Vanderbilt Law Review

Volume 31
Issue 2 *Issue 2 - March 1978*

Article 5

3-1978

Recent Cases

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RECENT CASES

Constitutional Law—Newsperson's Privilege—The First Amendment Guarantee of a Free Press Protects Against Compelled Disclosure of a Journalist's Exercise of Editorial Control and Judgment

I. Facts and Holding

Plaintiff, a former army officer who had achieved national prominence by claiming that his superiors ignored his reports of atrocities by American forces in Vietnam,[1] brought a libel suit against defendant television producer, reporter, and network for broadcasting a program that cast doubt upon plaintiff's allegations.[2] Contending that defendant did not present available information corroborating plaintiff's claims,[3] plaintiff sought discovery[4] of the producer's beliefs, opinions, intent, and conclusions in preparing

1. Colonel Anthony Herbert had formally charged his superior officers, Brigadier General John W. Barnes and Colonel J. Ross Franklin, with covering up war crimes that he had reported to them in Vietnam. When Herbert subsequently was relieved of his command, various magazine articles and television appearances generated interest in Herbert's story. The Army investigated Herbert's charges of war crimes and exonerated General Barnes in October 1971. In this period of intense public interest, Herbert announced his retirement from the service, citing incessant harassment by the military because of his disclosures.

2. Barry Lando, then an associate producer of the CBS "Weekend News," had produced a laudatory report on Herbert. When Lando became a producer for CBS's "60 Minutes" a year later, he decided to produce a comprehensive report on the Herbert controversy. Lando focused on particular allegations, conducting many interviews with people who could corroborate Herbert's claims. During the production period Lando received an uncorrected proof of *Soldier*, a book written by Herbert in collaboration with James Wooten of the *New York Times*. Lando found that several of those interviewed denied that certain incidents reported in the book had occurred, while others verified many of Herbert's reports. Lando's research culminated in the telecast of "The Selling of Colonel Herbert" on February 4, 1973. The telecast looked in detail at several aspects of Herbert's claims, presenting interviews and evidence that revealed many inconsistencies and contradictions in Herbert's allegations. Herbert responded to the CBS broadcast by instituting a defamation action alleging $44,725,000 in damages for injury to his reputation and impairment of his book *Soldier* as a literary property.

3. Although the broadcast alluded to information corroborating Herbert's claims, it clearly raised serious doubts about Herbert's allegations.

4. Rule 37(a)(2) of the Federal Rules of Civil Procedure allows a discovering party to apply for an order compelling discovery upon reasonable notice to the other party. If the deponent fails to answer a submitted question, the discovering party may move for an order compelling an answer. A motion under rule 37(a) implements the provisions of rule 26(b)(1), which allows parties to obtain discovery of any nonprivileged matter relevant to the pending action and reasonably calculated to lead to the discovery of admissible evidence.

the program.[5] The United States District Court for the Southern District of New York rejected defendant's contention that the first amendment protected the editorial process[6] and ruled that plaintiff's discovery of defendant's state of mind should be broad and unrestricted.[7] On interlocutory appeal to the United States Court of Appeals for the Second Circuit, *held,* reversed. In a libel action brought by a public figure, the first amendment guarantee of a free press protects against compelled disclosure of a journalist's exercise of editorial control and judgment. *Herbert v. Lando,* 568 F.2d 974 (2d Cir. 1977), *cert. granted,* 46 U.S.L.W. 3586 (U.S. Mar. 21, 1978) (No. 77-1105).

II. Legal Background

A. *Defamation*

At common law a defamation action was designed to protect an individual's interest in reputation. A publisher, broadcaster, or speaker could be held strictly liable[8] for the publication or utterance of a defamatory falsehood.[9] If a plaintiff proved that a defamatory

5. Herbert contended that Lando deliberately distorted the presentation of the facts by selective investigation, skillful editing, and one-sided interviewing, which created the impression that Herbert had been evasive in the interview. During discovery CBS turned over outtakes and notes to Herbert, choosing to assert an editorial privilege only for the intellectual decision of what materials to broadcast. Although the parties had cooperated throughout the discovery process, Lando refused to answer questions about his beliefs, opinions, intent, and conclusions in preparing the program. The objectionable inquiries pertained to Lando's conclusions concerning which leads he would pursue, his beliefs concerning the veracity of interviewees or facts imparted by them, his reasons for omitting certain information, and his conversations about matter to be included in the broadcast.

6. Lando, Mike Wallace (the correspondent for the program), and CBS maintained that the broadcast represented a fair and accurate account of public proceedings, reported in good faith and without malice. In addition, CBS claimed that the first amendment barred any inquiry into the editorial process used in producing the report.

7. The district court reasoned that a public figure (Herbert's status as a public figure was not contested) who must carry the heavy burden of proving that an alleged libeler acted with actual malice or in reckless disregard of the truth was entitled to a liberal interpretation of the rules on pretrial discovery.

8. Several justifications were offered for strict liability in defamation. The primary justification arose from the recoguition that defamation was difficult to prove, and a strict liability standard improved the chances that fair and adequate compensation would be awarded. Strict liability also gave the plaintiff an opportunity to vindicate his reputation in an appropriate public forum. Further, strict liability was viewed as an appropriate mechanism for insuring that public statements would reflect the truth. Finally, strict liability as to the mass media was advocated to penalize negligence and to implement the "enterprise liability" theory for those defamation judgments that did occur. *See* Eaton, *The American Law of Defamation Through* Gertz v. Robert Welch, Inc. *and Beyond: An Analytical Primer,* 61 Va. L. Rev. 1349, 1357-59 (1975).

9. W. Prosser, The Law of Torts § 113 (4th ed. 1971).

statement[10] was communicated to a third person, the defendant was liable unless he could demonstrate that the publication was true or was privileged.[11] To protect freedom of expression, the common law recognized limited privileges to defeat asserted reputational interests. An absolute privilege existed when the need for complete freedom of expression outweighed the state's interest in providing a remedy for reputational injury.[12] In addition, the courts developed two qualified privileges for the benefit of the media. The "fair comment" privilege protected statements of opinion, criticism, and comment, but did not extend to false assertions of fact.[13] The "reporter's privilege" allowed the press to report accurately on official or public proceedings.[14]

In the 1964 decision of *New York Times Co. v. Sullivan,*[15] the Supreme Court dramatically changed the common law by ruling that constitutional principles applied to defamation actions.[16] The

10. A defamatory statement was defined as one that "tends so to harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating or dealing with him." RESTATEMENT (SECOND) OF TORTS § 559 (1976).

11. Truth was a complete defense at common law. The law presumed, however, that tbe alleged defamation was false, leaving the burden of proving the truth of the statement on the defendant. The courts required detailed proof indicating the veracity of an alleged defamation. PROSSER, *supra* note 9, § 116.

12. The absolute privileges were limited to protecting defamatory statements made in judicial and legislative proceedings, executive communications, communications between a husband and wife, situations in which the plaintiff had consented to the defamatory publication, and political broadcasts requiring equal opportunity to all political candidates. *See* PROSSER, *supra* note 9, § 114.

13. Robertson, *Defamation and the First Amendment: In Praise of* Gertz v. Robert Welch, Inc., 54 TEX. L. REV. 199, 201 n.17 (1976). One problem created by the "fair comment" privilege was the difficulty encountered by courts in distinguishing between facts and opinion. Titus, *Statement of Fact Versus Statement of Opinion—A Spurious Dispute in Fair Comment,* 15 VAND. L. REV. 1203 (1962). The minority view protected even false statements of fact "if they were made for the public benefit with an bonest belief in their truth, because the public interest demanded that those who are in a position to furnish information about public servants be not deterred by fear of suit, with the resulting necessity of proving the truth of what they say in court." PROSSER, *supra* note 9, at 820.

14. PROSSER, *supra* note 9, § 115.

15. 376 U.S. 254 (1964).

16. On March 29, 1960, the *New York Times* published a full page advertisement that included an account of alleged actions taken by police against black demonstrators. Montgomery City Commissioner L.B. Sullivan was an elected public official responsible for supervising the police department. Although not named in the advertisement, Sullivan claimed to have been defamed as supervisor of the police department by two factual errors in the publication. The factual errors were relatively trivial, but Alabama law did not recoguize a privilege for good faith misstatement of fact in discussion of public issues, and it limited the "fair comment" privilege to opinion. The issue at trial boiled down to the truth of the advertisement's allegations. The jury determined that the *New York Times* had failed to demonstrate the truth of the allegations and awarded Sullivan $500,000, a decision which the Alabama Supreme Court affirmed. 376 U.S. at 256-64; *see* Kalven, *The New York Times*

Court held that the first amendment protected defamatory falsehoods published by a defendant about a public official if the statements were not made with "actual malice"[17] or in reckless disregard of the truth. The Court recognized the inherent tension between society's interest in protecting an individual's reputation and the national commitment to first amendment values.[18] Reasoning that the threat of constant litigation would inhibit the reporting of information about public officials,[19] the Court concluded that a constitutional privilege was necessary to protect uninhibited public debate and to alleviate the pressure on the media to exercise self-censorship.[20] The majority opinion, however, did not define the exact scope of the privilege. Justices Black and Douglas in a concurring opinion asserted that the first amendment provided an absolute immunity to all defamation actions.[21]

In *Garrison v. Louisiana*[22] the Court began to clarify the *New York Times* actual malice standard by emphasizing that only those false statements made with a high degree of awareness of their probable falsity[23] would be sufficient to meet the actual malice standard. The Court in *St. Amant v. Thompson*[24] ruled that actual malice requires proof that the defendant "entertained serious doubts as to the truth of his publication."[25] This requirement presents the plaintiff with the difficult task of affirmatively producing evidence of defendant's knowing state of mind, but removes motive or a desire to injure from the court's consideration.[26] Thus, under *Garrison* and *St. Amant,* the Court interpreted the *New York Times* standard to require the plaintiff to produce affirmative evidence of the defendant's subjective state of mind from which a jury might infer actual

Case: A Note on the "Central Meaning of the First Amendment," 1964 SUP. CT. REV. 191; Pierce, *The Anatomy of an Historic Decision:* New York Times Co. v. Sullivan, 43 N.C.L. REV. 315 (1965).

