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## Case Comments

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## CASE COMMENTS

SECURITIES REGULATION — CLASS ACTIONS — COMMON QUESTIONS OF MISREPRESENTATION PREDOMINATE OVER INDIVIDUAL QUESTIONS OF RELIANCE — PUNITIVE DAMAGES ARE NOT RECOVERABLE UNDER THE SECURITIES EXCHANGE ACT OF 1934.—The Wolf Corporation [Wolf] was organized in January, 1961 as a consolidation of various real estate limited partnerships syndicated by their general partners. In February, 1961, Wolf filed a registration statement and its first prospectus with the Securities and Exchange Commission. These covered Wolf's Class A common stock and its subordinated debentures, and became effective on June 2, 1961. Under this registration statement Wolf sold 60,000 shares of Class A common stock to the public at a price of \$10 per share, and offered 746,350 common shares plus \$2,808,000 of its debentures to the limited partners of the syndicated partnerships. In January of 1962, Wolf filed a second registration statement and prospectus which covered an additional issue of the corporation's Class A common stock and its subordinated debentures. Six months later Wolf amended its second registration statement to cover a different combination of securities and a third prospectus was prepared accordingly. The SEC began an investigation of Wolf in July, 1962. On September 24 of that year, the SEC instituted stop-order proceedings against Wolf's second registration statement on the ground that it contained allegedly untruthful statements, including inaccuracies in the amount of cash Wolf claimed was available for distribution to stockholders. In a decision dated May 4, 1966, the SEC found that Wolf's second registration statement was materially misleading. However, the SEC accepted Wolf's offer to withdraw the second registration statement and the second and third prospectuses upon the condition that all stockholders, and all other persons who received preliminary prospectuses, would be advised of the SEC's proceeding.<sup>1</sup> Because of the SEC stop-order action and Wolf's withdrawal in settlement, no securities were sold pursuant to the second registration statement.<sup>2</sup>

Leon Green purchased 100 shares of Wolf stock in the open market at \$10.25 a share on June 13, 1962, shortly after the third prospectus was issued.<sup>3</sup> Green brought an action against Wolf<sup>4</sup> pursuant to section 10b of the Securities

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1 A strong consideration behind the SEC's decision to consent to Wolf's offer of settlement was the fact that shareholders and all public investors would "have available to them the dismal record of the abortive financial program and the deceptive financial presentation of the registrant's [Wolf] earlier record of operations . . ." Brief for Appellant at 9, *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968).

2 Even though no stock was sold pursuant to the second and third prospectuses, the complaint alleged that the dissemination of all prospectuses in the financial community caused a subsequent inflation in Wolf securities. Brief for Appellees at 5, *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968).

3 Prior to June, 1961, Green had purchased for \$3,500 an interest in one of the limited partnerships which was consolidated into Wolf. According to the exchange offer covered by the first registration statement, Green exchanged this interest in the limited partnership for 350 shares of Wolf's Class A common stock and \$777 in company bonds. However, these securities were not the basis of the action. Brief for Appellant at 5, *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968).

4 In addition to Wolf Corporation, the other defendants named were Joseph Wolf, Joseph Eckhaus, and Leon Spilky (the controlling directors, officers and stockholders of Wolf Corporation); David Berdon & Co. (the public accounting firm which certified various financial

Exchange Act of 1934<sup>5</sup> and rule 10b-5,<sup>6</sup> on behalf of himself and all others who had purchased common stock or subordinated debentures of Wolf between June 2, 1961 and the end of 1963. He claimed that the item "Cash Available for Distribution to Shareholders" in the balance sheet incorporated in each prospectus was overstated and tended to artificially inflate the price of Wolf stock. Green alleged that he and the other members of his class relied on this misrepresentation in purchasing their securities. He sought to recover for the class the difference between the price paid and the unmanipulated value of Wolf stock,<sup>7</sup> plus possible punitive damages. In the United States District Court for the Southern District of New York, Judge Ryan ordered those portions of the complaint which asserted Green was maintaining the suit as a class action and those which sought punitive damages to be stricken from the pleadings. On appeal from that order, the United States Court of Appeals for the Second Circuit *held*: individual questions of reliance do not predominate over common questions of misrepresentations and therefore a class action could be maintained, but section 28(a) of the Securities Exchange Act of 1934 prohibits the recovery of punitive damages. *Green v. Wolf Corporation*, 406 F.2d 291 (2d Cir. 1968).

The effectiveness of civil remedies for defrauded investors is largely dependent upon the availability of the class action device.<sup>8</sup> The class action is essentially a creature of necessity which, in allowing one or more members of a class to bring an action on behalf of the entire class, serves the important

statements contained in the three prospectuses); and Troster, Singer & Co. (the broker-dealer who was the underwriter with respect to the corporation's second registration statement). These other defendants were charged with controlling and/or aiding and abetting Wolf Corporation in artificially and falsely inflating the market price of the corporation's securities. *Id.* at 7.

<sup>5</sup> Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891 (1934), 15 U.S.C. § 78j (1964), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

<sup>6</sup> SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

<sup>7</sup> Green claimed the unmanipulated value of Wolf Class A common was between 1 and 2½. This was the price range of the stock from the end of 1963 until November, 1967 when the defendants moved that the class action and punitive damages allegation be struck from the complaint. *Green v. Wolf Corp.*, 406 F.2d 291, 295 (2d Cir. 1968).

<sup>8</sup> 3 L. LOSS, *SECURITIES REGULATION* 1819 (2d ed. 1961).

function of providing claimants with a method of obtaining redress for claims that would otherwise be too small to warrant individual litigation.<sup>9</sup> This function is clearly served when the investor utilizes the class action device in claiming injury for a violation of the anti-fraud provisions of the federal securities laws.<sup>10</sup> Continued expansion of implied civil remedies under the securities laws<sup>11</sup> increases the importance and use of the class action.

The class action is not new to securities fraud suits<sup>12</sup> or even to actions pursuant to rule 10b-5.<sup>13</sup> While the federal courts in the past have tended to be overly restrictive in applying the class action rule,<sup>14</sup> a trend of liberality in interpreting Federal Rule of Civil Procedure 23 is clearly evident in two recent court of appeals decisions. In *Eisen v. Carlisle & Jacquelin*,<sup>15</sup> the Second Circuit conditionally permitted the maintenance of a class action where the class numbered 3,750,000 persons, but was represented by only one person who claimed a mere \$70 damage. The *Eisen* court refused to follow past cases decided under the old Rule 23 which had relied on quantitative elements in determining adequacy of representation. It recognized that the usefulness of the class action procedure would be greatly curtailed unless a liberal interpretation was given to Rule 23.<sup>16</sup> More germane to the securities fraud situation was the Tenth Circuit's decision in *Esplin v. Hirschi*.<sup>17</sup> In an action pursuant to section 10b of the Securities Exchange Act of 1934 and rule 10b-5, and the 1940 Investment Act, the court of appeals expressed the guiding principle that when class actions are viewed in the context of securities laws, "the interests of justice require that in a doubtful case . . . any error . . . should be committed in favor of allowing the class action."<sup>18</sup>

In line with the general thought of these opinions, *Green v. Wolf Corporation*<sup>19</sup> continued the trend of liberal interpretation of Rule 23 by delineating the broad scope of authority which the district court can and must exercise to insure flexible management of a class action in a 10b-5 suit.<sup>20</sup> Before the Second Circuit

9 Kalven & Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 714 (1941).

10 As stated in *Dolgow v. Anderson*, 43 F.R.D. 472 (E.D.N.Y. 1968): "There can be little doubt that an action on behalf of a group of defrauded securities purchasers presents a particularly appropriate reason for a class action." *Id.* at 488. See also Comment, *Adequate Representation, Notice and the New Class Action Rule: Effectuating Remedies Provided by the Securities Laws*, 116 U. PA. L. REV. 889, 890 (1968).

11 See generally 2 Loss, *supra* note 8, at 932-42. The first case to establish civil liability under rule 10b-5 was *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). For a collection of the cases which have adopted the *Kardon* doctrine, see Note, *Measurement of Damages in Private Actions under Rule 10b-5*, 1968 WASH. U.L.Q. 165 n.2.

12 See, e.g., *Escott v. BarChris Constr. Corp.*, 340 F.2d 731 (2d Cir. 1965); *Oppenheimer v. F.J. Young & Co.*, 144 F.2d 387 (2d Cir. 1944).

13 See, e.g., *Hohmann v. Packard Instrument Co.*, 399 F.2d 711 (7th Cir. 1968) (new Rule 23); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) (old Rule 23).

14 Note, *Class Action Treatment of Securities Fraud Suits Under the Revised Rule 23*, 36 GEO. WASH. L. REV. 1150, 1168 (1968).

15 391 F.2d 555 (2d Cir. 1968).

16 *Id.* at 563. The flexibility of Rule 23's notice provisions is analyzed in an interesting comment on *Eisen* in 44 NOTRE DAME LAWYER 151 (1968).

17 402 F.2d 94 (10th Cir. 1968), *cert. denied*, 37 U.S.L.W. 3355 (U.S. March 24, 1969).

18 *Id.* at 101.

19 406 F.2d 291 (2d Cir. 1968).

20 The striking of the class action allegation from *Green's* complaint was immediately appealable because for all practical considerations that would terminate the suit. In *Eisen v. Carlisle & Jacquelin*, 370 F.2d 119 (2d Cir. 1966), *cert. denied*, 386 U.S. 1035 (1967), an

would endorse the maintenance of a class action, all four of the prerequisites of Rule 23(a) had to be satisfied plus one of the three conditions listed in Rule 23(b).<sup>21</sup> Both Rule 23(a)(1) and Rule 23(a)(4) were easily fulfilled. There were over 2,000 members in the class represented by Green, so the joinder of all would be impracticable according to 23(a)(1).<sup>22</sup> Also, the lack of any conflict of interest between Green and the other members of the class, along with the exhibited competence of Green's counsel, met the standards of 23(a)(4).<sup>23</sup> Satisfying the prerequisites of Rule 23(a)(3), requiring that Green's claims be typical of the claims of the class, and Rule 23(a)(2), requiring the presence of questions of law or fact common to the class, presented more difficulty. However, the presence of these difficulties provided the occasion for the Second Circuit to illustrate the flexibility inherent in Rule 23.

Although some of the class had acquired their securities in 1961 under the first prospectus, Green did not purchase his shares of Wolf stock until after the third prospectus had been issued in June of 1962. This raised the logical contention that Green's claim may have been based on different elements of misrepresentation than some of the claims of the other class members. Yet this possible defect, standing alone, would not bar Green's class action because Rule

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order dismissing a class action was considered "final" within the practical rather than technical construction of 28 U.S.C. § 1291, which provides that courts of appeals have jurisdiction of appeals from all final decisions of the district courts. *Id.* at 120. The costly and complex litigation required in a 10b-5 action would prohibit Green from continuing his action for the recovery of an individual claim of less than \$1,000.

