). Nancy was her only child from a prior marriage and Diane was her only granddaughter.[59]

On April20, 1990, the decedent's predeceased husband ("Mr. Nowell") had established the A.L. Nowell Trust, contributing his one-half community property interest in certain publicly traded securities and real estate and naming himself and David as co-trustees. Upon Mr. Nowell's death on April 26, 1990, the assets in the A. L. Nowell Trust were distributed into three trusts: (i) The Decedent's Trust, (ii) The Exempt QTIP trusts.[60] Decedent and David were the co-trustees of each trust.

Decedent had a qualifying income interest for life in the QTIP trusts and the remainder interests upon the decedent's death were to go to David outright and to Diane in trust. Mr. Nowell's executor had made the appropriate election to treat the property in the trusts as QTIP property and, accordingly, a marital deduction was taken for such property.[61]

Prior to January 18, 1991, the decedent's assets consisted of her one-half community property interest in the publicly traded securities and real estate. The assets were held in the Ethel S. Nowell Revocable Trust (the "Revocable Trust"). On this date, the decedent and David formed the Prechel Farms Limited Partnership (the "PFLP"). The general partnership interests were held by David and the Non-Exempt QTIP Trust, while the limited partnership interests were held by the Decedent's Trust, The Exempt QTIP Trust, and the Revocable Trust. The property contributed to the PFLP primarily consisted of certain assets held by the trusts.

Also on January 18, 1991, decedent and David formed the ESN Group Limited Partnership ("the ESNGLP"). Property was contributed to ESNGLP by the Revocable Trust; the Decedent's Trust and the Exempt QTIP Trust. The general partner was The Decedent's Trust, while the Revocable Trust and The Exempt QTIP Trust were limited partners. Upon the decedent's death, all partnership interests held by the Revocable Trust[62] and the partnership interests held by the QTIP trusts.[63] The partnership interests were discounted for lack of marketability, lack of control and other factors. The discounts ranged from 50% to 65% of the net asset values of the partnership interests, specifically:

Partnership Interest	Discount
(a) PFLP interests in The Revocable Trust	65%
(b) ESNGLP interests in The Revocable Trust	50%
(c) PFLP interests in The Non-Exempt QTIP Trust	50%
(d) PFLP interests in The Exempt QTIP Trust	65%
(e) ESNGLP interests in The Exempt QTIP Trust	50%

The IRS determined that the partnership interests help by the Revocable Trust and the QTIP trusts should be merged for valuation purposes. This resulted in the

aforementioned estate tax deficiency of $342,688. Specifically, the issues were (i) whether the partnership interests included in the gross estate under I.R.C. § 2038 (relating to the Revocable Trust) and the partnership interests included in the gross estate under I.R.C. § 2044 (relating to the QTIP trusts) should be *aggregated* for valuation purposes, and (ii) whether the interests in the two partnership interests. If the interests were aggregated, the IRS concluded that the estate should be taxed on 84% of the limited partnership interest in the PFLP, a 99.9% general partnership interest in the PFLP, and a 100% limited partnership interest in the ESNGLP, rather than on separate partnership interests owned by each of the trusts.

Tax Court's Holding

The Tax Court concluded that the partnership interests included in the gross estate under I.R.C. §§ 2038 and 2044 should be valued separately, and that the limited partnership interests should be valued as assignee interests. The general partnership interest passing to David, however, passed as a general partnership interest since he was a general partner prior to the death of the decedent.

Tax Court's Analysis

1. The Issue of Aggregation

Under I.R.C. § 2038, a decedent's gross estate includes the value of any property interest transferred by the decedent during lifetime where at the decedent's death the enjoyment of such property is subject to a power retained by the decedent to alter, amend, *revoke* or terminate the transfer, unless the transfer is for full consideration. As previously discussed in this article, I.R.C. § 2044 requires inclusion in the estate of the surviving spouse of the fair market value, determined at date of death of the surviving spouse, of QTIP'd property with respect to which the predeceased spouse took a marital deduction under I.R.C. § 2056(b)(7).