17. Professor Prosser asserted that the term "malice" had been used in so many different contexts tbat it was an unfortunate word for the Court to employ in describing the defamation standard. It is used by the Court to describe a statement published with knowledge of its falsity. PROSSER, *supra* note 9, § 118

18. 376 U.S. at 270-73.

19. *Id.* at 282-83.

20. *Id.* at 270; *see* Anderson, *Libel and Press Self-Censorship,* 53 TEX. L. REV. 422 (1975); Anderson, *A Response to Professor Robertson: The Issue Is Control of Press Power,* 54 TEX. L. REV. 271 (1976); Robertson, *supra* note 13.

21. 376 U.S. at 293 (Black, J., concurring).

22. 379 U.S. 64 (1964).

23. *Id.* at 74.

24. 390 U.S. 727 (1968).

25. *Id.* at 731.

26. *See* Brosnahan, *From Times v. Sullivan to Gertz v. Welch: Ten Years of Balancing Libel Law and the First Amendment,* 26 HASTINGS L.J. 777, 782-83 (1975).

malice or reckless disregard of the truth. In *Goldwater v. Ginzburg,*[27] the Second Circuit liberally interpreted the *New York Times* standard in holding that proof of bad motive or failure to investigate could be cumulatively used to establish by appropriate inferences the fact of a defendant's recklessness or of his knowledge of falsity.[28]

The Court also sought to determine the classes of people or events that entitled the press to invoke the first amendment privilege. *Rosenblatt v. Baer,*[29] an action by the supervisor of a county-operated recreation area, extended the public official concept to include public employees who have or appear to have substantial responsibility for governmental affairs.[30] In *Curtis Publishing Co. v. Butts,*[31] the Court recognized that the values supporting uninhibited discussion of public matters must be weighed against society's interest in preventing attacks on an individual's reputation.[32] In making this balance, the Court allowed recovery by a "public figure" because it found an extreme departure from acceptable standards of investigation normally adhered to by responsible publishers.[33] More importantly, Chief Justice Warren's concurring opinion proposed expansion of the *New York Times* public official concept to include "public figures" because they often are influential in ordering society[34] and have ready access to the mass media, allowing them to influence policy and to counter criticism of their views and activities.[35] Indicating its deference to first amendment values, the plurality opinion in *Rosenbloom v. Metromedia, Inc.,*[36] held that any person involved in matters of public or general concern must prove actual malice to recover in a defamation action.[37] In dissent, Justice Harlan stated that the Court was undervaluing the reputational

27. 414 F.2d 324 (2d Cir. 1969), *cert. denied,* 396 U.S. 1049 (1970).

28. 414 F.2d at 342.

29. 383 U.S. 75 (1966).

30. The supervisor of a county-operated recreation area brought suit, claiming that the *New York Times* standard was not applicable to him because he was not a public official.

31. 388 U.S. 130 (1967). An article published by defendant *Saturday Evening Post* charged that plaintiff, tbe head football coach at the University of Georgia, had fixed a football game. The Court held plaintiff was a "public figure" and had to meet the *New York Times* standard of proof in order to be awarded damages.

32. *Id.* at 147.

33. *Id.* at 155.

34. *Id.* at 164 (Warren, C.J., concurring).

35. *Id.* For a discussion of this ready access argument, see Barron, *Access—The Only Choice for the Media?,* 48 TEX. L. REV. 766 (1970).

36. 403 U.S. 29 (1971). Defendant radio station broadcast news stories of plaintiff's arrest for possession of obscene literature and also reported on plaintiff's lawsuit against city and police officials alleging that the magazines he distributed were not obscene. These latter stories did not mention plaintiff's name, but referred to him in less than flattering terms.

37. *Id.* at 44.

interest and argued that publishers should be required to investigate statements carefully before publication.[38] Reasoning that a private person should be afforded greater protection because he has more limited access to the media than a public figure,[39] Justice Harlan advocated a negligence standard of liability for defamation of private persons by the media. The Court in *Gertz v. Robert Welch, Inc.*,[40] adopted Justice Harlan's reasoning, and held that the constitutional privilege established in *New York Times* extended only to defamatory falsehoods about public officials and public figures. The Court recognized the legitimate state interest in protecting an individual's reputational interests by allowing the states to determine the standard of care imposed upon the media for defamatory statements about private individuals.[41] The *Gertz* Court also limited recovery of damages to the amount of the actual injury unless liability was based upon a knowing falsity.[42] For public officials and public figures, *New York Times* and its progeny established the constitutional rule that a plaintiff must demonstrate that a false statement was knowingly made or was made in reckless disregard of the truth to recover against a media defendant.

B. *The Newsperson's Privilege*

The press has maintained that its right to acquire, edit, and disseminate the news is protected by the first amendment in order to assure the continued vitality of the press. A constitutional privilege has long existed for the unrestrained dissemination of the news by the press. In *Near v. Minnesota*,[43] the Court viewed prior restraints on the press as constitutionally impermissible even if the suppressed information was libelous and emphasized the public's need for a vigorous press to expose governmental corruption.[44] In

38. *Id.* at 70 (Harlan, J., dissenting).

39. *Id.* at 66-72.

40. 418 U.S. 323 (1974). The plaintiff was an attorney representing the family of a youth who had been unlawfully shot by a police officer. The defendant magazine, *American Opinion*, published an article identifying plaintiff as the architect of a nationwide Communist conspiracy to undermine law enforcement agencies. The article contained false statements about plaintiff's membership in certain Communist organizations and his criminal record.

41. *Id.* at 341-47. The Court gave the states the right to define liability standards for defamatory statements injurious to the individual, provided that they do not impose liability without fault. *See* 29 VAND. L. REV. 1431 (1976).

42. 418 U.S. at 349.

43. 283 U.S. 697 (1931). The Court invalidated a Minnesota statute that allowed the state to enjoin the publication of newspapers containing defamatory matter.

44. *Id.* at 719-20.

Grosjean v. American Press Co.,[45] the Court held that a Louisiana newspaper tax graduated to reflect circulation levels jeopardized the free flow of information. The Court recently reaffirmed the constitutional prohibition against prior restraints in *Nebraska Press Ass'n v. Stuart*,[46] advising judges to investigate carefully alternative methods for minimizing the effect of pretrial publicity before imposing gag orders on the press. The Court's decisions reflect a willingness to scrutinize the burdens imposed upon the distribution process by statutes or rulings even if such burdens only indirectly affect first amendment values.

Commentators have argued that the press must have the right to acquire information in order to exercise effectively its right to distribute the news.[47] This logical precedent has led the courts to consider a qualified constitutional newsperson's privilege. The constitutional claim to a newsperson's testimonial privilege is of recent origin. Because the common law viewed the duty to testify as something owed by all persons in the community, common-law courts repeatedly rejected claims to a newsperson's privilege based upon ethical considerations and economic hardship.[48] In *Garland v. Torre*,[49] the first case to consider whether news sources must remain confidential to assure the free flow of information guaranteed by the first amendment,[50] the Second Circuit held that the fair administration of justice is a paramount public interest that impinges upon the

45. 297 U.S. 233 (1936).

46. 427 U.S. 539 (1976).

47. *See* Guest & Stanzler, *The Constitutional Argument for Newsmen Concealing Their Sources*, 64 NW. U.L. REV. 18 (1969); Note, *The Right of the Press to Gather Information*, 71 COLUM. L. REV. 838 (1971).

48. Reporters argued that to reveal sources would impinge upon the ethical standards of their profession and would endanger their economic survival by disrupting the confidential relationships upon which the trade often depends. Both of these rationales for a newsperson's privilege were rejected by courts because of the priority given to legal considerations. Common-law courts, however, have shown some understanding of the newsperson's delicate position either by refusing to compel testimony from a newsperson when it was of doubtful relevance to the pending action or by minimizing the penalties for contempt charges made against a reluctant reporter. For a more thorough discussion of the common law history of the newsperson's privilege, see Comment, *The Newsman's Privilege After Branzburg v. Hayes: Whither Now?*, 64 J. CRIM. L. & CRIM. 218, 225-27 (1973).

49. 259 F.2d 545 (2d Cir. 1958). Defendant columnist attributed several statements that were alleged to be false and highly damaging to plaintiff's career to an unidentified CBS network executive. When Garland brought a defamation action, Torre refused to divulge the name of the CBS executive and was held in criminal contempt by the court. *Id.* at 547.

50. *See* Guest & Stanzler, *supra* note 47; Note, *The Newsman's Privilege: Government Investigations, Criminal Prosecutions and Private Litigation*, 58 CALIF. L. REV. 1198 (1970). *See generally* Blasi, *The Newsman's Privilege: An Empirical Study*, 70 MICH. L. REV. 229 (1971).

freedom of the press.[51]

The Supreme Court considered the newsperson's testimonial privilege in *Branzburg v. Hayes.*[52] Although the Court acknowledged that news gathering qualified for some first amendment protection, it emphasized that the first amendment did not invalidate every incidental burden on the press caused by the application of general laws.[53] Thus, Justice White's plurality opinion rejected a constitutional immunity from grand jury subpoenas for newspersons, holding that newspersons must appear before grand juries and answer all relevant questions concerning criminal investigations.[54] Justice Stewart's dissent, adopted by two other Justices, advocated a qualified newsperson's privilege that would protect the reporter from appearing before a grand jury unless the government could demonstrate the following: (1) probable cause to believe that the reporter had information clearly relevant to a specific probable violation of law; (2) the information could not be obtained by means less destructive of first amendment rights; and (3) a compelling interest in the information.[55] Justice Douglas's dissent argued that the first amendment required an absolute privilege protecting newspersons from revealing their sources.[56] Justice Powell, exercising the pivotal vote, wrote a concurring opinion that stressed the limited nature of the Court's holding.[57] Endorsing a qualified privilege, Justice Powell proposed a case-by-case balancing "between freedom of the press

51. 259 F.2d at 549.