21 FED. R. CIV. P. 23 provides in part:

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

22 *Green v. Wolf Corp.*, 406 F.2d 291, 298 (2d Cir. 1968).

23 The two primary ingredients that enable one to be termed an adequate representative of a class were listed by Judge Medina in *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555 (2d Cir. 1968), as (1) representation by a qualified attorney, and (2) complete absence of any interests antagonistic to those of the absent members of the class. *Id.* at 562.

23(c)(4)<sup>24</sup> allows the division of a class into subclasses "[w]here a class is found to include subclasses divergent in interest . . ."<sup>25</sup> It has been recognized that in order to effectuate the purpose of the securities laws, "courts should employ the full measure of the discretion granted by the Rule, whenever a fair reading of the complaint permits, to define classes of injured investors in a manner which will permit utilization of the class action procedure."<sup>26</sup> Also, it was evident that dual grounds of commonality did exist between Green and all the other members of the class. In each prospectus the major portion of the overstated amount was traced to the misrepresentation in one account — that of Tidelands Motor Inn.<sup>27</sup> Besides this common question in regard to Tidelands, the Second Circuit found that the interrelated misrepresentations in all three prospectuses were indicative of Wolf engaging "in a common course of conduct designed to continually manipulate the market price of Wolf stock."<sup>28</sup> This common scheme ingredient, which was sometimes used under old Rule 23,<sup>29</sup> was approved under new Rule 23 in *Fischer v. Kletz*.<sup>30</sup> In that decision, the corporate defendant had falsely overstated its earnings and revenue in seven financial statements over a two year period with the result of inflating the value of the company's securities. The federal court for the Southern District of New York concluded that the issuance of "a series of false and misleading statements based on cumulative and interrelated data" constituted a common course of conduct which met the common question requirement.<sup>31</sup>

The other, and perhaps the greater, obstacle to the maintenance of a 10b-5 class action was meeting the standards of Rule 23(b). Subdivision b(3), the alternative condition utilized in 10b-5 suits, requires the court to find that common questions of fact or law predominate as to all members of the class and that a class action is superior to alternative ways of conducting the litigation.<sup>32</sup>

In determining the predominance of common over individual questions, the critical test appears to be whether there is "material variation" in elements like the representations made by the defendants to different members of a plaintiff class or the degrees of reliance by members of the class.<sup>33</sup>

Prior to *Green* there had been some conflict at the district court level as to whether varying degrees of individual reliance would defeat the predominance of the common questions.<sup>34</sup> The majority of the decisions appeared to express

24 FED. R. CIV. P. 23(c)(4) provides:

When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

25 Advisory Committee's Note, Proposed Rules of Civil Procedure No. 23, 39 F.R.D. 98, 106 (1965).

26 *Dolgow v. Anderson*, 43 F.R.D. 472, 492 (E.D.N.Y. 1968).

27 *Green v. Wolf Corp.*, 406 F.2d 291, 299-300 (2d Cir. 1968).

28 *Id.* at 300.

29 *E.g.*, *Harris v. Palm Springs Alpine Estates, Inc.*, 329 F.2d 909, 914 (9th Cir. 1964).

30 41 F.R.D. 377 (S.D.N.Y. 1966).

31 *Id.* at 381.

32 FED. R. CIV. P. 23(b)(3), quoted in full at note 21 *supra*.

33 A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10B-5* § 11.6, at 257-58 (1968).

See also Advisory Committee's Note, *supra* note 25, at 103.

34 Compare *Mersay v. First Republic Corp. of America*, 43 F.R.D. 465 (S.D.N.Y. 1968), *Fischer v. Kletz*, 41 F.R.D. 377 (S.D. N.Y. 1966), *Kronenberg v. Hotel Governor Clinton*,

the notion that the common issues in class actions need not be dispositive of the entire litigation.<sup>35</sup> *Green* openly confirmed this view when it found that the common questions of misrepresentation were predominant over individual questions of reliance.<sup>36</sup> By recommending the use of "split trials,"<sup>37</sup> the court substantively applied Rule 23(c)(4) which provides that an action may be maintained as a class action to particular issues only. This recommendation also recognized the court's power to make appropriate orders "to prevent undue repetition or complication in the presentation of evidence or argument . . . ."<sup>38</sup>

The procedure that would be followed in settling the remaining individual questions is best explained by the Advisory Committee's Note to Rule 23:

[I]n a fraud or similar case the action may retain its "class" character only through the adjudication of liability to the class; the members of the class may thereafter be required to come in individually and prove the amounts of their respective claims.<sup>39</sup>

Therefore, such questions as damages and reliance could be individually determined after a proper resolution of the common questions. While the *Green* court did not verify defendant's contention that proof of reliance by each member of the class is necessary for every 10b-5 action, it affirmed the belief that reliance is at least lurking in the background.<sup>40</sup> Assuming that reliance exists in every 10b-5 case, the court necessarily had to conclude that individual questions of reliance were subservient to the common questions. Otherwise, the only effective means of attaining civil relief in a 10b-5 suit — the class action — would be foiled. In addition, the Second Circuit had already admitted that suits involving section 10b of the Securities Exchange Act of 1934 and rule 10b-5, "though often involving separate consideration of the elements of misrepresentation and reliance as they affect individual members, have also been accorded treatment as class actions under the new rule [23]."<sup>41</sup>

The superiority of the class action over other methods available for a fair and efficient adjudication of the controversy — admittedly the most important requirement to be met under a subdivision b(3) class action — was the last issue to be analyzed by the *Green* court. The court agreed with the Seventh Circuit's conclusion in *Hohmann v. Packard Instrument Co.*<sup>42</sup> that the most relevant question in determining the superiority of the class action procedure is the size of the class.<sup>43</sup> This formulation of a numbers criterion<sup>44</sup> reflects the

Inc., 41 F.R.D. 42 (S.D.N.Y. 1966), and *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), all of which upheld the maintenance of a class action despite various degrees of reliance by class members, with *Berger v. Puralator Products, Inc.*, 41 F.R.D. 542 (S.D.N.Y. 1966), and *Speed v. Transamerica Corp.*, 5 F.R.D. 56 (D. Del. 1945) (old Rule 23), which denied the class action.

35 See, e.g., *Dolgow v. Anderson*, 43 F.R.D. 472, 490 (E.D.N.Y. 1968).

36 *Green v. Wolf Corp.*, 406 F.2d 291, 300 (2d Cir. 1968).

37 *Id.* at 301.

38 FED. R. Civ. P. 23(d)(1).

39 Advisory Committee's Note, *supra* note 25, at 106.

40 *Green v. Wolf Corp.*, 406 F.2d 291, 301 (2d Cir. 1968).

41 *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555, 565 (2d Cir. 1968).

42 399 F.2d 711 (7th Cir. 1968).

43 *Green v. Wolf Corp.*, 406 F.2d 291, 301 (2d Cir. 1968).

44 The reliance on the numerical size of the class to determine the superiority of the class action device over the available alternatives of joinder, intervention, consolidation, and the

purpose of the class action — especially the b(3) type. Concerning Rule 23(b)(3), the Advisory Committee's Note states: "Subdivision(b)(3) encompasses those cases in which a class action would achieve economies of time, effort, and expense, and promote uniformity of decisions as to persons similarly situated, without sacrificing procedural fairness or bringing about other undesirable results."<sup>45</sup> These economies are directly proportioned to the number of claims or possible suits the class action device will settle. For plaintiff Green, a class membership of over 2,000 made the class action his most feasible device.

The superiority of the class action in *Green* over the alternatives of joinder, intervention, consolidation, and the test case stands out even more when the class action is considered as furthering the objectives of the federal securities laws. It is acknowledged that there is a need for private action in the securities field because civil relief supplements any SEC action "by both affording relief to those injured by violations of the securities laws and serving as a deterrent to future wrong-doing."<sup>46</sup> When this is coupled with the fact that the class action is practically the sole method of civil relief in securities violations,<sup>47</sup> no cogent argument can be proposed to refute the contention that it is the superior technique to be employed. The knowledge that investors possess a group remedy against a securities law violator acts as a practical check on many securities abuses.<sup>48</sup> But this prophylactic function can only be effective when courts liberally construe Rule 23's provisions to allow optimum use of the class action. *Green* is a prime example of a court's liberal interpretation of Rule 23 and utilization of that Rule's inherent flexibility to better serve the function of a class action in a securities fraud suit.

After a favorable determination on the class action issue, the Second Circuit turned to the question of the punitive damages. However, unlike the striking of the class action allegation, the striking of the punitive damages portion of the complaint would not have terminated the litigation.<sup>49</sup> Thus, the order was not immediately appealable.<sup>50</sup> Nevertheless, since a favorable opinion on the class action allegation was rendered, the court provided guidelines to the district court on the punitive damages issue in order to avoid the attendant expense and delay of a possible retrial.<sup>51</sup> Following the almost unanimous principle of prior district

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test case should not be confused with the recent holding in *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555 (2d Cir. 1968), which denounced reliance on quantitative elements as a factor in determining the "adequacy of representation" [Rule 23(a)(4)] of the representative of the class.

45 Advisory Committee's Note, *supra* note 25, at 102-03.

46 *Dolgow v. Anderson*, 43 F.R.D. 472, 484 (E.D.N.Y. 1968).

47 See text accompanying note 8 *supra*.

48 Hornstein, *Legal Therapeutics: The "Salvage" Factor in Counsel Fee Awards*, 69 HARV. L. REV. 658, 662-63 (1956).

49 This point is discussed at note 20 *supra*.

50 The court relied on *Harvey Aluminum v. International Longshoremen's Union, Local 8*, 278 F.2d 63 (9th Cir. 1960), which held that an order striking from the complaint the allegations praying for punitive damages was not a final order or decision within the meaning of section 1291 of Title 28 of the United States Code. *Id.*

51 *Green v. Wolf Corp.*, 406 F.2d 291, 302 (2d Cir. 1968).



court cases<sup>52</sup> and legal authorities,<sup>53</sup> the court of appeals interpreted section 28(a)<sup>54</sup> of the 1934 law as precluding recovery of punitive damages in all Exchange Act suits.