The first observation of the Tax Court was that it rejected IRS's aggregation approach in *Mellinger*, and found no reason to reach a different conclusion in this case. The Court reiterated what it said in *Mellinger*, namely that "at no time did decedent possess, control, or have any power over the ...shares in the QTIP trust,"[64] and concluded that "[t]hese principles are equally applicable to the case before us."[65] Although I.R.C. § 2044(c) treats QTIP property as "property passing from the decedent," the Court concluded that there was nothing in the section indicating that the decedent should be treated as the owner of the property for purposes of aggregation. Accordingly, the partnership interests in the Revocable Trust and the QTIP trusts were to be valued separately.[66]

2. The Issue of Valuation as a Partnership Interests or Assignee Interests.

Once the Tax Court determined that the partnership interests were not to be aggregated for purposes of valuation, it then considered whether the partnership interests should be valued as partnership interests or only a*ssignee* interests.

Initially, the Tax Court observed that " '[T]he property to be valued for estate tax purposes is that which the decedent actually transfers at his death rather than the interest held by the decedent before death, or that held by the legatee after death.' "[67]

The Tax Court determined that whether the limited partnership interests were to be valued as regular partnership interests or only as assignee interests depended upon the terms of the partnership agreement. Such agreement provided, in pertinent part, that a transferee of a limited partner was entitled only t allocations and distributions, but had (i) no right to any information or accounting of the affairs of the partnership, (ii) no right to inspect the books or records of the partnership, (iii) no rights of a general partner or limited partner under state law, bur (iv) was subject to the obligations of a unit holder under other provisions of the partnership agreement. Another provision of the partnership agreement provided that a transferee of units could be admitted as a substitute limited partner only if all general partners consented to such admission. The agreement went on to provide that a transferee of a general partnership interest could become a general partner only if the transferee was otherwise a general partner or was approved as a general partner by a majority of the other general partners.

The IRS argued that the partnership interests passing to David remained partnership interests, and did not convert to mere assignee interests, since David was admitted " 'automatically' as a general partner by virtue of his already being a partner in both partnerships."[68] It also argued that since the trusts continued to hold some of the partnership interests after decedent's death, substituting only Diane as a beneficiary, the interests remained partnership interests.[69]

Referring to the state's partnership law, the Tax Court observed that a partner could not confer to an assignee the rights of a partner unless so provided in the partnership agreement. With respect to the partnership agreement at hand, the Court concluded that the transferee of a limited partnership interest become only an assignee and not a substitute limited partner, unless the general partners consented to admission as a limited partner. However, since David was already a general partner in the PFLP, the Court found that he general partnership units in the PFLP transferred to him continued to be partnership units. Accordingly the Tax Court concluded that the limited partnership interests had to be valued as assignee interest, whereas the general partnership units in the PLLP transferred to David had to be valued as general partnership interests.[70] Although David and Diand3 could gave been admitted as limited partners by a vote of a majority of the general partners, the Court opine that whether this would happen was a subjective factor that could not be considered "under the objective standard of the Hypothetical seller/buyer analysis."[71] NO general partnership interest passed to Diane.

Since the case was before the Tax Court on cross-motions for summary judgement, the taxpayer's motion for summary judgement was granted in part and denied in part, and the IRS's motion for summary judgment was granted in part and denied in part.

The Fundamental Question

The fundamental and difficult question before the Tax Court, was whether the partnership interests could be transferred as assignee interests due to circumstances existing *prior to* the death of he deceased or became assignee interests because of who wound up owning the interests after death. Arguably, a *pre-distribution transformation* of the nature of an asset should be taken into account.[72] For instance, if a father owns 100% of the stock of a company, his estate should include the full value of the stock without any minority interest discounts despite the fact that he leaves 25% minority interests to each of his four children. In such scenario, there are no restrictions on the father's ownership at the time of his death and the minority ownership situation results because of the fact that four people wind up owning the stock after the father's death.[73] In *Nowell*, as noted, state law provided that a partner could not confer the rights of a partner to an assignee unless the partnership agreement provided otherwise. The partnership agreement in question did not provide otherwise, and in fact was consistent with state law, except that a general partnership interest could be transferred as a general partnership interest to someone who was already a general partner. Consequently, the *restrictions* in the partnership agreement on the transfer of interests existed prior to the death of the deceased. The Tax Court holding was thus a recognition that the restrictions on transfer were a *pre-distribution circumstance* that changed the very nature of what the deceased could transfer at death – namely, only assignee interests.