52. 408 U.S. 665 (1972). The Court consolidated for review four cases concerning a newsperson's qualified privilege to withhold grand jury testimony. Paul Branzburg wrote a story for the *Louisville Courier-Journal* about the making of hashish, which caused him to be subpoenaed by two separate grand juries. In the first case *(Branzburg I),* he refused to say whom he had observed making the hashish; in the second case *(Branzburg II),* he refused to divulge the names of informers who had told him where the drugs were being used. Earl Caldwell, a reporter for the *New York Times,* had interviewed a Black Panther leader who expressed an intention to kill President Nixon. Caldwell had refused to appear before a grand jury or to turn over his notes and recordings relating to the interview. Paul Pappas, a reporter for a Providence, Rhode Island, television station, had been invited iuside a Black Panther headquarters to witness an anticipated raid that never occurred. Pappas testified about what he had seen outside the Panther headquarters before a grand jury, but not about what he had observed inside. *See* Goodale, *Branzburg v. Hayes and the Developing Qualified Privilege for Newsmen,* 26 HASTINGS L.J. 709, 710-13 (1975).

53. 408 U.S. at 682-83; *see* Note, *The Rights of the Public and the Press to Gather Information,* 87 HARV. L. REV. 1505 (1974); Note, *supra* note 47.

54. 408 U.S. at 690-91.

55. *Id.* at 743 (Stewart, J., dissenting).

56. *Id.* at 712 (Douglas, J., dissenting). Douglas stated, "His [reporter's] immunity in my view is therefore quite complete, for, absent his involvement in a crime, the First Amendment protects him against an appearance before a grand jury and if he is involved in a crime, the Fifth Amendment stands as a barrier." *Id.*

57. *Id.* at 709 (Powell, J., concurring).

and the obligation of all citizens to give relevant testimony with respect to criminal conduct."[58] Thus, the *Branzburg* opinions indicated that a qualified newsperson's privilege exists, but failed to define the scope of the privilege.[59] In *Baker v. F & F Investment,*[60] the Second Circuit, attempting to apply *Branzburg,* held that the public interest in receiving information from confidential informants can outweigh the public and private interest in compelled testimony.[61] In *Carey v. Hume,*[62] another Second Circuit decision since *Branzburg,* the court did order disclosure of a confidential source, but only because the allegedly libelous statement was based entirely on confidential sources, and the plaintiff had no way of proving the case without knowing the identity of those sources.[63]

The newsperson's constitutional protections for acquiring and disseminating information inevitably led to the Court's recognition that the editorial process also required safeguards. In *Columbia Broadcasting System, Inc. v. Democratic National Committee*[64] the Court held that the first amendment did not require the media to accept paid political advertisements, ruling that the first amendment implicitly protects the journalist's discretionary choice of material.[65] Subsequently, in *Miami Herald Publishing Co. v. Tornillo,*[66] the Court unanimously invalidated a state law compelling newspapers to accept editorial replies, reasoning that the law interfered with the editor's judgment of what constituted newsworthy material.[67] *CBS* and *Tornillo* highlight the Court's concern for governmental intrusions upon the editing process. Emphasizing the need for a vigorous and responsible press, the Court has authorized substantial protections against any encroachments upon the media's

58. *Id.* at 710; *see* Goodale, *supra* note 52, at 716-19. Goodale suggests that Powell has in effect adopted Stewart's tripartite test of (1) relevance; (2) exhaustion of alternative sources; and (3) compelling national interest in the testimony.

59. Several courts have considered the qualified privilege since *Branzburg,* and they generally have recognized a first amendment privilege hoth to gather and edit the news. *See* Goodale, *Subpoenas,* in PRACTISING LAW INSTITUTE, COMMUNICATIONS LAW 221-46 (1977).

60. 470 F.2d 778 (2d Cir. 1972), *cert. denied,* 411 U.S. 966 (1973).

61. *Id.* at 782.

62. 492 F.2d 631 (D.C. Cir.), *cert. dismissed,* 417 U.S. 938 (1974).

63. 492 F.2d at 637-39. A concurring opinion indicated that the immense power of the modern media required reporters to divulge sources in a civil libel suit. *Id.* at 639-40 (MacKinnon, J., concurring).

64. 412 U.S. 94 (1973).

65. *Id.* at 126-30.

66. 418 U.S. 241 (1974).

67. *See generally* Abrams, *In Defense of* Tornillo, 86 YALE L.J. 361 (1976); Note, *Reconciling* Red Lion *and* Tornillo: *A Consistent Theory of Media Regulation,* 28 STAN. L. REV. 563 (1976).

news-gathering, editing, or distribution functions, but has failed to delineate the full scope of these protections.

III. The Instant Opinion

Initially recognizing that the free flow of information depends upon the uninhibited acquisition, processing, and dissemination of information, the instant court held that the first amendment guarantee of a free press protects against disclosure of the editorial process. Asserting that *Branzburg* recognized the right of the press to acquire information and a testimonial privilege for reporters,[68] the court noted that prior restraints encouraging anticipatory censorship were constitutionally impermissible. The court also observed that the Supreme Court had given specific protections to the editorial process in *CBS* and *Tornillo.*[69] The court recognized that inquiries into defendant's thoughts, opinions, and conclusions while preparing a report endangered "the heart of the vital human component of the editorial process."[70] Reasoning that inquiries into the editorial process would chill candid discussion in the newsroom and encourage the media to avoid controversy,[71] the court concluded that the *New York Times* decision had sought to safeguard the constitutional values threatened by plaintiff. The court thus denied permission to inquire into defendant's thoughts, opinions, and conclusions in preparing the broadcast.

In addition to relying on the newsperson's privilege, the concurring opinion emphasized Justice Stewart's theory that the press has a special status in a constitutional scheme.[72] Justice Stewart had argued that the free press clause guaranteed the press more than freedom of expression since everyone is guaranteed such freedom under the freedom of speech clause.[73] Noting that the press is the only private business given constitutional protection, Justice Stew-

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68. 568 F.2d 974, 977-78 (2d Cir. 1977), *cert. granted,* 46 U.S.L.W. 3586 (U.S. Mar. 21, 1978) (No. 77-1105).

69. *Id.* at 978-79.

70. *Id.* at 984.

71. *Id.* The court presupposed that one of the first amendment's purposes was to encourage the press to enter controversies in fulfilling its role of informing and protecting the general public. *Id.*

72. Stewart, *Or of the Press,* 26 HASTINGS L.J. 631 (1975). *See also* Lange, *The Speech and Press Clauses,* 23 U.C.L.A. L. REV. 77 (1975); Nimmer, *Introduction—Is Freedom of the Press a Redundancy: What Does It Add to Freedom of Speech?,* 26 HASTINGS L.J. 639 (1975); Van Alstyne, *The Hazards to the Press of Claiming a "Preferred Position,"* 28 HASTINGS L.J. 761 (1977).

73. Stewart, *supra* note 72, at 633. Justice Stewart argued: "If the Free Press guarantee meant no more than freedom of expression, it would be a constitutional redundancy." *Id.*

art had asserted that the primary purpose for the freedom of press guarantee was "to create a fourth institution outside the Government as an additional check on the three official branches."[74] The concurring opinion concluded that in order to avoid anticipatory self-censorship the special protection provided in the Constitution for the media[75] dictated that editorial selections concerning choice of material, duration, and content of the broadcast be absolutely privileged.[76]

The dissent maintained that *Branzburg* did not establish a newsperson's privilege and that the instant decision therefore lacked "precedential foundation."[77] Noting that a defamation action under the *New York Times* standard required examination of the defendant's subjective state of mind, the dissent argued that investigation of editorial judgment was necessary to the cause of action.[78] The dissent concluded that because the purpose of a defamation action was to impose a necessary chill in media expression, a privilege protecting the editorial function was unnecessary.

IV. Comment

The instant court's recognition of an absolute editorial privilege is difficult to justify in light of its reliance upon *New York Times* and the cases prohibiting government infringement on press functions. The constitutional background of the newsperson's privilege reveals that it was not intended as a media defense in a defamation action. *Branzburg, CBS,* and *Tornillo* involved some form of government interference[79] that provoked the Court to protect the press by finding that the first amendment values of free expression outweighed the asserted states' interests. In the instant case, however, the government did not interfere with the media's right to gather, process, and disseminate the news. A public figure attempted to protect an interest in his reputation. The Supreme Court has never indicated under the newsperson's privilege line of cases that the press should be granted an absolute editorial privilege in not re-

74. *Id.* at 634.

75. 568 F.2d at 988-89 (Oakes, J., concurring).

76. *Id.* at 995.

77. *Id.* at 996 (Meskill, J., dissenting).

78. *Id.* at 997. The dissent noted that the *New York Times* standard focused upon an examination of the defendant's subjective state of mind and as such had a consequent chilling effect on the media. By suggesting that the publication of falsehoods should be discouraged, the dissent justified the resulting deterrent effect. *Id.* at 995.

79. In *Branzburg* the three reporters resisted a compelled appearance to testify before a grand jury hearing. Both *CBS* and *Tornillo* dealt with attempted government regulation of newspapers or broadcasting stations.

sponding to inquiries about a newsperson's thought processes in a defamation action. In *New York Times* the Supreme Court ruled that a public figure could recover damages only if he proved that a statement was knowingly false or made in reckless disregard of the facts. By erecting such a demanding standard, the Court perceived that the press would be encouraged to pursue public issues in a relentless and uninhibited manner, but a public figure plaintiff still would be able to recover damages when the press had engaged in gross indiscretions. Since *New York Times* was decided, the Supreme Court has considered several defamation cases to clarify the standards enunciated therein, and none of these cases indicates a desire by the Court to implement more stringent protections for the press in public figure defamation cases. The effect of the instant decision, however, is to narrow the application of discovery rules for a public figure plaintiff, thereby increasing the plaintiff's difficulty in meeting the heavy burden of proving the defendant's knowledge.

Because the press has the significant protection of the *New York Times* standard, a public figure plaintiff should be entitled to liberal pretrial discovery of information relevant to his cause of action. The desired inquiries in the instant case are highly relevant. Under *St. Amant* the defendant's subjective state of mind is critical to the plaintiff's cause of action. By allowing a media defendant to assert a privilege protecting disclosure of the defendant's subjective state of mind, the court forces the plaintiff to meet the heavy burden of proof required by *New York Times* without the benefit of discovering the journalist's thoughts, opinions, and conclusions in preparing a publication or broadcast, and requires the trier of fact to draw inferences about the state of an individual's mind from the facts surrounding the alleged defamation. The court should have provided the plaintiff with some assurance that he would be given a full opportunity to prove his claim. In *Goldwater* the Second Circuit indicated that the trier of fact could appropriately infer a defendant's recklessness or his knowledge of falsity from evidence of negligence, motive, or intent.[80] The trier of fact thus can reach a reasonable conclusion about the defendant's subjective state of mind at the time of publication.[81] The court should have emphasized this point since its holding precludes a plaintiff's inquiry into relevant aspects of the case within the defendant's sole control. By emphasizing the trier of fact's interpretative function in a defamation action,

80. *See* text accompanying note 28 *supra*.
81. *See* text accompanying note 26 *supra*.

the court could have accommodated fairly the public figure's interest in protecting against injury to his reputation.