The most recent and elaborate judicial expression of punitive damages in relation to securities law violation was noted in *Globus v. Law Research Service, Inc.*<sup>55</sup> Although that case was the first<sup>56</sup> to award punitive damages under the Securities Act of 1933,<sup>57</sup> it contained pertinent dicta on section 28 of the Securities Exchange Act of 1934. In interpreting section 28, the district court judge believed that

the second clause of § 28(a) . . . should be read only as indicating that in no event shall double compensatory damages be recovered by reason of the fact that plaintiff alleges alternative theories for relief . . . and that *punitive or exemplary damages are not recoverable for violations of the Securities Exchange Act of 1934.*<sup>58</sup> (Emphasis added.)

The result in *Green* is consistent with this dictum from *Globus*. However, there are statements in *Green* which hint at a limitation on the scope of the *Globus* holding. The Second Circuit thought the policies behind punitive damages were not being furthered by allowing such awards in a 10b-5 suit.<sup>59</sup> "Punitive damages can be justified only as retribution or as a deterrent measure."<sup>60</sup> The imposition of punitive damages upon a publicly held corporation fulfills little retributive function because many innocent shareholders bear the burden. Any statement to the effect that punitive damages perform a deterrent function upon 10b-5 violations must be analyzed in the context of the Exchange Act. Section

52 *E.g.*, *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). ("[T]he only effect of this provision [section 28(a)] is to prohibit punitive damages . . . *Id.* at 748"); *Pappas v. Moss*, 257 F. Supp. 345 (D.N.J. 1966), *rev'd on other grounds*, 393 F.2d 865 (3rd Cir. 1968) ("The corporation's actual damages are recoverable. . . . No punitive damages are recoverable." *Id.* at 364.); *Meisel v. North Jersey Trust Co.*, 216 F. Supp. 469 (S.D.N.Y. 1963) ("The narrow point raised by the motion is whether punitive damages may be recovered . . . [T]he Act expressly provides in section 28, 15 U.S.C. § 78bb, that a plaintiff may never recover more than his 'actual damages.'" *Id.*).

53 *E.g.*, *BROMBERG*, *supra* note 33 ("Section 28(a) does preclude punitive damages." *Id.* § 9.1, at 229); 3 *Loss*, *supra* note 8 ("But § 28(a) of the 1934 act has been held to rule out exemplary damages." *Id.* at 1624 n.5.); Comment, *Private Remedies Available Under Rule 10b-5*, 20 Sw L.J. 620 (1966) ("Thus, any recovery of exemplary damages in a 10(b) action is precluded. . . . [R]ights of action under the Exchange Act are 'remedial' and not 'penal' in nature." *Id.* at 624).

54 Section 28(a) of the Securities Exchange Act of 1934, 48 Stat. 903 (1934), 15 U.S.C. § 78bb (1964), reads:

(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provision of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

55 287 F. Supp. 188 (S.D.N.Y. 1968).

56 54 VA. L. REV. 1560, 1565 (1968).

57 48 Stat. 74 (1933), 15 U.S.C. §§ 77a-77aa (1964).

58 *Globus v. Law Research Service, Inc.*, 287 F. Supp. 188, 196 (S.D.N.Y. 1968).

59 *Green v. Wolf Corp.*, 406 F.2d 291, 303 (2d Cir. 1968).

60 *Id.*

32<sup>61</sup> of the Securities Exchange Act of 1934 imposes criminal sanctions upon violators of the Act. The possibility of confinement or stigma of a criminal record are greater deterrents to wrongful conduct than the mere imposition of monetary sanctions.<sup>62</sup> In addition to the criminal penalties, express or implied civil actions are available. Through such devices as the class action and the shareholder's derivative suit, large claims can be recovered against violators. As pointed out earlier, this in itself serves as a deterrent to securities abuses.<sup>63</sup> But neither the criminal sanctions nor the group civil remedy devices are limited to the 1934 Act. They are both also used under the 1933 Act.<sup>64</sup> Thus the policy of allowing punitive damages would seem to serve no real function in these securities fraud actions, regardless of whether they are decided under the 1933 or 1934 securities laws.

There is language in *Globus* to the effect that punitive damages will aid in deterring fraud generally in the sale of securities: "An award of punitive damages as a means of deterring fraudulent conduct of a heinous character, such as was found by the jury here, also accords with the overall purpose of the anti-fraud provisions of the 1933 Act."<sup>65</sup> *Green* rejected the theory that punitive damages can be an effective third tier deterrent behind criminal sanctions and group civil remedies.<sup>66</sup> It is submitted that since the federal courts have the power to determine the availability of possible remedies in an implied cause of action,<sup>67</sup> the *Green* decision may influence some courts to limit *Globus* to those situations where either group civil remedies are unavailable or where an award of punitive damages can have a direct, personal retributive effect on the securities law violator.

Thomas J. DeLuca

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UNFAIR COMPETITION — FEDERAL TRADE COMMISSION ACT — THE FEDERAL TRADE COMMISSION LACKS JURISDICTION OVER NONPROFIT CORPORATIONS ORGANIZED FOR AND ACTUALLY ENGAGED IN BUSINESS FOR ONLY CHARITABLE PURPOSES. — A commercial blood bank commenced operation in Kansas City, Missouri in May, 1955 under the name of Midwest Blood Bank and Plasma Center [Midwest].<sup>1</sup> Midwest's objective was to serve as a central supplier of human whole blood on a profit making basis for the numerous hospitals in the Kansas City area. At the time, most of the area hospitals operated their own individual banks or borrowed from others. However, the increasing

61 48 Stat. 904 (1934), as amended, 15 U.S.C. § 78ff (1964).

62 Note, *The Imposition of Punishment by Civil Courts: A Reappraisal of Punitive Damages*, 41 N.Y.U. L. REV. 1158, 1161-62 (1966).

63 See text accompanying note 48 *supra*.

64 Section 24 of the Securities Act of 1933, 48 Stat. 87 (1933), 15 U.S.C. § 77x (1964), imposes criminal sanctions. For an example of the group civil remedies under the 1933 Securities Act, see *Escott v. BarChris Constr. Corp.*, 340 F.2d 731 (2d Cir. 1965).

65 *Globus v. Law Research Service, Inc.*, 287 F. Supp. 188, 194 (S.D.N.Y. 1968).

66 *Green v. Wolf Corp.*, 406 F.2d 291, 303 (2d Cir. 1968).

67 See 54 VA. L. REV. 1560, 1562-63 & n.7 (1968).

1 This statement of facts is taken from the Initial Decision of the Hearing Examiner, Record, vol. 1, at 107-277, *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011 (8th Cir. 1969).

demands for blood rendered this system unsatisfactory. The dissatisfaction had been recognized by the Jackson County Medical Society. Prior to the opening of Midwest in 1955, the Society had attempted to generate support for the establishment of a nonprofit community blood bank to serve the needs of the area hospitals. Discussions were instituted with the Kansas City Area Hospital Association [AHA]<sup>2</sup> as early as 1953, but little progress had been made by the time Midwest commenced operations. The commercial blood bank was viewed unfavorably in Kansas City medical circles because of an aversion to the idea of "trafficking" in blood and a feeling that the personnel and procedures used at Midwest were substandard. Because of this feeling there were incidents involving refusals by individual hospitals in the area to accept delivery of blood from Midwest.

In early 1956, various interested groups in the community — AHA, Jackson County Medical Society, area pathologists, hospital administrators, members of the medical profession and prominent citizens — finally agreed that a community blood bank would be the best solution to the area's blood needs. A nonprofit corporation was organized under the name of Community Blood Bank of the Kansas City Area, Inc. [Community] and it commenced operations in April, 1958. Because of its local origins and support,<sup>3</sup> Community was able to acquire the affiliation of all but a few of the area hospitals by 1962. The practical effect of this arrangement was that most of the hospitals dealt exclusively with Community for their blood needs to the detriment of Midwest and its successor, World Blood Bank [World]. During the period from 1958 to 1962 incidents continued to occur in which area hospitals and Community refused to accept delivery of blood from Midwest and World as a replacement for blood used by hospital patients who had blood supplier contracts with Midwest and World. The reasons given were the alleged substandard quality of blood issued by Midwest and World and their failure to adhere to the blood delivery rules of the North Central Blood Bank Clearing House.<sup>4</sup>

On July 5, 1962, the Federal Trade Commission issued a complaint<sup>5</sup> against Community, a nonprofit corporation, and its officers, directors and agents; AHA, a nonprofit corporation, and its officers, directors, agents and certain

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2 The Kansas City Area Hospital Association is a nonprofit corporation composed of individual area hospitals that are volunteer participants in the Association. It is funded by loans, grants, gifts, and dues from member hospitals. It serves as an agency to make studies and to survey, collect, integrate and analyze data in the field of hospital activities in the Kansas City area. Such studies are supplied to about 1,000 agencies including hospitals, city and state officials, United States Public Health Service, etc. *Id.* at 133.

3 The governing body of Community is composed of thirty-nine directors. Groups of thirteen are chosen from the medical profession in Kansas City, AHA (representatives of area hospitals), and public figures from outside the medical profession. *Id.* at 114-15.

4 Blood bank clearing houses are similar to monetary clearing houses. All member blood banks deal through the clearing house when forwarding blood or receiving it from other banks. This way a bank only has one account with the clearing house rather than individual accounts with every bank with which it deals. Member banks are not supposed to ship blood directly to each other unless ordered to do so by the clearing house. Petitioners alleged that the failure of Midwest and World to use these procedures when delivering blood was one of the reasons that the deliveries were refused. *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011, 1014 n.4 (8th Cir. 1969).

5 Record, vol. 1, at 2, *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011 (8th Cir. 1969).

member hospitals; and twenty-six pathologists who were affiliated with hospitals in the Kansas City area [these organizations and individuals will be collectively referred to as "petitioners"]. The Commission alleged that the petitioners had entered into a common course of action to hamper and restrain the sale and distribution of human whole blood in interstate commerce, and that they carried out this combination by committing unfair practices in refusing to deal with Midwest and World between 1955 and 1962. The petitioners challenged the jurisdiction of the Commission on the grounds that the corporate petitioners (Community, AHA, and the hospitals) were nonprofit corporations not within the Commission's jurisdiction, and that the officers, directors, agents, and pathologists were acting solely as representatives of the corporations and thereby were not subject to being named individually.

The jurisdictional challenge was rejected by the Hearing Examiner, who found that the petitioners had engaged in acts that constituted unfair practices under the Federal Trade Commission Act.<sup>6</sup> The Commission agreed with the findings of the Hearing Examiner and issued an order to the petitioners to cease and desist from their unfair methods of competition in refusing to deal with the commercial blood bank.<sup>7</sup> The petitioners then appealed to the United States Court of Appeals for the Eighth Circuit, which set aside the Commission's order and *held*: the Commission was without jurisdiction under section 4 of the Federal Trade Commission Act,<sup>8</sup> because the corporate petitioners were true nonprofit corporations, not engaged in business for profit for themselves or their members. *Community Blood Bank, Inc. v. Federal Trade Commission*, No. 18,645 (8th Cir., Jan. 10, 1969).