A Sophisticated Estate Plan

After the death of Mr. Nowell, the family apparently realized that the property in the QTIP trusts, formed pursuant to her husband's *inter vivos* trust, would be included in Mrs. Nowell's gross estate under I.R.C. § 2044. The family apparently also realized that he property in the Revocable Trust would be included in her estate under I.R.C. §2038. The property in the trusts consisted of marketable securities and real estate. Accordingly, to reduce the values, she and David formed two limited partnerships, PFLP and ESNGLP.[74] It should be noted that the partnerships were formed *approximately one year before Mrs. Nowell died.* Ultimately, David was to wind up with all of the partnership interests in PFLP and Diane was to wind up with all of the partnership interests in ESNGLP (in trust for her). Property was then contributed by Mrs. Nowell's revocable trust to the partnerships in exchange for partnership interests. Other property was transferred from the QTIP trusts to the partnerships in exchange for partnership interests. Thus, on Mrs. Nowell's death, the QTIP trusts held only (or perhaps primarily), partnership interests, limited and general. Her revocable trust likewise held only (or perhaps primarily) partnership interests, but only limited. The partnership interests were discounted by her estate for lack of marketability, lack of control and other factors. The discounts claimed, as previously noted, ranged from 50% to 65% of the actual net assets in stock and real estate held by the partnerships. The IRS obviously felt the discounts were unwarranted. Consequently, it tried to eliminate or at least reduce the discounts by asserting that the partnership interests held by Mrs. Nowell's revocable trust and the partnership interests held by the QTIP trust should be aggregated for purposes of valuation. If aggregated, the estate would be deemed to hold 84% of the limited

partnership interests in the PFLP, 100% of the limited partnership interests in ESNGLP and almost 99.9% of the general partnership interests in the PFLP (David had put in $500 accounting for the .1% difference). The general partnership interest in ESNGLP was held by the Decedent's Trust, which seems to have been a credit shelter trust and thus not part of Mrs. Nowell's estate. On an aggregated basis, there apparently would be no discount for lack of control and a reduced discount, or perhaps none, for lack of marketability. The IRS's aggregation quest was, of course, unsuccessful.

Moreover, the Tax Court held that the limited partnership interests were to be valued as only assignee interests rather than substitute limited partnership interests due to the fact that the restrictions on their transfer were existent prior to the death of the deceased. As such, their value could be discounted even lower. The Tax Court, however, did not determine the actual discounts. The matter was just before the Court on cross motions for summary judgement: on the aggregation issue and the assignee issue. The exact discounts to be allowed will no doubt be, or have been, the subject of negotiations between the estate and the IRS. Of course, if no compromise has been or will be, reached, the matter may be back before the Tax Court.

CONCLUSION

It seems quite clear from the foregoing cases, that the Tax Court has a negative view of the IRS's aggregation theories. The Court has struck down this concept in the family situation and now has done so in another respect. In essence, the Tax Court held in *Mellinger* and *Nowell* that, for purposes of valuation, property interests included in a decedent's gross estate under either or both I.R.C. §§2033 or 2038 do not have to be aggregated with property interests included in a decedent's gross estate under I.R.C. § 2044. Whether the IRS will now surrender on its aggregation theory or fight further on appeal remains to be seen.

With respect to valuation *per se,* it has been and remains a battle of the experts. In this regard, the more highly qualified and experienced the expert, especially in testifying in court, the more likely will be the desired outcome. However, the work product of the expert should be carefully scrutinized and questioned. A the *Mellinger* case instructs, if a court finds an expert's work product lacking or contradictory, it can disregard it or accept only such parts as it deems satisfactory. Importantly, the expert should not rely solely on raw external statistics when valuing a company. There should be a thorough analysis of the particular company's operations and markets, along with the general and local economic conditions at the time.

The concept of discounting utilizing a FLP or FLLC seems to be well sanctioned by the courts. The discount for the transfer of a general partnership interest, limited partnership interest or member ship interest will in part depend on whether the transferee can come onto the entity as a partner or member as the case may be, or only as an assignee of the interest. A mere assignee interest will be valued lower than a regular partnership or membership interest. What interest a transferee takes will depend upon the terms of the partnership or membership agreement and the provisions of local law. Since

most state laws defer to the terms of an agreement, the estate or gift tax outcome will largely depend upon how the agreement is drafted. Consequently, the *Nowell* case is an object lesson to draftsman of what should e done to assure that what is transferred is only an assignee interest, with a resultant lower value.

Finally, as *Nowell* instructs, it is *important* to recognize that the assignee discount that seems to be recognized for the transfer by gift of an interest in a FLP or FLLC seems equally to be recognized on the transfer of such an interest at death.