In addition, the court should have defined more precisely the limits to be placed upon the protections afforded the press by an absolute editorial privilege. In this case defendant turned over notes and outtakes relevant to the broadcast of the alleged defamation, choosing to make a stand on the intellectual decision making inherent in the editorial process.[82] Future media defendants, however, likely will assert that the constitutional privilege announced in this case protects notes and outtakes, arguing that to turn them over also would have a chilling effect on the editorial process. Notes and outtakes that are in the sole control of the defendant are material items relevant to the plaintiff's cause of action and should be discoverable since they are not part of the intellectual decision of what information should be broadcast. By carefully confining the protection of the constitutional privilege to the newsperson's thought processes, and by emphasizing the jury's interpretative function in a defamation action, the court could have insulated the press from any possible chilling effects while accommodating a public figure plaintiff's right of access to relevant evidence bearing on a defamation claim.

ALAN WILLIAM DUNCAN

Income Taxation—Alternative Tax—In Computing Alternative Tax Under Section 1201 of the Internal Revenue Code Taxpayer May Not Deduct from Net Long-Term Capital Gain That Portion of Capital Gain Required To Be Set Aside Permanently for Charitable Organizations

I. FACTS AND HOLDING

Decedent's will required taxpayer estate to distribute to specified charitable organizations a specific portion of net long-term capital gain realized upon the sale of any securities included in the

82. CBS recognized that this was a case of first impression and chose to contest the discoverability of the intellectual aspect of the editorial process by claiming an editorial privilege. After this decision, CBS might decide to argue for an editorial privilege for notes and outtakes relating to a broadcast. *See* N.Y.L.J., Dec. 7, 1977, at 2, col. 3.

residue of the estate.[1] In calculating the alternative tax[2] on the capital gains realized by the estate in 1967 and 1968, taxpayer deducted from capital gains the amounts required to be set aside for charities.[3] The Internal Revenue Service disallowed the taxpayer's

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1. The will of Walter E. Disney required taxpayer estate to set aside 45% of the residue of the estate to designated charitable organizations. During 1967 and 1968, plaintiffs, United California Bank and Lillian Disney Truyens, co-executors of the estate, sold certain securities included in the residue of the estate and realized net long-term capital gains of $500,622.38 and $1,058,018.43. In 1967 a net short-term capital gain of $16,944.16 also was realized. As directed by the will, plaintiffs set aside 45% of the net long-term capital gain to the designated charitable organizations.

2. The court construed the alternative tax provisions in Int. Rev. Code of 1954, ch. 1, § 1201(b), 68A Stat. 320 (now I.R.C. § 1201(b)), which read:

> (b) Other Taxpayers.—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—
>
> (1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and
>
> (2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

See notes 10-14 *infra* and accompanying text.

3. The instant opinion contains the following hypothetical example as an illustration of the taxpayer's method of computing the alternative tax. Although the actual figures involved in the case differ, they approximate those used in this example. Assume that the taxpayer estate realized and recognized $50,000 in ordinary income and $500,000 in net long-term capital gain, and that the estate is required to set aside for charities 50% of its long-term capital gain. Assume finally that an effective tax rate of 60% applies to this taxpayer.

Both the taxpayer and the government agreed that estate taxable income must be calculated in the following manner:

Gross Income		$550,000
Less: § 1202 deduction	$250,000	
§ 642(c) deduction (adjusted as required by § 642(c)(4))	125,000	
Total Deductions	$375,000	
Estate Taxable Income		$175,000

Assuming a 60% effective rate, the tax owed by the estate (if the alternative tax is not used) would be $105,000. The taxpayer computed the alternative tax in the following manner:

Estate Taxable Income	$175,000
Less: 50% of that portion of the excess of net long-term capital gain over net short-term capital loss *not permanently set aside for charity* ($250,000)	125,000
Partial Taxable Income	$ 50,000
Partial Tax (assume 60% effective rate)	30,000
Tax on excess of net long-term capital gain over net short-term capital loss *not permanently set aside for charity* (25% of $250,000)	62,500
Total Alternative Tax	$ 92,500

computation method, contending that a deduction for charitable set asides and payments was not allowable under section 1201.[4] Taxpayer instituted a suit for refund of the additional tax paid,[5] and the district court granted the refund.[6] On appeal to the United States Court of Appeals for the Ninth Circuit, *held,* reversed. In computing the alternative tax under I.R.C. § 1201, a taxpayer may not deduct from net long-term capital gain that portion of capital gain required to be set aside permanently for charitable organizations. *United California Bank v. United States,* 563 F.2d 400 (9th Cir. 1977), *cert. granted,* 46 U.S.L.W. 3586 (U.S. Mar. 21, 1978) (No. 77-1016).

II. LEGAL BACKGROUND

Congress has continuously given preferential treatment to the realization of capital gains, taxing them at a lower rate than ordinary income.[7] The favored status of capital gains originally was designed to allow individuals to sell or exchange capital assets without fear of a prohibitive tax at ordinary rates.[8] The alternative tax,

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The alternative tax computed in the taxpayer's manner ($92,500) would be lower than the tax that would be paid if no alternative computation were used ($105,000). United Cal. Bank v. United States, 563 F.2d 400, 402-03 (9th Cir. 1977), *cert. granted,* 46 U.S.L.W. 3586 (U.S. Mar. 21, 1978) (No. 77-1016).

4. The government argued that § 1201(b) requires computation on the excess of net long-term gain over net short-term loss and that it does not mention any exclusion of amounts required to be set aside permanently for charities. Assuming the same facts given in the hypothetical in note 3, the government calculated the alternative tax in the following manner:

Estate Taxable Income	$175,000
Less: 50% of excess of net long-term capital gain over net short-term capital loss ($500,000)	250,000
Partial Taxable Income	—0—
Partial Tax	—0—
Tax on excess of net long-term capital gain over net short-term capital loss (25% of $500,000)	125,000
Total Alternative Tax	$125,000

Id. at 402.

Because the alternative tax computed by the government's method ($125,000) exceeded the tax computed without using the alternative method ($105,000), the latter figure represented the correct tax in the government's view.

5. Taxpayer was assessed deficiencies in the amounts of $4,998.93 for 1967 and $27,445.05 for 1968, plus interest of $1,099.76 and $4,386.41 for the respective years. Taxpayer sought a refund of these amounts, which represent the additional tax owed as a result of the government's disallowance of the taxpayer's alternative tax computation method. *See* notes 3-4 *supra.*

6. United Cal. Bank v. United States, 75-1 U.S. Tax Cas. ¶ 9164 (C.D. Cal. 1974).

7. J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 22.01-.02 (rev. ed. 1973).

8. *Id.*

which provides a further incentive for these taxpayers, permits tax computation at a rate even more favorable than regular capital gains treatment.[9] Prior to 1969, the alternative tax provisions of section 1201 applied to all of an individual taxpayer's net long-term gain.[10] Although relatively few taxpayers used the alternative tax, those that did benefited substantially.[11] Congressional concern that section 1201 provided inordinate benefits to a select group of taxpayers led to a considerable curtailment of the individual alternative tax by the Tax Reform Act of 1969.[12] The amended version of section 1201 provides that only the first 50,000 dollars of capital gains are entitled to the alternative rate.[13] By so amending section 1201, Congress eliminated the opportunity for taxpayers with large amounts of capital gain to save substantial amounts of tax by using the alternative method.[14]

Few federal appellate decisions have addressed directly the alternative tax provisions of the Code. In *Weil v. Commissioner*,[15] individual taxpayers calculated the alternative tax by using an excess of charitable contribution deductions over ordinary income to

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9. *Id.* at § 22.07. The alternative tax provisions of § 1201 apply a flat 25% rate to capital gains, thereby benefiting taxpayers who have an effective long-term capital gains rate in excess of 25%.

10. *Id.* The instant case was decided under the pre-1969 alternative tax provision. *See* note 2 *supra*.

11. In 1969 only 2% of all taxpayers reporting capital gains could compute an alternative tax that was lower than their tax computed at regular rates, but this group accounted for approximately 28% of all capital gains reported by individual taxpayers. S. REP. No. 91-552, 91st Cong., 1st Sess. 191, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2225 [hereinafter cited as S. REP. 91-552].

12. Tax Reform Act of 1969, Pub. L. No. 91-172, § 511(b), 83 Stat. 487, 635-36. The House Report to this amendment advocated abolishing the alternative tax altogether. H.R. REP. No. 91-413, 91st Cong., 1st Sess. 144-46, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 1988. The Senate Report agreed with the objectives of the House Report, but proposed to limit alternative tax treatment to the first $140,000 of capital gain in order to allow taxpayers with relatively small amounts of capital gain to continue using the alternative tax. S. REP. 91-552, *supra* note 11, at 192-94, [1969] U.S. CODE CONG. & AD. NEWS at 2226.

13. This limitation remains in the current version of I.R.C. § 1201. The $50,000 figure represents a conference committee compromise. CONF. REP. No. 91-782, 91st Cong., 1st Sess. 162-64, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2392, 2431-32.

14. With the current $50,000 limitation, the largest amount a taxpayer could save by using the alternative method is $5,000. For example, assume that a taxpayer is in the 70% bracket and that the application of the 50% capital gains deduction formula of § 1202 would therefore result in an effective tax rate of 35%. The alternative tax rate of 25% can be applied only to capital gains up to $50,000, giving an alternative tax of $12,500 on that maximum amount. If the tax on the $50,000 was computed at the 35% effective rate, the amount owed would be $17,500.