Section 5 of the Federal Trade Commission Act<sup>9</sup> states that unfair methods of competition and unfair or deceptive practices in commerce are illegal. It empowers the Commission to prevent the use of such practices<sup>10</sup> by issuing a complaint against any party whom it has reason to believe may be using prohibited practices.<sup>11</sup> If the Commission determines that there has been a violation of the Act it will order the offending party to cease and desist from engaging in unfair methods of competition.<sup>12</sup> A failure to obey such an order would subject the offending party to civil penalties of up to \$5,000 for each violation.<sup>13</sup>

Section 5 contains no delineation of specific acts that constitute unfair competition or unfair practices in restraint of trade. The Commission is left with broad discretion to investigate any and all trade practices and make its own determination of fairness or unfairness based on the circumstances of a particular situation, normal trade practices, and the practical requirements of the business in question.<sup>14</sup> While it does have this broad power to rule on the competitive practices used in commerce, the Commission's authority is limited by the juris-

6 15 U.S.C. §§ 41-58 (1964).

7 *Community Blood Bank, Inc.*, [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,728 (FTC 1966).

8 15 U.S.C. § 44 (1964).

9 15 U.S.C. § 45(a)(1) (1964).

10 15 U.S.C. § 45(a)(6) (1964).

11 15 U.S.C. § 45(b) (1964).

12 *Id.*

13 15 U.S.C. § 45(l) (1964).

14 *FTC v. Motion Picture Advertising Service Co.*, 344 U.S. 392, 396 (1953).

dictional boundaries set out in the Act.<sup>15</sup> The general proposition is that the Commission is empowered to prevent "persons, partnerships, or corporations" from engaging in unfair methods of competition.<sup>16</sup> However, certain groups are exempted from this general proviso, namely, banks, common carriers, air carriers subject to the Federal Aviation Act of 1958,<sup>17</sup> and those parties subject to the Packers and Stockyards Act of 1921.<sup>18</sup> The Commission's jurisdiction is further limited by statutory definition. The Commission has jurisdiction to determine unfair competition charges over "corporations" only to the extent allowed by the definition of that word in section 4 of the Federal Trade Commission Act:<sup>19</sup>

"Corporation" shall be deemed to include any company, trust, so-called Massachusetts trust, or association, incorporated or unincorporated, *which is organized to carry on business for its own profit or that of its members*, and has shares of capital or capital stock or certificates of interest, and any company . . . incorporated or unincorporated, without shares of capital . . . *which is organized to carry on business for its own profit or that of its members.*<sup>20</sup> (Emphasis added.)

This definition raises the question of how the phrase "organized to carry on business for its own profit or that of its members" should be interpreted for the purpose of including corporations within the jurisdiction of the Commission.

In *Community Blood Bank* all of the corporate petitioners (Community, AHA, and the hospitals) were organized as nonprofit charitable corporations under the laws of Missouri and Kansas.<sup>21</sup> Despite this nonprofit form, the Commission made the determination that they were organized to carry on business for their own profit or that of their members within the meaning of section 4. In their appeal to the Eighth Circuit, the petitioners challenged all of the Commission's findings, but their primary contention was that the Commission was without jurisdiction.<sup>22</sup> The court seized upon the jurisdictional issue as foremost in the case, stating the substantive question to be whether "corporation" as defined in section 4 of the Act "embraces any and all nonprofit corporations regardless of their objectives, motives and the results of their operations."<sup>23</sup>

The position taken by the Commission on this point was set out in its decision ordering the petitioners to cease and desist from using unfair practices in

15 The Commission only has such jurisdiction as given it by the Federal Trade Commission Act. *FTC v. Western Meat Co.*, 272 U.S. 554, 559 (1926).

16 15 U.S.C. § 45(a)(6) (1964).

17 49 U.S.C. §§ 1301-1542 (1964).

18 7 U.S.C. §§ 181-229 (1964).

19 15 U.S.C. § 44 (1964).

20 *Id.*

21 *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011, 1013 (8th Cir. 1969).

22 Brief for Petitioners at 52, *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011 (8th Cir. 1969). The petitioners also argued that the Commission lacked jurisdiction over the subject matter on the grounds that human whole blood (living tissue) is not a commodity or article of commerce within the meaning of section 5; that the process of hemotherapy constitutes a medical service; that the evidence failed to establish any common cause of action among the petitioners to restrain interstate commerce in blood; that the proceeding was not in the public interest; and that they had been denied due process in the proceeding. *Id.* at 52-98.

23 *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011, 1015 (8th Cir. 1969).

dealing with Midwest and World.<sup>24</sup> The basic proposition was that the non-profit form of the corporate petitioners did not necessarily take them out of the Commission's jurisdiction. Incorporation under state not-for-profit statutes and federal income tax exemptions were not considered the proper criteria by which to delineate the Commission's jurisdiction over corporations. The test in section 4 for inclusion of a corporation within the jurisdiction of the Commission is phrased in the same terms for a corporation with shares of capital and one without shares of capital (nonprofit) — is it "organized to carry on business for its own profit or that of its members"? Normally, "to carry on business for its own profit" means to realize a pecuniary gain that will inure to the benefit of the corporation or that will be distributed to the member shareholders. However, the Commission felt that the phrase should not be interpreted in its traditional sense when applied to corporations without shares of capital such as the corporate petitioners. This conclusion was based on an interpretation of the history of the definition in section 4, and its application to the modern day commercial structure.

The original definition of "corporation" as contained in section 4 of the Federal Trade Commission Act of 1914<sup>25</sup> distinguished between a corporation with shares of capital and one without shares of capital. A corporation with shares came within the Commission's jurisdiction if "organized to carry on business for profit." A corporation without shares was included if "organized to carry on business for its own profit or that of its members."<sup>26</sup> The Wheeler-Lea Act of 1938<sup>27</sup> amended the definition by making the test the same for both, *i.e.*, "organized to carry on business for its own profit or that of its members." However, the Commission felt that the discrepancy in the original version was significant. There is a fundamental difference between these corporations with and those without shares of capital. The former are in business to realize a "profit" in the generally accepted sense of the word — a pecuniary gain that will be distributed to the shareholders. However, a corporation without shares of capital has no shareholders and therefore it does not distribute "profit." Considering this fundamental difference along with the different tests used in the original version of section 4, the Commission came to the conclusion that

[t]he phrase "organized to carry on business for its own profit . . ." when applied to such a corporation [without capital shares], must, therefore, have a different meaning from the traditional phrase "organized to carry on business for profit," which is applied to corporations having capital stock or shares of capital.<sup>28</sup>

Although the test phrases were worded the same as each other in the amended Act, the Commission gave them different interpretations. In dealing with corporations having shares of capital, the word "profit" would mean pecuniary benefit inuring to the corporation or to be distributed to the shareholders. But

24 Community Blood Bank, Inc., [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,728 (FTC 1966).

25 Ch. 311, § 4, 38 Stat. 719 (1914).

26 *Id.*

27 15 U.S.C. § 44 (1964).

28 Community Blood Bank, Inc., [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,728, at 23,018 (FTC 1966).

as applied to corporations without shares of capital, the Commission interpreted "profit" to mean any income left over after expenditures that was used for the self-perpetuation or expansion of the corporation. Under this interpretation, the corporate petitioners (with no shares of capital) were considered to be in business for "profit" within the meaning of section 4, because they were so organized that any excess income could be used for self-perpetuation or expansion.

The court of appeals took a dim view of the Commission's varying interpretations of the phrase "organized to carry on business for its own profit or that of its members." In the court's opinion,

[n]either the legislative history of the Act nor the language of § 4 supports the Commission's theory that Congress intended that "profit" is to be given different meanings depending upon the character of the corporation under consideration. Additionally, the strained interpretation of the Commission runs counter to the principle "that Congress will be presumed to have used a word in its usual and well-settled sense."<sup>29</sup>

Profit, in its "usual and well-settled sense," means pecuniary benefit inuring to the organization or its members. This was the meaning the Commission gave to the phrase "organized to carry on business for its own profit or that of its members" when applied to a corporation with shares of capital. Since the phrase is worded exactly the same for a corporation without shares of capital, the court felt that it should be interpreted in the same manner. Such a corporation should be within the jurisdiction of the Commission only if it is in business for profit in the traditional and generally accepted meaning of the word.

In reaching this determination, the court went beyond the plain wording of the statute. It also took note of the delineation of jurisdiction over corporations in other antitrust laws. The relevant sections of the Sherman Act<sup>30</sup> and the Clayton Act<sup>31</sup> are structured to encompass all corporations. The Robinson-Patman Act<sup>32</sup> delineates those organizations which are exempt from its provisions — "schools, colleges, universities, public libraries, churches, hospitals, and charitable institutions not operated for profit."<sup>33</sup> In section 4 of the Federal Trade Commission Act, it can be seen that Congress chose to use neither the sweeping inclusion of the Sherman and Clayton Acts nor the specific exclusions of the Robinson-Patman Act. By using the phrase "organized to carry on business for its own profit or that of its members," Congress gave the Commission jurisdiction over all normally commercial organizations and also enabled it to pierce the non-corporate veil of those organizations that are ostensibly nonprofit but are actually being used to serve the pecuniary interests of their directors and members, or

<sup>29</sup> *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011, 1016 (8th Cir. 1969), citing *United States v. Stewart*, 311 U.S. 60, 63 (1940).

<sup>30</sup> 15 U.S.C. § 7 (1964) reads as follows:

The word "person" . . . shall be deemed to include corporations and associations existing under or authorized by the laws of either the United States, the laws of any of the Territories, the laws of any State, or the laws of any foreign country.

<sup>31</sup> 15 U.S.C. § 12 (1964). Section 12 is identical to section 7 of the Sherman Act, which is quoted in full at note 30 *supra*.

<sup>32</sup> 15 U.S.C. § 13(c) (1964).

<sup>33</sup> *Id.*

other corporations.<sup>34</sup> The court saw this as a congressional recognition of the distinction between business corporations and true nonprofit charitable corporations, and as an indication that the latter were to be excluded from the Commission's jurisdiction.<sup>35</sup>

In *Community Blood Bank*, the corporate petitioners qualified as true nonprofit charitable corporations. They were organized solely for charitable and educational purposes, no income was to be distributed to the benefit of any of the members, officers, or directors, and they did not exist as devices or instrumentalities of individuals or firms that sought monetary gain through the use of their nonprofit corporate structure. Therefore, the court did not think that the Commission could acquire jurisdiction over them by giving "profit" an interpretation that would destroy the apparent exclusion of true nonprofit charitable corporations from the Federal Trade Commission Act.