ENDNOTES

[1] A FLP or FLLC is often used because direct factional transfers of property may not be feasible or advisable. For instance, a FLP or FLLC would be necessary where the property desired to be transferred at a discount is marketable securities. Although fractional parts of real estate may be transferred, this would subject the property to a partition action, which would not be the case of the property was held by a FLP or FLLC.

[2] In a FLP, the transferors usually keep control through ownership of a general partnership interest. In a FLLC, control may be exercised by having the transferor named as manger in the operating agreement. Note that there must be at least two transferors to set up a FLP since by definition a partnership requires at least two partners. Most states, including New York, permit a FLLC to be formed by one person. *See,* Treas. Reg. § 301.7701-3. All references herein to "Treas. Reg. §" are to U.S. Treasury Department regulations interpreting the Internal Revenue Code of 1986, as amended. To avoid a *substance over form* charge that what is being gifted is really undivided interests in the property transferred to the entity, it is advisable for their to be a hiatus (commentators have suggested at least 6 months) between the transfer of the property and the gifting of the partnership or membership interests.

[3] Eisenberg v. Commissioner, 82 AFTR 2d 98-5757 (2nd Cir. 1998); Estate of Davis, 110 T.C. No. 35 (1998).

[4] As a caveat, in order to better ward off an IRS challenge to the validity of a FLP or FLLC, there should be well-documented valid reasons, other than tax reduction, for forming the entity. There are numerous valid non-tax reasons for forming such an entity, which are beyond the scope of this paper.

[5] *E.g.*, I.R.C. §§ 267 and 318. All references herein to "I.R.C.§" are to the Internal Revenue Code of 1986, as amended.

[6] Rev. Rul. 93-12, 1993-1 CB 202; TAM 9449001 (1994).

[7] Priv. L. Rul. 9436005 (1994) (citing Estate of Winkler v. Comm., 57 T.C.M. 373 (1989).

[8] Estate of Mellinger v. Commissioner, 112 T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15 (1999).

[9] Estate of Nowell v. Commissioner, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15 (1999).

[10] I.R.C. § 2056(b)(7).

[11] A *qualifying income interest for life* is defined as one where the surviving spouse is entitled to all the income from the property payable at least annually, and no person has the power to appoint any part of the property to any person other than the surviving spouse during his or her lifetime. I.R.C. §2056(b)(7)(B)(ii).

[12] I.R.C. §§ 2033 and 2044.

[13] I.R.C. § 2031.

[14] Treas. Reg. § 20.2033-1(a).

[15] I.R.C. § 2041.

[16] I.R.C. §§ 2056(b)(7) and 2044.

[17] Treas. Reg. § 20.2031-1(b) (as mentioned in 1965).

[18] Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).

[19] *See, e.g.*, Estate v. Commissioner, 79 T.C. 938, 952-953 (1982) (minority and marketability discount for stock held by estate) and Estate of Piper v. Commissioner, 72 T.C. 1062 (1979) marketability discount allowed for gifted shares).

[20] Estate of Bright v. Commissioner, 658 F.2d 999 (5th Cir. 1981).

[21] Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982). *Also, see* Estate of Andrews v. Commissioner, 79 T.C. 938 (1982).

[22] Rev. Rul. 93-12, 1993-1 C.B. 202. Previously, the IRS position had been that, in the absence of family discord, a minority discount would not be allowed for transfers of stock in a corporation to family members where such members controlled the corporation. Riv. Rul. 81-253, 1981-2 C.B. 187.

[23] Propstra v. United States, 680 F.2d 1248, 1251 (9th Cir. 1982).

[24] *Id.*

[25] *E.g.*, I.R.C. §§267 and 318.

[26] It is not clear why the IRS asserted that the assets in the revocable Harriet Trust were included in the deceased's gross estate under I.R.C. § 2033 rather than I.R.C. § 2038, which deals with revocable transfers. In this regard, *see* Estate of Nowell, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15, discussed later in this article, where the revocable trust was included in the deceased's gross estate under I.R.C. § 2038. It may be speculated that the transfer to the Harriet Trust was deemed to come from the family trust (or from Mr. Mellinger who founded the company) thus making I.R.C. § 2038 technically inapplicable since this section requires a transfer by the decedent. In any event, it appears that if a person can revoke a trust, and dies holding that power, that person has a beneficial interest in the property in the trust requiring estate inclusion under I.R.C. §2033 of the property in the trust, despite the fact that the person did not transfer such property to the trust.