15. 229 F.2d 593 (6th Cir. 1956). The *Weil* court construed the alternative tax as it existed in the 1939 Code. Int. Rev. Code of 1939, ch. 1, § 117(c), 53 Stat. 51 (now I.R.C. § 1201).

reduce long-term capital gain before applying the twenty-five percent rate.[16] In affirming the Tax Court's rejection of the taxpayers' method of alternative tax computation, the Sixth Circuit held that these unused deductions could be used only to reduce ordinary income, not to reduce taxable capital gain in computing the alternative tax.[17] The *Weil* court emphasized that denying the taxpayers' calculation method would not be unfair because the government's alternative tax computation method also resulted in a tax substantially lower than that provided by the regular method of tax computation.[18]

Statler Trust v. Commissioner,[19] decided by the Second Circuit in 1966, represents the only case to consider directly whether a taxpayer computing the alternative tax can deduct from long-term capital gain an amount required to be set aside permanently for charitable organizations. In *Statler Trust* the government argued disallowance of the deduction on the ground that section 1201 does not refer to any deductions for charitable contributions and is on its face clear and unambiguous.[20] The government further contended that a literal interpretation of the statute would not be unfair since, as in *Weil,* the alternative tax computed by the government's method still would be less than the tax computed without using the alternative provision.[21] In rejecting the government's strict interpre-

16. The deductions claimed by the taxpayers in *Weil* resulted from charitable contributions made by the taxpayers out of capital gains they had realized during the year. Because these deductions exceeded the ordinary income of the taxpayers, they argued that they be allowed first to use the deductions to reduce their ordinary income to zerò and then to use the excess to reduce their long-term capital gain in computing the alternative tax.

17. 229 F.2d at 595-96.

18. *Id.* at 596. Courts, however, have not held uniformly against the taxpayer. A line of cases allows taxpayers to use a § 691(c) deduction for estate taxes paid to offset capital gains in computing the alternative tax. Read v. United States, 320 F.2d 550 (5th Cir. 1963); Meissner v. United States, 364 F.2d 409 (Ct. Cl. 1966); Estate of Sidles v. Commissioner, 65 T.C. 873 (1976). *See also* Quick v. United States, 503 F.2d 100 (10th Cir. 1974); Goodwin v. United States, 458 F.2d 108 (Ct. Cl. 1972). Section 691(c) allows a deduction for estate taxes properly allocable to income in respect of a decedent.

19. 361 F.2d 128 (2d Cir. 1966), *rev'g* 43 T.C. 208 (1964). The taxpayer trust in *Statler Trust* was required to make charitable gifts of not less than 15% nor more than 30% each year from the net income of the trust. The charities were to be chosen by majority vote of the trustees and the children of Ellsworth M. Statler, with the trustees to determine the precise percentage of the gifts. A later settlement agreement between the trustees, the income beneficiaries, and a representative of the undesignated charitable beneficiaries provided for a set percentage of capital gain recognized on a specific sale of shares of stock to be paid to charitable organizations. The Tax Court considered *Weil* to be applicable and controlling. Statler Trust v. Commissioner, 43 T.C. 208, 215 (1964); *see* notes 15-18 *supra* and accompanying text.

20. 361 F.2d at 130.

21. *Id.* at 130-31.

tation, Judge Friendly's majority opinion in *Statler Trust* reasoned that amounts required to be set aside permanently for charitable use should fall within the conduit principle governing the trust provisions of Subchapter J.[22]

The conduit principle of Subchapter J generally taxes estates and trusts in the same manner as it taxes individuals, but provides that income distributions to trust beneficiaries are deductible by the estate and taxable to the beneficiaries.[23] This approach necessitates the use of a measure to impose a maximum limit on the total distributions deductible by the estate or trust and taxable to the beneficiaries.[24] For this purpose Congress devised the concept of distributable net income, defined in section 643 to mean the taxable income of the estate or trust with certain modifications.[25] The concept of distributable net income thus gives statutory expression to the conduit principle since estates and trusts become only conduits through which distributed taxable income of the current year flows to and is taxed to the beneficiaries.[26] Income accumulated for future distribution remains taxable to the estate or trust.[27] Because section 643(a)(3)[28] includes capital gains required to be distributed to charities within the definition of distributable net income, Judge Friendly in *Statler Trust* determined that Congress considered such

22. *Id.* at 131-32. I.R.C. §§ 641-692 constitute Subchapter J and deal generally with taxation of estates, trusts, beneficiaries, and decedents.

23. *See* I.R.C. §§ 651-652, 661-662; S. REP. No. 1622, 83d Cong., 2d Sess. 82, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4623, 4714-15 [hereinafter cited as S. REP. 1622].

24. S. REP. 1622, *supra* note 23, at 82, [1954] U.S. CODE CONG. & AD. NEWS at 4715.

25. *Id.* at 343, [1954] U.S. CODE CONG. & AD. NEWS at 4984. Since the distributable net income concept is used to determine the character of amounts distributed to a beneficiary, the taxable income of the estate or trust must be adjusted by adding to it items of trust income that are not includible in the gross income of the estate or trust, but are nevertheless available for distribution to the beneficiaries. Section 643(a) defines distributable net income as the taxable income of the estate or trust computed to include, among other things, amounts deductible by the trust under § 661 as distributions and amounts deductible by the trust under § 642(c) that are paid to charities. *See* note 28 *infra*.

26. S. REP. 1622, *supra* note 23, at 343, [1954] U.S. CODE CONG. & AD. NEWS at 4984.

27. *Id.*

28. I.R.C. § 643 provides in part:

> (a) Distributable Net Income.—For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—
>
> . . . .
>
> (3) Capital gains and losses.—Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not . . . (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

charitable payments to be within the conduit structure of Subchapter J.[29]

The government criticized Judge Friendly's conduit analysis by pointing out the differences between the general conduit approach of Subchapter J and the special Code provisions applicable to charitable payments from trusts and estates.[30] Although Subchapter J generally treats amounts paid by the trust to beneficiaries as distribution deductions for the trust under section 661(a),[31] the Code treats charitable payments as charitable deductions for the trust under section 642(c)[32] and forbids in section 663(a)(2)[33] a section 661 distribution deduction for amounts paid to charities. The government contended that if Congress had intended that charitable payments be accorded Subchapter J conduit treatment, Congress would not have provided for this separate treatment.[34] The government focused on the apparent inconsistency between the general Subchapter J requirement that distributions to beneficiaries be included in the income of the beneficiaries pursuant to section 662(a)[35]

29. 361 F.2d at 131-32. In reaching this conclusion, Judge Friendly undertook an examination of the relevant legislative history of Subchapter J. *See* notes 23-27 *supra* and accompanying text.

30. 361 F.2d at 131.

31. I.R.C. § 661 provides in part:

> (a) Deduction.—In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—
>
> (1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and
>
> (2) any other amounts properly paid or credited or required to be distributed for such taxable year;
>
> but such deduction shall not exceed the distributable net income of the estate or trust.

32. The version of § 642(c) in effect until 1969 authorized a deduction by an estate or trust for any amount of gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for charity. Int. Rev. Code of 1954, ch. 1, § 642(c), 68A Stat. 215 (now I.R.C. § 642(c)). The Tax Reform Act of 1969 amended § 642(c) to eliminate the unlimited deduction allowed trusts and estates for amounts set aside for (rather than paid to) charity. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201, 83 Stat. 487, 558-59. Under the current version of § 642(c), taxable trusts must pay out their income currently to charities in order to obtain the charitable deduction.

33. I.R.C. § 663 provides in part:

> (a) Exclusions.—There shall not be included as amounts falling within section 661(a) or 662(a)—
>
> . . . .
>
> (2) Charitable, etc., distributions.—Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642(c) (computed without regard to sections 508(d), 681, and 4948(c)(4)).

34. 361 F.2d at 131-32.

35. I.R.C. § 662 provides in part:

and the section 663(a)(2) prohibition against such inclusion in the case of charitable payments.[36]

Judge Friendly answered the government's objections by examining the legislative history of sections 642(c) and 663(a)(2).[37] He determined that Congress had enacted section 642(c) to prevent charitable gifts by trusts from being subject to the percentage limitations imposed on individuals by section 170(b).[38] The opinion reasoned that the decision to enact the broad deduction of section 642(c) led Congress to enact section 663(a)(2) in order to prevent a trust from having a double deduction and a beneficiary from claiming a charitable deduction already taken by the trustee.[39] Judge Friendly concluded that the strict reading of the Code urged by the government exalted form over substance and conflicted with the general congressional scheme of trust taxation.[40] Finally, the *Statler Trust* court noted that adoption of the government's literal interpretation would increase the tax burden on either the charities or the remaindermen, a result Congress was unlikely to have intended.[41]

(a) Inclusion.—Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in section 661(a) is paid, credited, or required to be distributed (by an estate or trust described in section 661), the sum of the following amounts:

(1) Amounts required to be distributed currently.—The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. . . .

(2) Other amounts distributed.—All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year.

36. 361 F.2d at 131; *see* note 33 *supra.*

37. 361 F.2d at 132.

38. The House Report's detailed discussion of § 642 states: "Except as provided in section 681 (relating to prohibited transactions, improper accumulations, and so forth), a trust or estate is allowed an unlimited deduction for charitable contributions and is not subject to the limitation imposed on the charitable contributions of individuals." H.R. REP. No. 1337, 83d Cong., 2d Sess. A 193, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4019, 4332.

I.R.C. § 170(b) places percentage limitations upon charitable contributions of certain capital gain property by individual taxpayers.

39. The House Report's detailed discussion of § 663(a)(2) states:

> Paragraph (3) provides that any amount paid, permanently set aside or to be used for the purposes specified in section 642(c) (relating to charitable, etc., deductions) is excluded from the provisions of sections 661 and 662. Since the estate or trust is allowed a deduction under section 642(c) for these amounts, they are not allowed as an additional deduction for distributions nor are they treated as amounts distributed for purposes of section 662 in determining the amounts includible in the gross income of the beneficiaries.

Id. at A 205, [1954] U.S. CODE CONG. & AD. NEWS at 4344.

40. 361 F.2d at 131-32.