The Commission's contention that the corporate petitioners were embraced within the definition of section 4 was its main basis for assuming jurisdiction. However, the Commission also set out alternative grounds in support of jurisdiction. It stated that even if the corporate petitioners did not come within the section 4 definition of "corporation," it would still be able to adjudicate their participation in the alleged common cause of action against Midwest and World under the doctrine of conspiracy.<sup>36</sup> The Commission would treat the alleged conspiracy among the corporate petitioners as a partnership and proceed against it under the statutory grant of authority over partnerships contained in section 5(a)(6) of the Act.<sup>37</sup>

The court could find no support for this "novel and ingenious" theory asserted by the Commission. The four cases that had been cited by the Commission in support of it were distinguished as irrelevant. Three were criminal prosecutions<sup>38</sup> under antitrust laws other than the Federal Trade Commission Act, and one was an action in equity for an injunction that involved an evidentiary problem.<sup>39</sup> None of the cases involved the specific contention proposed by the Commission — that it had jurisdiction over nonprofit corporations as partners to a conspiracy under the Federal Trade Commission Act.

The Commission also stated that even though it might lack jurisdiction over the corporate petitioners, it still had the power to determine the existence of the alleged conspiracy and the identity of the co-conspirators. Such a determination would not give the Commission jurisdiction over those corporate petitioners found to be conspirators if it otherwise lacked jurisdiction. However,

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34 See *FTC v. Cement Institute*, 333 U.S. 683 (1948); *Chamber of Commerce v. FTC*, 13 F.2d 673 (8th Cir., 1926).

35 *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011, 1018 (8th Cir. 1969).

36 *Community Blood Bank, Inc.*, [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,728, at 23,019 (FTC 1966).

37 15 U.S.C. § 45(a)(6) (1964).

38 These cases, in the order discussed by the court, were: *United States v. Kissel*, 218 U.S. 601 (1910) (involved the question of continuance of a conspiracy for statute of limitation purposes); *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 253-54 (1940) (involved the question of the acts of a conspiracy as binding all the other conspirators in a partnership); *Fiswick v. United States*, 329 U.S. 211 (1946) (decided on the question of the necessity of overt acts as marking the duration and scope of the partnership to conspire).

39 *Hitchman Coal & Coke Co. v. Mitchell*, 245 U.S. 229 (1917) (decided on the issue of admissibility of conspiracy declarations as against each co-conspirator).



the Commission felt that an order could be indirectly enforced against the corporations involved in the conspiracy by enforcing it against the officers, directors, agents and employees of such corporations in their individual capacities.<sup>40</sup> The Federal Trade Commission Act grants the Commission jurisdiction over all "persons" whether or not they are acting for profit.<sup>41</sup> By restraining the individual officers, directors, agents, and pathologists named in the complaint in *Community Blood Bank*, the Commission would be able to effectuate indirect jurisdiction over the nonprofit corporate petitioners. Two cases, *Benrus Watch Co. v. FTC*<sup>42</sup> and *Standard Distributors, Inc. v. FTC*,<sup>43</sup> were cited in support of enforcement of an order against individual directors or officers of corporations.

The court noted a number of distinguishing characteristics between the cited cases and the situation in *Community Blood Bank*. In the cited cases, the Commission had jurisdiction over the named corporations (Benrus and Standard) and had found them to be in violation of the Federal Trade Commission Act. The individual officers were included in the Commission's order because they had been the policy-makers and directors of the offending corporations and had profited by the violations of the Act. The idea was to make the order more effective by including them individually. In *Community Blood Bank*, the court noted that the officers, directors, agents, and pathologists named in the complaint and order were acting entirely in a representative capacity on behalf of the corporate petitioners or other area hospitals (mostly nonprofit organizations) over whom the Commission had no jurisdiction. They were "public spirited" volunteers who derived no personal benefit from the activities of the blood bank. The fact that the Commission had jurisdiction over the corporation in *Benrus* and *Standard* and the consideration of the individuals striving for profit were not present in *Community Blood Bank*. The court reiterated the feelings of dissenting Commissioner Elman on this point:

[T]he distinction made in the Act between corporations acting for profit and nonprofit corporations would be erased if all the Commission had to do, in order to obtain jurisdiction, was to name the officers, directors, and other personnel of a nonprofit corporation as the respondents. . . . Such a result flouts the express policy of Congress of exempting nonprofit corporations from the Commission's jurisdiction.<sup>44</sup>

The decision in *Community Blood Bank* has been acclaimed as "significant"<sup>45</sup> and "an important victory"<sup>46</sup> for nonprofit organizations across the country. That this is so cannot be denied. If the Commission's order had been allowed to stand, a serious blow would have been struck against the efforts of

40 *Community Blood Bank, Inc.*, [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,728, at 23,020 (FTC 1966).

41 15 U.S.C. § 45(a)(6) (1964).

42 352 F.2d 313 (8th Cir. 1965).

43 211 F.2d 7 (2d Cir. 1954).

44 *Community Blood Bank, Inc.*, [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,728, at 23,039 (FTC 1966). See *Community Blood Bank, Inc. v. FTC*, 405 F.2d 1011, 1021 (8th Cir. 1969).

45 *Wall Street Journal*, Jan. 14, 1969, at 8, col. 2.

46 *Kansas City Times*, Jan. 22, 1969, at 28, col. 1.

volunteer blood banks, at a time when blood shortages are increasing.<sup>47</sup> Also, valuable precedent would have been established by which the Commission could have extended its authority over numerous other nonprofit organizations such as hospitals, churches, charities, fraternal orders and the like. However, these are only the more practical considerations underlying the decision, which do not reach to the heart of the legal issues involved.

The basic question in *Community Blood Bank* dealt with the extent to which the Commission would be allowed to expand its jurisdiction in order to prevent unfair methods of competition and illegal combinations in restraint of trade from becoming widespread. The Commission has the power to pierce the nonprofit corporate veil of any so-called nonprofit organizations that are actually organized to carry on business for the benefit of some officers or members.<sup>48</sup> From this premise, the question evolves into whether the Commission can pierce the apparent immunity of a true nonprofit charitable corporation if such a corporation is engaged in unfair practices and conspiratorial activities which contravene established antitrust policies.<sup>49</sup> The Commission's attempt to make such an extension in *Community Blood Bank* has revealed an underlying clash of policy considerations. On one hand there is the policy of enforcement of the antitrust laws to their fullest extent by the Commission. On the other hand, there is the congressional policy of excluding true nonprofit charitable corporations from the Commission's jurisdiction. There may be merit to the Commission's idea that public sponsored projects (such as blood banks, hospitals, etc.) which encourage charitable public participation should not be allowed to engage in unfair practices or methods of competition to the extent that they hinder the growth of legitimate private competitors.<sup>50</sup> However, it would appear from the plain language of section 4 of the Federal Trade Commission Act,<sup>51</sup> and from the Eighth Circuit's interpretation of it in *Community Blood Bank*, that the policy of excluding true nonprofit charitable corporations from the Commission's jurisdiction is the dominant consideration at the present time. The Commission's attempt to override this consideration with an extremely broad and destructive interpretation of rather unambiguous statutory language was a failure. As long as Congress feels that the policy of exclusion of nonprofit organizations should take precedence, the Commission will have to restrict its efforts under the Federal Trade Commission Act to those corporations organized to carry on business for the profit of themselves or their members.

*John G. Bambrick, Jr.*

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47 Wall Street Journal, Jan. 14, 1969, at 8, col. 2.

48 See cases cited in note 34 *supra*.

49 This is not to imply that the petitioners in *Community Blood Bank* were engaged in such activity. Although the Commission found them to be violating section 5 of the Federal Trade Commission Act, this finding was never discussed by the court. (The petitioners contended that the Commission erred in its finding that they were engaged in a common cause of action to hinder Midwest and World. See note 22 *supra*.)

50 *Community Blood Bank, Inc.*, [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,728, at 23,036 (FTC 1966).

51 15 U.S.C. § 44 (1964).

**NEGLIGENCE — PARENT-CHILD — NEW YORK ABROGATES PARENT-CHILD IMMUNITY DOCTRINE.**—Mrs. Adele Gelbman was a passenger in an automobile owned by her and operated by her unemancipated minor son, James. While proceeding along a major thoroughfare in White Plains, New York, the automobile collided with another vehicle and Mrs. Gelbman was seriously injured. She commenced an action against her son James for negligent driving. The insurance company, representing James, interposed as an affirmative defense its contention that the suit was barred by the doctrine of parent-child immunity. Relying upon past decisions of the court of appeals, the trial court dismissed the complaint and the appellate division unanimously affirmed. The New York Court of Appeals reversed the dismissal and *held*: since the reason behind the original adoption of parent-child immunity no longer exists, the doctrine is abolished. *Gelbman v. Gelbman*, 23 N.Y.2d 434, 245 N.E.2d 192, 297 N.Y.S.2d 529 (1969).

It was well established in early English common law that an action would lie between parent and child for a breach of contract, and also in tort for injuries to property.<sup>1</sup> However, for some unknown reason, the issue of whether such an action would lie in tort for personal injuries had never been adjudicated.<sup>2</sup> This exact issue was not raised in American common law until 1891.<sup>3</sup> In that year, the Supreme Court of Mississippi, in the landmark case of *Hewellette v. George*,<sup>4</sup> held that an unemancipated minor child could not sue her parents for the intentional tort of false imprisonment.<sup>5</sup> The Mississippi court made the following unsupported policy declaration which eventually was to snowball into an American common law doctrine:

The peace of society, and of the families composing society, and a sound public policy, designed to subserve the repose of families and the best interests of society, forbid to the minor child a right to appear in court in the assertion of a claim to civil redress for personal injuries suffered at the hands of the parents.<sup>6</sup>

Twelve years later, the theory of parent-child immunity received a tremendous boost when the Tennessee Supreme Court, in *McKelvey v. McKelvey*,<sup>7</sup> declared that the theory was a rule of common law. *Hewellette*, which never purported to announce a common law rule, was the sole support for the Tennessee court's declaration.<sup>8</sup> In 1905, the Washington Supreme Court, in *Roller v. Roller*,<sup>9</sup> expounded upon and polished the reasoning behind the immunity doctrine. The *Roller* court stated:

1 For a collection of authorities on this point, see Comment, *Tort Actions Between Members of The Family — Husband & Wife — Parent & Child*, 26 MO. L. REV. 152, 180 n.146 (1961).

2 *Id.* at 180. See also Annot., 19 A.L.R. 2d 423, 425 (1951).