[27] Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS 4, *19

[28] Technical Corrections Act of 1982, Pub. L. 97-448, sec. 104(a)(1)(B), 96 Stat. 2365, 2380.

[29] In general, the marital deduction is not allowed if the interest passing to the surviving spouse is a life estate or other terminal interest. I.R.C. § 2056(b).

[30] I.R.C. § 2032 generally permits the value of the gross estate to be valued, if the executor so elects, at a value 6 months after the decedent's death.

[31] Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS 4, *21. *Cf.* I.R.C. §§ 2035, 2036, 2038, 2041 (these section require inclusion in the gross estate because the decedent controlled the assets sometime during his or her life).

[32] Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS4, *23.

[33] *Id.* at *26.

[34] Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996).

[35] *Id.* at 199.

[36] *See, also,* Reg. § 20.2040-1 (1958).

[37] A different rule applies to property held jointly by a decedent and a spouse. Here, only one-half the value there of is included in the estate of the decedent. However, a marital deduction is allowed for such one-half since it passes to the survivor.

[38] Estate of Mellinger v. Commissioner, 112 T.C. No. 4m 1999 U.S. Tax Ct. LEXIS 4, *26

[39] Estate of Davis v. Commissioner, 110 T.C. 530, 540 (1988).

[40] Ahamanson Found. v. United States, 674 F.2d 761, 769 (9th Cir. 1981).

[41] Reg. § 20.2031-2(b)(1) (as amended in 1992).

[42] Reg. § 20.2031-2(e) (as amended in 1992).

[43] Estate of Horne v. Commissioner, 720 F.2d 1114, 1117 (9th Cir. 1983), *affg.* 78 T.C. 728 (1982).

[44] Rockwell v. Commissioner, 512 F.2d 882, 885 (9th Cir. 1975), *affg.* T.C. Memo. 1972-133.

[45] Parker v. Commissioner, 86 T.C. 547, 561 (1986).

[46] IT&S of Iowa v. Commissioner, 97 T.C. 496, 508 (1991).

[47] Casey v. Commissioner, 38 T.C. 357, 381 (1962).

[48] Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980).

[49] Parker v. Commissioner, 86 T.C. 547, 561 (1986).

[50] Estate of Davis v. Commissioner, 110 T.C. 530, 538 (1998).

[51] Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS 4, *30-32.

[52] *Id.* at *32-33.

[53] *Id.*

[54] This approach was rejected by the expert since he concluded it would take seven years to liquidate the stock, which he concluded was inadequate.

[55] Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999U.S. Tax Ct. LEXIS 4, *37-39.

[56] *Id.* at *39.

[57] *Id.* at *40.

[58] *Id.* at *41.

[59] The case does not explain the nature of the relationship between Nancy, David and Diane, and one is thus left to speculate as to what it was. Were they necessarily husband, wife and daughter?

[60] The case does not explain the reason for the two QTIP trusts. One may speculate, however, that two trusts were set up for generation skipping tax purposes. David was the beneficiary f the non-exempt QTIP trust, while Diane, the granddaughter of the deceased, and thus a *skip person,* was the ultimate beneficiary of the exempt QTIP trust. Most likely, a sufficient amount of generation skipping tax exemption was allocated to the exempt QTIP trust so that it had an *inclusion ratio* of zero, which meant that upon the death of the deceased the resulting *taxable termination* would not result in any generation skipping tax.

[61] I.R.C. § 2056(b)(7).

[62] I.R.C. § 2038.

[63] I.R.C. § 2044.

[64] Estate of Nowell, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15, *12.

[65] *Id.* at *13.

[66] *Id.* at *14.

[67] Estate of Nowell, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15, *14 (citing Propstra v. United States, 680 F.2d 1248, 1250 (9th Cir. 1982); *see, also,* Ahmanson Foundation v. United States, 674 F. 2d 761, 769 (9th Cir. 1981).

[68] *Id.* at *15.

[69] *Id.*

[70] *Id.* *17.

[71] *Id.* *18.

[72] *See, e.g.,* Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981) and United States v. Land, 303 F.2d 170 (5th Cir. 1962).

[73] This may be contrasted with a situation where a father *gives* each of his four children 25% interests. Here, minority interests are being transferred and discounts would be appropriate since, as previously noted, the IRS has conceded the family attribution issue. *See,* TAM 9449001 (March 11, 1994).

[74] A transfer of an interest in a FLP or a FLLC owning real estate should be valued lower than a transfer of an undivided interest in the real estate itself since a partner or member has no right to bring a partition action.