41. *Id.* at 132. Judge Friendly reasoned that, if the trust were required to pay more tax, it would do so by taking income away from amounts that otherwise would have gone either to the charitable beneficiaries or to the remaindermen. Judge Friendly believed that a tax paid out of amounts that would have gone to charities would encroach indirectly upon the

District Judge Dooling's[42] strong dissent in *Statler Trust* challenged the majority's conduit analysis.[43] The dissent emphasized that the conduit provisions of Subchapter J constitute a tight and explicit structure, but section 663(a)(2) removes payments out of trusts to charities from this structure.[44] The dissent found that the inclusion in distributable net income of capital gains paid or set aside to charity did not support an inference of general conduit treatment for such amounts since sections 642(c) and 663(a)(2) evidence a congressional refusal to treat distributable charitable amounts in the general Subchapter J manner.[45] He concluded that the clear words of Congress provide a safer guide to statutory meaning than the invocation of a purpose or spirit inferred from the more general structural features of a very complex enactment.[46] Although Judge Dooling's well-articulated dissent urged further judicial scrutiny of the majority's conduit analysis, prior to the instant case *Statler Trust* was the only federal appellate decision to address the deduction of capital gains required to be set aside for charities in the computation of the alternative tax.

III. THE INSTANT OPINION

In holding that set asides of capital gains to charity are not accorded conduit treatment by the Internal Revenue Code and may not be excluded by a trust in computing its alternative tax on capital gains, the instant court adopted an analysis substantially different from that employed in the *Statler Trust* dissent. As a means of demonstrating that the Code does not provide conduit treatment for charitable gifts by insulating them from other transactions affecting the taxable status of an estate or trust, the court constructed a model of a true conduit approach.[47] The court contended that true conduit treatment would suggest that charitable amounts be ex-

tax exempt status of charities afforded by § 501. On the other hand, to pay the tax out of amounts that would otherwise have gone to the remaindermen would increase indirectly their tax burden and thus would discourage trusts from including charities among the income beneficiaries. In either situation, Judge Friendly concluded, the result would be inconsistent with the favorable treatment Congress has accorded charities.

42. Judge Dooling from the Eastern District of New York sat by designation.

43. 361 F.2d at 133 (Dooling, J., dissenting).

44. *Id.*

45. *Id.* Judge Dooling asserted that the consequence of Judge Friendly's conduit analysis would require that currently distributable amounts, by their intrinsic nature, be characterized as distributions and deductible as such on the trustee return under § 661(a). Since by enacting § 642(c) and § 663(a)(2), Congress denied to charitable payments this consequence, Judge Dooling reasoned that a conduit analysis was invalid.

46. *Id.*

47. 563 F.2d at 404-05.

cluded from the distributable net income concept rather than being included within distributable net income by section 643(a)(3).[48] Addressing the determination of the amounts includible in the gross income of an estate or trust beneficiary under a pure conduit approach, the instant opinion stated that section 662 ideally would allocate only an amount reduced by charitable distributions and would not be limited by a distributable net income figure arrived at after allowing an unlimited deduction for charitable contributions.[49] The court insisted that no deduction would ever be taken under a pure conduit approach for amounts set aside for charity in computing the taxable income of an estate or trust. These amounts simply would be excluded from gross income altogether.[50] The court further argued that a pure conduit approach would necessitate calculating the regular tax by excluding charitable payments from gross income, not by relying on the deductions provided by sections 642(c) and 1202.[51] The court also insisted that consistent application of the conduit approach would require a provision in section 1202[52] requiring the exclusion of capital gains distributed to or set aside for charity in computing the long-term capital gain deduction.[53]

Confronted with the apparent inconsistencies between the taxpayer's conduit theory and the structural characteristics of the Code, the court agreed with the *Statler Trust* dissent that the wording of the statute was too plain to be inadvertent and felt compelled to follow closely the precise language of the Code.[54] Although recognizing that its decision precluded the taxpayer from using the alternative tax provision because the regular tax on capital gains would be lower than the government's computation, the court concluded

48. *Id.* at 404; *see* notes 28-29 *supra* and accompanying text.

49. 563 F.2d at 404.

50. *Id.*

51. *Id.* I.R.C. § 1202 allows a taxpayer to deduct 50% of net capital gain from gross income. Although § 642(c) allows an unlimited deduction for charitable contributions, § 642(c)(4) provides that proper adjustment be made for any deduction allowable to an estate or trust under § 1202. Estates and trusts thus are allowed to deduct an adjusted amount for charitable distributions under § 642(c) after taking the general capital gains deduction under § 1202. *See* the deduction calculations in note 3 *supra.*

The calculation of the regular tax on capital gains is the same if payments to charities simply are excluded from gross income at the outset or if the charitable payments are deducted from gross income during the computation process as the Code requires.

52. *See* note 51 *supra.* Section 1202 requires the exclusion of capital gains that under § 652 and § 662 are includible in the gross income of income beneficiaries of estates or trusts as gain derived from the sale or exchange of capital assets.

53. 563 F.2d at 405.

54. *Id.* at 405-06. The instant opinion refused to apply the line of decisions allowing the deduction for estate taxes allocable to income in respect of a decedent under § 691(c) against capital gain in computing the alternative tax. *See* note 18 *supra.*

that its decision satisfied both the letter and the spirit of the applicable provisions of the Code and was not unfair to the taxpayer.[55] Despite its initial recognition that *Statler Trust* was directly on point, the Ninth Circuit ultimately agreed with the government that *Statler Trust* was decided wrongly.[56] Its decision thus created a circuit court split on the issue whether amounts required to be set aside for or distributed to charities can be excluded from net long-term capital gain in the computation of the alternative tax.

IV. Comment

In applying a literal interpretation of the alternative tax provisions of section 1201, the instant court disregarded the intent and spirit of the Code provisions relating to trust taxation. Instead of analyzing carefully the legislative history of the alternative tax and of the hybrid conduit scheme of Subchapter J, the court took the narrow view that Congress's failure to adopt a pure conduit approach mandated a literal interpretation of the wording of the alternative tax provision. The legislative history of Subchapter J clearly shows that Congress intended to adopt a conduit approach in its treatment of trusts and estates when it devised the concept of distributable net income.[57] *Statler Trust* correctly points to the inclusion in distributable net income of amounts required to be paid to or set aside for charities as evidence of a congressional intent to accord Subchapter J conduit treatment to these amounts. Even the dissent in *Statler Trust* indicates that this analysis would be correct if sections 642(c) and 663(a)(2) did not evidence a separate treatment for charitable payments.[58] As the *Statler Trust* majority discovered upon examination of the legislative history of sections 642(c) and 663(a)(2), these sections were enacted to serve specific and limited purposes and clearly were not intended to take charitable payments made by trusts out of the Subchapter J conduit structure.[59]

Unlike the clear articulation of the issues by the *Statler Trust* dissent, the instant opinion's confusing construction of a pure conduit approach to trust taxation ignores the intent of Congress behind the conduit-like principle embodied in Subchapter J. Although the court correctly discerns that a pure conduit approach would

55. 563 F.2d at 406. The court cited *Weil. See* notes 15-18 *supra* and accompanying text.
56. 563 F.2d at 402.
57. *See* notes 23-29 *supra* and accompanying text.
58. 361 F.2d at 133; *see* notes 42-46 *supra* and accompanying text.
59. *See* notes 38-39 *supra* and accompanying text.

eliminate the necessity for the distributable net income concept by providing for exclusions instead of deductions,[60] Congress never intended to apply a pure conduit approach to trust taxation. Instead, Congress has established a hybrid conduit system in the mechanism of Subchapter J. The court fails to note that its objections to the taxpayer's conduit arguments are not confined merely to charitable payments out of trusts, but apply logically to any characterization of the entire Subchapter J structure as a conduit approach.

The instant decision further fails to explain clearly that sections 642(c) and 663(a)(2) treat charitable payments differently than other Subchapter J distributions. Although Judge Friendly in *Statler Trust* opined that the legislative history of these sections indicated that their purpose was not to take payments from trusts to charities out of the conduit approach of Subchapter J, Judge Dooling's dissent had made a plausible argument that these sections should be read to deny the conduit principle to such payments. By not recognizing and utilizing this argument, the instant court deprived itself of the most effective analysis supporting its conclusion.

The validity of the court's analysis also is diminished by its assumption that had Congress intended a conduit approach for income distributed to charitable beneficiaries, section 1202 would require estates and trusts to exclude charitable payments in calculating the fifty percent capital gains deduction in the same manner that section 1202 currently requires the exclusion from this calculation of capital gains includible in the gross income of noncharitable trust beneficiaries under sections 652 and 662.[61] This argument ignores the tax-free status given to charitable beneficiaries by the Code. The exclusion provision in section 1202 clearly was intended to prevent a trust from taking a capital gains deduction on amounts that would be taxed to the trust beneficiaries. Section 642(c) provides a special unlimited deduction for trusts making contributions to charities intended to encourage taxpayers to contribute to charities and is taken after the section 1202 capital gains deduction.[62] If the section 1202 capital gains deduction had to be passed through to charitable beneficiaries who have no taxable income, the benefit of the capital gains deduction would be lost.[63] Therefore, the exclu-

60. Judge Sneed's opinion raised both conceptual and semantic objections to using deductions instead of exclusions in any type of conduit system. While this position is theoretically correct, it ignores the mechanism embodied in Subchapter J.

61. *See* notes 51-53 *supra* and accompanying text.

62. *See* note 51 *supra.*

63. The argument that the loss of the full § 1202 capital gains deduction would be recovered by the trust in using the full § 642(c) charitable deduction without adjustment is

sion provision in section 1202 should be interpreted as a measure to preserve the full benefit of the deduction for capital gains paid to charities, not as evidence of congressional intent to take these distributions outside the conduit structure of Subchapter J.

As Judge Friendly in *Statler Trust* correctly noted, if conduit treatment is not accorded charitable payments in the computation of the alternative tax, the resulting increase in tax will be borne ultimately by either the charities or the remaindermen.[64] Although Judge Friendly might have been exaggerating when he contended that a decision against the taxpayer is an indirect incursion on the tax exemption afforded charities by the Code, he undoubtedly is correct in noting that decisions such as the instant case inevitably will lessen the attractiveness of including charities in the income beneficiaries of trusts. Congress could not have intended such an adverse effect in light of the general Code policy favoring charities and encouraging charitable contributions.