3 There were, however, three American cases prior to 1891 which dealt with personal injuries inflicted by persons standing in loco parentis. For a discussion of American law in this area prior to 1891, see *Dunlap v. Dunlap*, 84 N.H. 352, 357-58, 150 A. 905, 908 (1930); Annot., *supra* note 2, at 425.

4 68 Miss. 703, 9 So. 885 (1891).

5 *Id.* at 710, 9 So. at 887.

6 *Id.* at 711, 9 So. at 887.

7 111 Tenn. 388, 77 S.W. 664 (1903).

8 *Id.* at 390, 77 S.W. at 664.

9 37 Wash. 242, 79 P. 788 (1905).

The rule of law prohibiting suits between parent and child is based upon the interest that society has in preserving harmony in the domestic relations, an interest which has been manifested since the earliest organization of civilized government, an interest inspired by the universally recognized fact that the maintenance of harmonious and proper family relations is conducive to good citizenship, and therefore works to the welfare of the state.<sup>10</sup>

In refusing to allow the plaintiff to recover against her father for rape, the Washington court unknowingly demonstrated the absurdity which could result from a mechanical application of the rule. The plaintiff argued that the harmonious relation had already been disturbed to its limits and, therefore, the reasons for the immunity rule were totally inapplicable.<sup>11</sup> The court admitted that "[t]here seems to be some reason in this argument,"<sup>12</sup> but stated that "if it be once established that a child has a right to sue a parent for a tort, there is no practical line of demarkation [*sic*] which can be drawn . . . ."<sup>13</sup>

*Hewellette, McKelvey* and *Roller* have been referred to as "the great trilogy upon which the American rule of parent-child tort immunity is based."<sup>14</sup> These three cases created a doctrine which came to be accepted by nearly every jurisdiction in America that considered the issue in the context of negligent personal torts.<sup>15</sup> During this period of assimilation, the original family harmony rationale was buttressed by other policy arguments in favor of the existence of the immunity. These newer rationales could be classified into such categories as "fear of fraud," "depletion of the family exchequer," and "possibility of succession."<sup>16</sup>

Although courts also had begun developing exceptions to the rule,<sup>17</sup> it was not until 1930, in the New Hampshire case of *Dunlap v. Dunlap*,<sup>18</sup> that the immunity was first subjected to an actual frontal attack. In an opinion which has been highly praised<sup>19</sup> and is probably the most well reasoned in the area, the New Hampshire court allowed recovery to an unemancipated minor who was negligently injured while in the employ of his father. *Dunlap* was the first case to recognize that there had never existed a general common law rule that a child could not sue his parent.<sup>20</sup> Instead, the court concluded that the immunity doctrine was the exception to the much broader rule that a "minor has the same right to redress for wrongs as any other individual."<sup>21</sup> Thus, the immunity would exist only when it was in the interest of public policy that a child be disabled from bringing suit rather than because the parent had violated no duty.<sup>22</sup> In the *Dunlap*

10 *Id.* at 243-44, 79 P. at 788.

11 *Id.* at 244, 79 P. at 788.

12 *Id.*

13 *Id.*, 79 P. at 789.

14 Comment, *supra* note 1, at 182.

15 For a list of these cases, see *id.* at 183 n.168.

16 These and other similar reasons are listed and discussed at some length in McCurdy, *Torts Between Persons in Domestic Relation*, 43 HARV. L. REV. 1030, 1072-77 (1930); Comment, *supra* note 1, at 187-93.

17 These exceptions are listed and discussed in Comment, *Child v. Parent: Erosion of The Immunity Rule*, 19 HASTINGS L.J. 201, 206-18 (1967).

18 84 N.H. 352, 150 A. 905 (1930).

19 See, e.g., *Briere v. Briere*, 107 N.H. 432, 433, 224 A.2d 588, 589 (1966); Annot., *supra* note 2, at 430.

20 84 N.H. at 354, 150 A. at 906.

21 *Id.*

22 *Id.* at 372, 150 A. at 915.

court's opinion, the only time the immunity should be employed was when the suit would undermine parental authority and disrupt family unity.<sup>23</sup> The court recognized that other reasons for the application of the immunity had been developed, but considered these as "mere makeweights, to add something to the persuasiveness of the more substantial"<sup>24</sup> parental authority and family peace arguments. The court specifically denounced the mechanical application of the immunity — as in *Roller* — and noted that the issue of whether the immunity should be allowed was a practical one to which no rule of thumb could be applied.<sup>25</sup> A major factor in the court's decision was the presence of liability insurance. Insurance, the court felt, emasculated the reason for the immunity, because as a practical matter the parent would lose nothing.<sup>26</sup>

*Dunlap* established the initial major attack on the immunity doctrine, and its practical approach soon received the applause of numerous authors, commentators and dissenting judges.<sup>27</sup> Nevertheless, the immunity doctrine continued to stand in every jurisdiction until 1963, although it had become severely eroded by exceptions.<sup>28</sup> One dissenting judge stated that in his opinion, the "exceptions . . . have almost swallowed the rule."<sup>29</sup> Then, in 1963, Wisconsin became the first jurisdiction to strike the immunity doctrine a fatal blow. In *Goller v. White*,<sup>30</sup> Wisconsin's Supreme Court abrogated the rule save for two exceptions: (1) situations involving an exercise of parental authority, and (2) situations involving an exercise of ordinary parental discretion with respect to the provision of necessities.<sup>31</sup> Wisconsin, having started a trend, was followed three years later by Minnesota. There, in *Balts v. Balts*,<sup>32</sup> the court for all practical purposes abrogated the rule by allowing a mother to bring suit against her son for injuries sustained as a result of his negligent driving. Finally, New Hampshire, in the case of *Briere v. Briere*,<sup>33</sup> became the first jurisdiction to abrogate the immunity doctrine in its entirety. The *Briere* court<sup>34</sup> relied strongly on the reasoning in *Dunlap*, and refused to be impressed by the fact that the majority of jurisdictions upheld the immunity:

We do not believe that our case should be determined by the number of authorities which support one rule or the other, any more than that a jury

23 *Id.* at 354, 150 A. at 906.

24 *Id.* at 361, 150 A. at 909.

25 *Id.* at 363, 150 A. at 910-11.

26 *Id.* at 370, 150 A. at 914.

27 For an impressive list of the writings of these authors and commentators see Hastings v. Hastings, 33 N.J. 247, 254-55, 162 A.2d 147, 151 (1960) (dissenting opinion); for a list of the dissenting opinions, see Comment, *supra* note 17, at 218 n.121.

28 See note 17 *supra* and accompanying text.

29 *Badigan v. Badigan*, 9 N.Y.2d 472, 478, 174 N.E.2d 718, 722, 215 N.Y.S.2d 35, 40 (1961) (Fuld, dissenting).

30 20 Wis. 2d 402, 122 N.W.2d 193 (1963).

31 *Id.* at —, 122 N.W.2d at 198.

32 273 Minn. 419, 142 N.W.2d 66 (1966). Although the court stated that it was not to be understood as abrogating the immunity in actions by a child against a parent, it has been suggested that for all practical purposes, that is what the court in fact did. See Comment, *Abrogation of the Parent-Child Immunity Doctrine*, 12 S.D.L. Rev. 364 (1967).

33 107 N.H. 432, 224 A.2d 588 (1966).

34 For a discussion of *Briere* and its probable effect on New Hampshire law, see 19 CASE W. RES. L. REV. 139 (1967).

should resolve issues according to the number of witnesses who appear for the plaintiff or the defendant.<sup>35</sup>

Alaska considered the problem for the first time in 1967, in the case of *Hebel v. Hebel*.<sup>36</sup> In refusing to apply the immunity doctrine, the Alaskan Supreme Court stated that it felt the reasoning of *Goller* and *Briere* was more convincing than any of the reasons developed in favor of the immunity.<sup>37</sup>

The parent-child immunity doctrine was introduced into New York law in 1928 in the case of *Sorrentino v. Sorrentino*.<sup>38</sup> The court's precise reasoning for adopting it was not revealed, since the decision contained no opinion. From its inception the doctrine met with opposition in New York. *Sorrentino* was a four to three decision with the legal giants Cardozo, Crane and Andrews dissenting. The lower New York courts accepted the rule only with reluctance and soon began adopting the exceptions formulated in other jurisdictions.<sup>39</sup> In 1939, the New York Court of Appeals, in *Rozell v. Rozell*,<sup>40</sup> refused to extend the immunity doctrine to the brother-sister factual situation. A twelve year old boy was permitted to recover against his sixteen year old sister for personal injuries he sustained in an accident caused by her negligent driving. The family harmony and public policy arguments were rejected for reasons that would seem to have equal application to the parent-child situation.<sup>41</sup> As could have been expected, when the court of appeals, in the case of *Cannon v. Cannon*,<sup>42</sup> faced the issue of parent-child immunity for the second time, the plaintiff argued that *Rozell* foreshadowed a change of policy leading away from the harsh result in *Sorrentino*.<sup>43</sup> However, bypassing an excellent opportunity to abrogate the rule, the court distinguished *Rozell* and reiterated the family harmony argument, citing only *Sorrentino* for support.<sup>44</sup> The immunity doctrine was not again considered by the court of appeals until 1961, in *Badigan v. Badigan*.<sup>45</sup> The court there reaffirmed *Sorrentino* for the second time. Citing only *Sorrentino* and *Cannon* for support, the majority concluded that it was a "settled New York rule that an unemancipated minor child has no right of action against his parent for non-willful injuries."<sup>46</sup> The opinion invoked a very strong dissent from Judge Fuld, which in effect laid the foundation for the doctrine's abrogation some seven years later.

Finally, in 1969, the court of appeals in the relatively brief opinion in *Gelbman*, abolished completely the parent-child immunity doctrine in New York. At the outset the court acknowledged that the immunity doctrine was the law in that state.<sup>47</sup> It then noted that the rule was created to prevent disruption of

35 107 N.H. at 434, 224 A.2d at 589-90 (1966).

36 425 P.2d 8 (Alas. 1967).

37 *Id.* at 14.

38 248 N.Y. 626, 162 N.E. 551 (1928).

39 For citations to many of these cases, see Comment, *supra* note 17.

40 281 N.Y. 106, 22 N.E.2d 254 (1939).

41 See *id.* at 109-14, 22 N.E.2d at 255-58.

42 287 N.Y. 425, 40 N.E.2d 236 (1942).

43 *Id.* at 427, 40 N.E.2d at 237.

44 *Id.* at 427-28.

45 9 N.Y.2d 472, 174 N.E.2d 718, 215 N.Y.S.2d 35 (1961).

46 *Id.* at 473, 174 N.E.2d at 719, 215 N.Y.S.2d at 36.

47 *Gelbman v. Gelbman*, 23 N.Y.2d 434, 436, 245 N.E.2d 192, 297 N.Y.S.2d 529, 530 (1969).

family unity, the very foundation of society. The court stated, however, that such a rule could only be reaffirmed if it were in fact essential to the preservation of family unity.<sup>48</sup> This was so, because, as the court later noted, “[a] rule which so incongruously shields conceded wrongdoing bears a heavy burden of justification<sup>49</sup> . . . .” The conclusion was that this heavy burden was not met — *Sorrentino, Cannon and Badigan* were expressly overruled.<sup>50</sup>

In reaching its decision, the *Gelbman* court stated that it was merely summarizing “the convincing arguments advanced by Judge Fuld in his comprehensive dissent in *Badigan* . . . .”<sup>51</sup> Two different lines of reasoning were followed in *Gelbman*. First, it was noted that the existence of the multitude of exceptions to the rule could not be reconciled with the alleged purpose of the immunity — the preservation of family harmony.<sup>52</sup> For instance, one exception was that a child could sue a parent on a contract or for matters involving property rights. Why, as Judge Fuld had asked in *Badigan*, should a child be permitted to sue for a broken contract, but not for a broken leg?<sup>53</sup> Furthermore, the rule seemed illogical in view of the fact that some of the most acrimonious family disputes arise out of controversies over property rights. It was the *Gelbman* court’s view that these various exceptions did not support the rule but rather attested to its primitive nature and required its repudiation.<sup>54</sup>

Second, because of New York’s compulsory automobile insurance laws, the *Gelbman* court felt that the parent-child litigation, in fact if not in law, would be between the plaintiff and the insurance company.<sup>55</sup> Therefore, permitting suit would in no way impair family harmony. Pertinent to this issue is one of Judge Fuld’s “convincing arguments” which, while not cited in the *Gelbman* opinion, probably influenced that court’s decision:

The problem, in short, comes to this: A child is seriously injured by his father’s careless operation or maintenance of his automobile. As the law now stands, the judgment recovered against the parent is more than likely, in the vast majority of cases, to be paid by an insurer. If the crippled child may have the benefit of this insurance, a fund will be supplied the family to provide for him. If the fund is cut off, cripple as well as parent will have to stagger beneath the load. To tell them that the pains must be endured for the peace and welfare of the family is something of a mockery.<sup>56</sup>

Two arguments have often been raised against withdrawing the immunity when insurance is present. The court recognized and answered both. First, pro-

48 *Id.* at 437, 245 N.E.2d at 193, 297 N.Y.S.2d at 530.

49 *Id.*, quoting from *Badigan v. Badigan*, 9 N.Y.2d 472, 475, 174 N.E.2d 718, 721, 215 N.Y.S.2d 35, 38 (1961) (Fuld, dissenting).

50 *Gelbman v. Gelbman*, 23 N.Y.2d 434, 438, 245 N.E.2d 192, 193, 297 N.Y.S.2d 529, 531 (1969).

51 *Id.* at 437-38, 245 N.E.2d at 193, 297 N.Y.S.2d at 531.

52 *Id.* at 438, 245 N.E.2d at 193, 297 N.Y.S.2d at 531.

53 *Badigan v. Badigan*, 9 N.Y.2d 472, 476, 215 N.Y.S.2d 35, 39, 174 N.E.2d 718, 721 (1961).

54 *Gelbman v. Gelbman*, 23 N.Y.2d 434, 438, 245 N.E.2d at 193, 297 N.Y.S.2d 529, 531 (1969).

55 *Id.*, 245 N.E.2d at 193-94.

56 *Badigan v. Badigan*, 9 N.Y.2d 472, 481-82, 215 N.Y.S.2d 35, 43, 174 N.E.2d 718, 724 (1961).

ponents of the immunity doctrine contended that removing immunity when insurance is present would increase the danger of fraudulent and collusive suits. The court's answer — the same it had used in *Rozell* — was that reliance must be placed upon the ability of the jury to distinguish between valid and fraudulent claims.<sup>57</sup> The second argument, which seems to be the favorite of the majority of the courts, is that the presence of insurance cannot create a liability where none existed before. The *Gelbman* court, in answering, utilized the approach originally formulated by Judge Peaslee in *Dunlap*. The gist of this position is that the presence of insurance does not create a liability, but rather removes a defense which was set up, for reasons of public policy, to an already existing liability.<sup>58</sup> Since, with the presence of insurance, there is no danger of family trouble, there is no reason for the defense to the liability.

The history of the parent-child immunity doctrine is a sad example of what can result from a blind application of judicial precedent. The sole reason for the creation of the immunity was to preserve family peace. Society's interest in family unity was thought to be so great that it outweighed the child's right to redress for civil wrongs. However, the courts soon began applying the immunity without regard to whether the reasons for the rule were present. In time, this blind application ironically produced the precise evil that the doctrine was created to prevent.

New York, finally realizing the absurdity of applying the immunity doctrine to cases involving insurance, has abolished it. However, the *Gelbman* court went from one extreme to the other in abrogating the rule in its entirety. Admittedly, most parent-child suits probably do arise from automobile accidents. Furthermore, compulsory insurance laws would emasculate the reasons for the immunity in those situations. However, as few as they may be, there are situations in which a suit may arise that would not be covered by insurance and that would cause animosity in the family. Under New York law, the immunity would now be denied without regard to the suit's effect on family harmony.

Probably a more logical way of dealing with the immunity would have been to recognize, as did *Dunlap*, that the immunity is in certain situations desirable, but only when the reasons for its development are present — that is, when its application will in fact prevent family discord. Thus, whether the immunity would be permitted to be raised as a defense should depend upon the facts of each individual case.

*Richard F. Battagline*

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FEDERAL INCOME TAX — TAXPAYER'S DEDUCTIONS FOR ENTERTAINMENT EXPENSES OF OVER \$25 DISALLOWED BECAUSE OF FAILURE TO SUBSTANTIATE DIARY WITH CORROBORATING DOCUMENTARY EVIDENCE — TREASURY REGULATION 1.274-5(c)(2) HELD VALID.—Petitioner, William F. Sanford, was employed during 1963 as an outside salesman of television advertising time. As

<sup>57</sup> *Gelbman v. Gelbman*, 23 N.Y.2d 434, 439, 245 N.E.2d 192, 194, 297 N.Y.S.2d 529, 532 (1969).

<sup>58</sup> *Id.* See *Dunlap v. Dunlap*, 84 N.H. 352, 370-72, 150 A. 905, 914-15 (1930).



such, he was required to make presentations at luncheons and dinners in order to procure buyers for his product. Part of his expenses incurred in this manner were reimbursed by his employer. Sanford recorded in a diary the expenditures for which he neither sought nor received reimbursement, but failed to obtain any supporting receipt or other documentary evidence for these amounts as required by Treasury Regulation 1.274-5(c)(2). On his federal income tax return for that year he deducted \$5,667.17 as nonreimbursed entertainment expense. The Commissioner disallowed the deduction for all entertainment expenditures of more than \$25, which invalidated \$4,984.31 of Sanford's deduction. Upon hearing Sanford's petition, the Tax Court affirmed the Commissioner's ruling and *held*: the Treasury Regulations promulgated under section 274(d) of the Internal Revenue Code specifying substantiation requirements for deduction of entertainment expenses over \$25 are valid, and petitioner failed to substantiate his deductions in accordance with those regulations. *Sanford v. Commissioner*, 50 T.C. 823 (1968).

Prior to 1962, the major theory of calculating deductions for business entertainment expenses was set forth in Judge Learned Hand's decision in *Cohan v. Commissioner*.<sup>1</sup> In that case, George M. Cohan sought to deduct substantial entertainment expenses for which he had no record. The Board of Tax Appeals refused to allow a deduction for any part of the expenses because the exact amount of the expenditures could not be determined.<sup>2</sup> However, in the court of appeals, Judge Hand took the view that a finding that some money was spent necessitated an allowance of some deduction.<sup>3</sup> He felt that the Board should approximate the expenses to ascertain the amount of the deduction, "bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making."<sup>4</sup> Judge Hand's sole complaint was with the Board's decision to disallow any deduction. Seemingly, if it had allowed some deduction, however small, he would have found no fault.

The *Cohan* rule became one of the most widely used methods for determining deductions for business entertainment expenses.<sup>5</sup> However, "the absence of any fixed standards of substantiation, as a practical matter (because of excessive deductions), resulted in a shifting of the burden of proof from the taxpayer to the government."<sup>6</sup> Furthermore, this lack of fixed standards created a temptation for many taxpayers, and a feeling arose that the right to take a deduction for entertainment expenses was being abused.<sup>7</sup> Typically, a taxpayer would keep no records and then claim more than he had actually spent in the hope that eventually the Internal Revenue Service would allow him deductions in excess

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1 39 F.2d 540 (2d Cir. 1930).

2 *Id.* at 543.

3 *Id.* at 544.

4 *Id.*

5 Caplin, *The Travel and Entertainment Expense Problem*, 39 TAXES 947, 959 (1961); Emmanuel & Lipoff, *Travel and Entertainment: The New World of Section 274*, 18 TAX L. REV. 487, 517 (1963).

6 Eichel, *The Missouri Rule — Substantiation Requirements for Travel and Entertainment Expenditures Under Section 274(d) of the Internal Revenue Code of 1954*, 18 U. MIAMI L. REV. 613, 617 (1964).

7 *Id.*

of his actual expenditures.<sup>8</sup> The courts, using various arguments, attempted to control such alleged abuses.<sup>9</sup> In *Williams v. United States*,<sup>10</sup> the Fifth Circuit, in disallowing any deduction, held that the taxpayer must still introduce "sufficient evidence to satisfy the trier that *at least* the amount allowed in the estimate was in fact spent or incurred for the stated purpose."<sup>11</sup> The court heeded Judge Hand's admonition that the rule should bear heavily on the taxpayer. In some cases<sup>12</sup> the Tax Court interpreted *Cohan* strictly and did not feel obligated to apply the rule as long as the Commissioner had allowed some deduction. Other courts<sup>13</sup> allowed the Commissioner's approximation to stand in the absence of sufficient proof that the taxpayer had indeed incurred a greater expense. It might appear from these cases that the alleged abuses had been overcome; however, while this might have been true in the courtroom application of the rule, the Internal Revenue Service was still faced with the administrative burden of applying it in the field.<sup>14</sup> With the *Cohan* rule hanging over them, agents were forced to make compromises rather than burden an already overcrowded court docket.<sup>15</sup>

President Kennedy, in his tax message to Congress in 1961, expressed concern over the abuses which were prevalent in the expense account area and requested that all business entertainment expenses be disallowed as tax deductions.<sup>16</sup> While Congress did not respond in full to the President's request, it did pass section 4 of the Revenue Act of 1962, which became the present section 274 of the Internal Revenue Code,<sup>17</sup> in an effort to curb abuses in the expense account area. This section did not specifically overrule *Cohan*, but its legislative history leaves no doubt that *Cohan* was superseded.<sup>18</sup> In the words of Senator Smathers, section 274(d) was passed to eliminate "one of the most flagrant abuses of existing law; that is, the fraudulent practice of claiming deductions for more expenses than were actually incurred and maintaining no records."<sup>19</sup> Whether this abuse did in fact exist is a much debated question.<sup>20</sup> However, even the possibility of abuse is unsatisfactory since a self-assessment tax system must necessarily make all taxpayers feel that the burden is being shared equally.<sup>21</sup>

8 Caplin, *supra* note 5, at 961.

9 Eichel, *supra* note 6, at 620.

10 245 F.2d 559 (5th Cir. 1957).