The practical significance of the instant case has been tempered by the changes made in the Code in 1969. Both *Statler Trust* and the instant case concerned taxable years prior to these Code changes. Section 1201 now expressly limits the availability of the alternative tax computation to the first 50,000 dollars of capital gains.[65] As a result of this limitation, large amounts of tax in taxable years subsequent to 1969 will not be disputed because of different alternative tax computation methods. Furthermore, although both *Statler Trust* and the instant case clearly apply to both current charitable payments as well as charitable set asides, the current version of section 642 applies only to current payment situations and denies a deduction for charitable set asides.[66] Indeed, with the substantial erosion of section 1201 by the Tax Reform Act of 1969, Congress possibly will not retain the alternative tax in any form.[67]

Despite the impact of the 1969 Code amendments on the significance of the instant case, the issue remains relevant because many high-bracket taxpayers will continue to use the alternative tax for the first 50,000 dollars of their net long-term capital gains. Since

difficult to justify. The Code clearly is not written in this manner. Congress designed the § 1202 deduction to be taken first, with any necessary adjustment for charitable deductions to be made afterward pursuant to § 642(c)(4). The instant opinion recognized that these two sections interact in this manner in its illustration of the conflicting alternative tax computation methods. 563 F.2d at 402; *see* notes 3 & 51 *supra*.

64. *See* note 41 *supra* and accompanying text.

65. *See* notes 12-14 *supra* and accompanying text.

66. *See* note 32 *supra*.

67. *See* note 12 *supra*.

Congress has moved to limit the application of the alternative tax, it should set forth clearly the method of computation that should be used. In the absence of congressional action, a careful and thoughtful analysis of the relevant legislative history such as that undertaken by Judge Friendly in *Statler Trust* should lead the courts to conclude that Congress intended charitable payments from trusts to receive conduit treatment and that estates and trusts should not be required to include capital gains paid to charities in computing the alternative tax on net long-term capital gains.

ELTON GREGORY SNOWDEN

Income Taxation—Corporate Reorganization—Stock Received Under Contingent Payment Plan Is Subject to Imputed Interest Provisions of Section 483 of the Internal Revenue Code

I. FACTS AND HOLDING

Taxpayers,[1] pursuant to a "type B"[2] plan of reorganization, transferred their stock in the acquired corporation to the acquiring corporation for common stock and preferred stock in the acquiring corporation plus the right to receive additional shares of common stock in the acquiring corporation under a contingency provision.[3]

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1. Taxpayers are husband and wife.

2. A "type B" reorganization is defined by I.R.C. § 368(a)(1)(B), which provides:

(a) Reorganization.—

(1) In General.—For purposes of parts I and II and this part, the term "reorganization" means—

. . . .

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition); . . . .

3. Under the provision taxpayers would receive additional shares of common stock in the acquiring corporation if three years from the effective date of the reorganization taxpayers retained the shares initially received and the market value of the common stock was less than 120% of the market value on the date of reorganization or if the market value of the preferred stock initially received was less than $100 per share. The plan set out a formula for computing the number of shares to which taxpayers would be entitled if the contingencies occurred. During the contingency period, the acquiring corporation placed in a reserve account the

The plan did not provide that the acquiring corporation would pay interest to taxpayers on these additional shares if ultimately received under the contingency provision. When taxpayers, under the contingency provision, received additional shares of common stock in the acquiring corporation three years after the effective date of the reorganization, they reported no income with respect to the additional shares.[4] The Commissioner of Internal Revenue, relying on section 483[5] of the Internal Revenue Code, which requires that a

maximum numher of shares that taxpayers might receive. During the contingency period, taxpayers had no right to vote the shares in the reserve or to receive dividends thereon.

4. When the acquired corporation's stockholders receive stock under a "type B" plan of reorganization, they recognize no gain or loss by virtue of I.R.C. § 354(a)(1), which provides:

(a) General Rule.—

(1) In General.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

5. I.R.C. § 483 provides in pertinent part:

(a) AMOUNTS CONSTITUTING INTEREST.—For the purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) TOTAL UNSTATED INTEREST.—For purposes of this section, the term "total unstated interest" means . . . an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of the payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. . . .

(c) PAYMENTS TO WHICH SECTION APPLIES.—

(1) In general.—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regnlations prescribed by the Secretary for purposes of this subparagraph, there is total unstated interest.

. . . .

(2) Treatment of evidence of indebtedness.—For purposes of this section, an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property shall not be considered a payment. . . .

(d) PAYMENTS THAT ARE INDEFINITE AS TO TIME, LIABILITY, OR AMOUNT.—In the case of a contract for the sale or exchange of property under which the liability for, or the amount or due date of, any portion of a payment cannot be determined at the time of the sale or exchange, this section shall be separately applied to such portion as if it (and certain portion of each deferred payment received under a contract for the sale or exchange of property be treated as interest, assessed a deficiency for that year, claiming that taxpayers had failed to report an appropriate portion of the additional shares as interest income. In response to taxpayers' petition for a redetermination of the deficiency, the Tax Court of the United States upheld the Commissioner's application of section 483.[6] On appeal to the Court of Appeals for the Second Circuit, *held;* affirmed. When a taxpayer receives additional shares of stock under a contingency provision in a plan of reorganization, and the plan provides for no interest on the additional shares, a portion of the shares so received will be treated as imputed interest under section 483 of the Internal Revenue Code. *Solomon v. Commissioner*, 570 F.2d 28 (6th Cir. 1977).

II. LEGAL BACKGROUND

Section 368(a)(1)(B) of the Internal Revenue Code includes under the definition of corporate reorganization the acquisition of the stock of one corporation by another corporation solely in exchange for voting stock of the acquiring corporation.[7] Section 354(a)(1) provides that shareholders of the acquired corporation shall recognize no gain or loss on such an exchange.[8] The theory

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any amount of interest attributable to such portion) were the only payments due under the contract; and such determinations of liability, amount, and due date shall he made at the time payment of such portion is made.

. . . .

(f) EXCEPTIONS AND LIMITATIONS.—

(1) Sales price of $3,000 or less.—This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000.

(2) Carrying charges.—In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they include interest.

(3) Treatment of seller.—In the case of the seller, the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to this section if all of the gain, if any, on such sale or exchange would be considered ordinary income.

(4) Sales or exchanges of patents.—This section shall not apply to any payments made pursuant to a transfer described in section 1235(a) (relating to sale or exchange of patents).

(5) Annuities.—This section shall not apply to any amount the liability for which depends in whole or in part on the life expectance of one or more individuals and which constitutes an amount received as an annuity to which section 72 applies.

All references to sections in this Comment refer to the Internal Revenue Code of 1954.

6. Sidney R. Solomon, 67 T.C. 379 (1976).

7. *See* note 2 *supra.*

8. *See* note 4 *supra.*

justifying this nonrecognition treatment is that a reorganization based on a valid business purpose merely adjusts the form of corporate ownership and is therefore an inappropriate occasion for taxation. The Supreme Court adopted this theory in *Pinellas Ice & Cold Storage Co. v. Commissioner,*[9] and it is currently embodied in Treasury regulations promulgated under section 368.[10]

Desiring to obtain the tax deferral benefits of section 354,[11] many taxpayers planning a reorganization sought to bring their transactions within the requirements of the reorganization provisions. Problems in determining the value of the stock of each corporation, however, produced difficulties for the taxpayer who wished to consummate the reorganization in one step.[12] Therefore, taxpayers frequently structured plans of reorganization to include, in addition to an initial distribution of stock by the acquiring corporation, a contingency agreement entitling the stockholders of the acquired corporation to additional shares of the acquiring corporation if and when the contingencies provided for occurred.

Initially, such contingency agreements risked violating the "solely in exchange for voting stock" requirement of section 368(a)(1)(B).[13] In 1960, however, the Eighth Circuit in *Carlberg v.*

9. 287 U.S. 462 (1933).

10. I.R.C. § 368; Treas. Reg. § 1.368-1(b), (c) (1955).

11. Although § 354 provides for nonrecognition of gain or loss on transfers of stock pursuant to reorganization plans meeting its requirements, the taxpayer does not permanently avoid recognizing gain or loss but only defers recognition by virtue of § 356 of the Internal Revenue Code, which provides for a carryover of basis from the stock transferred in the reorganization to the stock received in the reorganization.

12. Often, even if the acquiring corporation's stock is traded on a national exchange, the stockholders of the acquired corporation may suspect that the market price is inflated. Similarly, the price may be so unstable that it is impossible to determine the value of the acquiring corporation's stock. Therefore, in a reorganization it may be desirable for the stockholders of the acquired corporation to receive some assurance that the shares they receive will not suffer a future decrease in value. This assurance usually consists of a contingency provision, which is a promise by the acquiring corporation to distribute more of its common stock to the acquired corporation's stockholders in the event that the market value of the acquiring corporation's stock declines. The contingency provision normally sets out a formula for the calculation of the precise number of shares to be distributed and fixes maximum and minimum numbers of shares that can be distributed.

A similar problem may exist in determining the value of the acquired corporation and the extent of its liabilities. In reorganizations in which the acquiring corporation acquires all the stock of the acquired corporation, no stock market value will exist on which to base a contingency provision. It is therefore customary to make additional stock payment provisions contingent on both the future earnings of the acquired corporation and a complete determination of its liabilities.

13. In defining a "type B" reorganization, § 368(a)(1)(B) requires that the stock of the acquired corporation be acquired "in exchange solely for all or a part of its [the acquiring corporation's] voting stock." If the transaction fails to meet this requirement, the transaction will not qualify for tax-free treatment.

United States[14] reviewed a plan of reorganization under which the acquired corporation's shareholders received an initial distribution of stock plus "certificates of contingent interest"[15] and held that such certificates constituted "voting stock" under section 368(a)(1)(B). Reasoning that the certificates were either "stock or they were nothing,"[16] the court found that the certificates did not constitute "other property" under section 356,[17] and that the transaction therefore qualified as a reorganization under section 368(a)(1)(B). This decision enabled taxpayers to use contingency provisions without risking a violation of the requirements of section 368.