11 *Id.* at 560.

12 Harrison A. Bennet, 19 P-H TAX CT. MEM. ¶ 50,243, at 803 (1950); Donald W. Bolt, 16 P-H TAX CT. MEM. ¶ 47,329, at 1115 (1947).

13 *E.g.*, Julian Cohen, 31 P-H TAX CT. MEM. ¶ 62,051, at 326 (1962).

14 Since the decision of the Second Circuit in 1930, *Cohan* has been relied on in an inestimable number of cases. In the last 12 months alone, over 30 reported cases involve *Cohan*. This is on top of docketed cases settled before trial and numerous controversies compromised at the administrative level. At informal field audit conferences, *Cohan* is the most frequent issue. Caplin, *supra* note 5, at 959.

See also Eichel, *supra* note 6, at 617.

15 Axelrad, *An Evaluation of the New Rules Relating to the Deductibility of Entertainment, Travel, and Gifts: A Critical Look at Section 274*, 16 U. SO. CAL. 1964 TAX INST. 345, 387.

16 1 U.S. CODE CONG. & AD. NEWS 1136-37 (1961).

17 INT. REV. CODE OF 1954, § 274.

18 2 U.S. CODE CONG. & AD. NEWS 3337 (1962).

19 108 CONG. REC. 18077 (1962).

20 Compare Axelrad, *supra* note 15, at 386-87, with Eichel, *supra* note 6, at 617-18.

21 A tax system which relies upon each taxpayer to be his own tax assessor is jeopardized when resentment is caused by discrimination which allows some tax-

This need to overcome the distrust of the general taxpayer<sup>22</sup> coupled with the need to alleviate the administrative burden on the Internal Revenue Service<sup>23</sup> gave rise to the passage of section 274.

Subsections (a) to (c) of section 274 place restrictions on the amount of deductions allowable for entertainment, gifts and foreign travel. Subsection (d), which is the basis of the Tax Court's holding in *Sanford*, outlines the substantiation requirements that must be fulfilled before any deductions will be allowed. Expenditures must be documented by "adequate records or by sufficient evidence corroborating [the taxpayer's] own statement."<sup>24</sup> The items that must be substantiated are (a) the amount of the expense, (b) the time and place of the expense, (c) the business purpose of the expense, and (d) the business relationship of the person entertained.<sup>25</sup> This subsection also provides that the Secretary or his delegate may exclude expenses below a specified amount from the substantiation requirement. Subsection (h) allows the Secretary to promulgate regulations which he may deem necessary to carry out the purposes of section 274.

Regulation 1.274-5, which attempts to implement section 274(d), was the direct target of the taxpayer's attack in the present case. This regulation specifically supersedes the *Cohan* rule<sup>26</sup> and sets out in detail the elements of expenditure which require substantiation before deduction will be allowed. Basically, the elements enumerated are those contained in section 274(d) of the Code, but there are slight variations depending upon whether the expenditure was for travel, entertainment in general, gifts, or entertainment directly preceding or following a substantial and bona fide business discussion.<sup>27</sup>

Subsection (c) of Regulation 1.274-5 delineates the method by which a taxpayer must substantiate each of the required elements of amount, time and place, business purpose and identity of recipient. The subsection envisions that the taxpayer's substantiation must constitute "clear proof" of the expenditure. To satisfy the "adequate records" method of substantiation the taxpayer must fulfill two requirements. First, he must maintain an account book, diary, statement of expense or similar record. This record must be made at or near the time of the expenditure and specify the necessary elements. However, if the element of business purpose is evident from the facts and circumstances, there is no need to keep a written record of it.<sup>28</sup> Second, the taxpayer must furnish documentary evidence corroborating the entries in the diary. (This was the requirement the Tax Court found lacking in *Sanford*.) This documentary evidence in the form of receipts, paid bills or similar evidence is necessary only for expenditures for lodging while traveling and for any other expenditure of \$25 or more. If the taxpayer fails to comply with the "adequate records" requirement with respect to an element of an expenditure, then he must establish

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payers to take unfair advantage of the laws. This discrimination makes taxpayers resentful of the law which permits the situation to exist, and encourages them toward laxity in discharging their full obligations. Eichel, *supra* note 6, at 618.

22 *Id.*

23 Axelrad, *supra* note 15, at 387.

24 INT. REV. CODE OF 1954, § 274(d).

25 *Id.*

26 Treas. Reg. § 1.274-5(a)(3) (1962).

27 Treas. Reg. § 1.274-5(b) (1962).

28 Treas. Reg. § 1.274-5(c)(2)(ii)(b) (1962).

the element (1) by his own statement in writing containing specific information, in detail, as to such element, and (2) by other corroborative evidence sufficient to establish such element.<sup>29</sup> If the element to be established by this "other sufficient evidence" test is the business relationship of the person entertained or the business purpose, circumstantial evidence may be used. However, for the other elements, direct evidence, such as testimony of persons entertained, or documentary evidence is required. The regulations also provide that if a taxpayer can show that by reason of "exceptional circumstances" he was unable to obtain evidence to satisfy the "adequate records" method or the "other sufficient evidence" method, he may fulfill the requirement of substantiation by presenting other evidence "which possesses the highest degree of probative value under the circumstances."<sup>30</sup> Besides these Treasury regulations, the Internal Service promulgated a revenue procedure to ensure that taxpayers were fully apprised of their responsibilities in this area.<sup>31</sup>

In the instant case, the Commissioner disallowed deductions for Sanford's entertainment expenditures of \$25 or more because of his failure to obtain receipts for these expenditures. In the Tax Court, the Commissioner asserted the additional argument that the expenses were not deductible under section 162(a) of the Code, which requires that deductible expenditures must represent ordinary and necessary expenses incurred in carrying on a trade or business. The Tax Court agreed with the Commissioner that the petitioner still had the initial burden under section 162(a) of proving that the expenses were ordinary and necessary. While the court felt that Sanford had not fully satisfied this burden with respect to some of the expenditures, it noted that this might have been an appropriate case for the application of the *Cohan* rule had it not been for the addition of section 274(d) to the Code.<sup>32</sup>

After discussing both the Code sections and the Treasury Regulations with respect to substantiation, the *Sanford* court concluded that the petitioner had not satisfied the "adequate records" requirement of 1.274-5(c) because of his failure to obtain receipts or other documentary evidence. Furthermore, since no direct evidence had been introduced to corroborate his diary, the petitioner could not rely on the "other sufficient evidence" mode of substantiation.<sup>33</sup> The Tax Court then reasoned that Treasury Regulations 1.274-5(c)(4) and (5), which allow a taxpayer to substantiate by other evidence in exceptional circumstances, were also inapplicable since receipts had been obtained for these types of expenditures when reimbursement was sought from the employer.<sup>34</sup>

The petitioner's main argument was that the regulations were invalid.<sup>35</sup> In upholding the regulations, the Tax Court maintained that the dollar limit in connection with the substantiation requirement was a matter expressly left to the Commissioner in section 274(d). It also reasoned that the requirement of corroborative evidence in the regulation, while not expressly specified by the

29 Treas. Reg. § 1.274-5(c)(3) (1962).

30 Treas. Reg. § 1.274-5(c)(4) (1962).

31 Rev. Proc. 63-4, 1963-1 CUM. BULL. 474.

32 *Sanford v. Commissioner*, 50 T.C. 823, 827 (1968).

33 *Id.* at 830.

34 *Id.*

35 *Id.*

language of the Code, was in accordance with the legislative intent to overcome the abuse of exaggerating the true amount of expenses.<sup>36</sup> After reviewing the pertinent legislative history, the court concluded:

[T]he committee reports are inconclusive in this respect, and we must conclude that in appropriate cases, involving larger expenditures, there was no intention to preclude the Commissioner from demanding that diary entries (self-serving statements) be supported by corroborating documentary evidence.<sup>37</sup>

Since this inconclusiveness was present and the regulations were not inconsistent with the plain language of the Code, the Tax Court heeded the Supreme Court's directive that "Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes . . . ."<sup>38</sup>

While it would not appear to be the usual case that a taxpayer would proceed under the hope that a Treasury Regulation would be declared invalid, this decision has now laid to rest, insofar as Tax Court litigation is concerned, any thoughts which taxpayers may have entertained along that line in regard to the substantiation regulations. While the court was correct in stating that the Code itself, in light of its legislative history, did not require that documentary evidence in the form of receipts be required, its further conclusion that "the regulations under consideration reflect a faithful observance of the congressional intent"<sup>39</sup> to curb rather flagrant abuses cannot be faulted.

At least one commentator has felt that compelling taxpayers to fulfill the "adequate records" requirement puts a burden of record keeping on the taxpayer which he will not be able to maintain.<sup>40</sup> However, the benefits to be gained by this requirement more than outweigh any burden placed on the taxpayer. Moreover, the instant case shows that the burden is no greater than that which many employers already require of their employees with respect to expense accounts. Furthermore, if a taxpayer fails to carry his burden with respect to the "adequate records," he can, at least theoretically, rely on the "other sufficient evidence" mode of substantiation.<sup>41</sup> A strict adherence to these regulations will not only provide a more uniform guideline under which treasury agents can better ascertain the amount of allowable deductions, but will also instill taxpayers who cannot avail themselves of the business entertainment deduction with a greater feeling of confidence in the American tax system.

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<sup>36</sup> *Id.* at 831.

<sup>37</sup> *Id.*

<sup>38</sup> *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1947).

<sup>39</sup> *Sanford v. Commissioner*, 50 T.C. 823, 832 (1968).

<sup>40</sup> Axelrad, *supra* note 15, at 387.

<sup>41</sup> See text accompanying note 29 *supra*.