Four years after *Carlberg,* Congress added section 483 to the Internal Revenue Code.[18] Section 483 applies to contracts for the sale or exchange of property in which part or all of the purchase price is to be deferred for more than one year. If the contract fails to provide for adequate interest, a certain portion of each payment received by the seller more than six months after the sale shall be treated as interest.[19] Section 483 was enacted to prevent taxpayers from converting interest income into capital gain when selling capital assets.[20] It did not expressly purport to affect the use of contingency stock provisions in corporate reorganizations.[21] The section expressly applies, however, to "any contract for the sale or exchange of property,"[22] and its legislative history states that it was intended

14. 281 F.2d 507 (8th Cir. 1960). *See also* Rev. Rul. 67-90, 1967-1 C.B. 79; Rev. Proc. 67-13, 1967-1 C.B. 590; Rev. Proc. 67-34, 1966-2 C.B. 1232.

15. "Certificates of contingent interest" are certificates that entitle the former shareholders of the acquired corporation to additional shares of common stock of the acquiring corporation if the contingencies provided for occur.

16. 281 F.2d at 519.

17. The court found that the "certificates of contingent interest" represented nothing more than an interest in common stock and that the fact that the exact number of shares to be distributed thereunder could not be determined on the effective date of reorganization did not alter the character of the certificates. *Id.*

18. I.R.C. § 483 was enacted as Pub. L. No. 88-272, § 224(a), 78 Stat. 19 (1964), on February 26, 1964.

19. *See* note 5 *supra.*

20. A seller accomplishes this conversion by inflating the sale price to account for interest, accepting payment over a period of years, and including no interest in the payments. The seller, therefore, recognizes only capital gain on the transaction. Of course, by including no interest in the payments, the buyer loses a deduction for the interest he would have paid, but when the buyer is in a significantly lower tax bracket than the seller, the resulting adjustment of the selling price will be beneficial to both.

21. H.R. Rep. No. 749, 88th Cong., 1st Sess. 72-75 (1963), *reprinted in* [1964] U.S. Code Cong. & Ad. News 1380-82; S. Rep. No. 830, 88th Cong., 2d Sess. 101-04 (1964); *reprinted in* [1964] U.S. Code Cong. & Ad. News 1774-77.

22. I.R.C. § 483(a). Section 483 also states that it applies "for all purposes of this title."

to apply for "all purposes of the Code."[23] Furthermore, 483(f) lists five exceptions to which section 483 does not apply,[24] implying that Congress intended to exempt only those enumerated exceptions. The exceptions listed in 483(f) do not include contingent stock payments received in a reorganization. Moreover, section 483 specifically applies to contingent payments in general,[25] and the legislative history indicates that Congress did not intend to limit the application of section 483 to transactions in which gain or loss is recognized by the seller.[26] Thus, neither the section's express terms nor its legislative history suggests inapplicability to corporate reorganizations.

In 1966, the Treasury Department published final regulations defining "payments" under section 483 to include stock.[27] The regulations contained examples demonstrating the effect of section 483, two of which dealt with shareholders receiving stock under contingency provisions in corporate reorganizations.[28] These regulations distinguished between two types of contingency provisions. If the acquiring corporation retains the shares that may be transferred ultimately, the regulations provide that the imputed interest provisions of section 483 apply to the additional shares.[29] On the other hand, if the contingent shares are placed in an escrow account and the shareholders of the acquired corporation have the right to vote the shares and receive dividends, upon which they are taxed, the regulations state that section 483 does not apply to the additional shares if ultimately released from escrow to the shareholders of the acquired corporation.[30] In addition, Treasury Regulation 1.483-2(b)(3)[31] specifically states that section 483 applies to deferred transfers of stock under contingency provisions of a plan of reorganization notwithstanding section 354.

After the publication of the regulations under section 483, the

23. H.R. Rep. No. 749, 88th Cong., 1st Sess. A84 (1963), *reprinted in* [1964] U.S. Code Cong. & Ad. News 1510.

24. *See* note 5 *supra*.

25. I.R.C. § 483(d). Section 483(d) provides that § 483 applies notwithstanding that the "liability for, or the amount or due date . . . cannot be determined at the time of the sale or exchange. . . ."

26. The legislative history indicates that Congress intended § 483 to apply regardless of whether the seller recognized gain on the transaction so long as the gain, if recognized, would be capital gain. H.R. Rep. No. 749, 88th Cong., 1st Sess. A87 (1963), *reprinted in* [1964] U.S. Code Cong. & Ad. News 1512-13.

27. Treas. Reg. § 1.483-1(b)(1) (1966).

28. *Id.* § 1.483-(1)(b)(6), examples 7 & 8 (1966).

29. *Id.* example 7.

30. *Id.* example 8.

31. Treas Reg. § 1.483-2(b)(3) (1966).

Internal Revenue Service published Revenue Ruling 67-90,[32] which reiterated the *Carlberg* rule but added the caveat that section 483 may apply to any shares transferred under a contingency provision. Subsequent revenue rulings dealing with section 483's treatment of shares received under contingency provisions in reorganization plans ruled that when the indicia of ownership[33] required by the regulations were not present, section 483 would apply to the additional shares transferred.[34] When the required indicia of ownership were present, however, no interest would be imputed under section 483.[35] Therefore, section 483 apparently constituted a new hurdle for taxpayers who sought to use contingency provisions in their reorganizations. In *Fox v. United States*,[36] however, the Third Circuit ruled that notwithstanding its broad wording and background, section 483 must yield to the specific provisions of section 71[37] in cases of conflict therewith. By analogy, this decision suggested that taxpayers might be able to avoid section 483 by demonstrating conflict with the reorganization sections of the Code, but in a 1976 decision, *Sidney R. Solomon*,[38] the Tax Court upheld the regulations, stating that section 483 applies to transfers of additional stock under contingency provisions in reorganization plans when the shareholders

32. *See* note 14 *supra* and accompanying text.

33. The "indicia of ownership" are the rights to vote the shares and receive the dividends thereon. *See* Treas. Reg. § 1.483-1(b)(6), example 8 (1966).

34. Rev. Rul. 73-298, 1973-2 C.B. 173; Rev. Rul. 73-300, 1970-1 C.B. 125.

35. Rev. Rul. 70-120, 1970-1 C.B. 124. The rationale for not imputing interest when the required indicia of ownership are present is that the transfer of the contingent shares actually "occurs" on the effective date of reorganization. Thus the subsequent release from escrow does not constitute the "payment" required to trigger § 483.

In each of the rulings and regulations applying § 483 to contingency plans, the contingency provisions in question made the additional stock transfers depend on the future earnings of the acquired corporation. In 1973, however, the Internal Revenue Service published Revenue Ruling 73-298 which ruled that § 483 also applies when additional stock transfers are contingent upon the future market price of the acquired corporation's stock. This ruling therefore eliminated the belief that the Internal Revenue Service would only apply § 483 to contingency provisions based on the future earnings of the acquired corporation.

36. 510 F.2d 1330 (3d Cir. 1975).

37. Section 71 provides that periodic payments incident to a divorce are included in the gross income of the wife, but nonperiodic or lump-sum payments are not. In *Fox* taxpayer claimed that interest should be imputed under § 483 to nonperiodic payments incident to a divorce that he was paying to his wife. The court denied this contention, finding that under § 215, only those portions of the payments includable in the gross income of the wife are deductible by the husband, and finding that under § 71 the full amount of the nonperiodic payments is excluded from the gross income of the wife. Since treating any portion of the payments as interest income to the wife would conflict with § 71, the court held that § 483 did not apply. Therefore, since no portion of the payments was included in the income of the wife, under § 215 no portion was deductible by the hushand.

38. 67 T.C. 379 (1976). This was the Tax Court's decision in the instant case. *See* note 6 *supra* and accompanying text.

of the acquired corporation do not receive, on the effective date of reorganization, sufficient indicia of ownership.[39] In a holding similar to that in *Solomon*, the Court of Claims in *Jeffers v. United States*[40] ruled that in applying section 483 to contingent reorganization transfers, the Commissioner need not show that the parties intended any portion of the payments to represent interest if the transaction presented a potential for abuse by converting interest into capital gain.[41] The *Jeffers* court also rejected the argument that under *Carlberg* the contingent rights were "stock" so that any shares ultimately transferred pursuant to the contingent rights should be treated as having been received on the effective date of reorganization. The court argued that *Carlberg* was concerned with the nature of the shares ultimately transferred, not the question of the timing of the transfer. Thus a finding that the shares were transferred subsequent to the effective date of reorganization did not conflict with *Carlberg*.[42] The Tax Court subsequently affirmed the *Solomon* decision in *Alfred H. Catterall, Sr.*[43] and again in *John Cocker, III*,[44] finding the language of section 483 broad enough to apply to corporate reorganizations. In *Cocker* the court also cited a potential for abuse argument similar to that of the *Jeffers* court.[45]

A number of decisions thus had upheld the application of sec-

39. *Id.* at 387. According to the court, the required indicia of ownership were those specified in Revenue Ruling 70-120. *See* note 35 *supra* and accompanying text. Also, the court rejected petitioners' argument that the transfer of additional shares was not a payment under § 483, noting that the regulations clearly indicated that the transfer in question was a payment. 67 T.C. at 385-86.

40. 556 F.2d 986 (Ct. Cl. 1977).

41. *Id.* at 995. The court found that the legislative history indicated that Congress did not intend to hinge the application of § 483 on a finding that the parties intended any portion of the payments to account for interest. Rather, in view of the economic reality that a deferred payment is not equivalent to a current payment, Congress determined that when there was no provision for interest in the deferred payment, there was a potential for abuse—the conversion of interest into capital gain—and in such cases interest should be imputed. *Id.*

42. *Id.* at 996. Moreover, the court found that what the taxpayer actually received on the effective date of reorganization was an "evidence of indebtedness," which, by virtue of § 483(c)(2), was not a "payment." Thus, the "payment" of the stock eventually transferred could not be considered to have been received on the effective date of reorganization. *Id.* at 996-97.

43. 68 TAX CT. REP. DEC. (P-H) 228. The court in *Catterall* ruled that the absence of language such as that in I.R.C. § 1250 which provides that "[t]his section shall apply notwithstanding any other provision of this subtitle," did not make § 483 inapplicable, stating that when the language is broad enough to include a particular application, it is immaterial that Congress did not have that application in mind when it enacted the legislation.

44. 68 TAX CT. REP. DEC. (P-H) 302.

45. *Id.* at 308. The court found that, in substance, in contracts utilizing deferred payments, the payments usually included a portion that represented compensation for not receiving the payment immediately.

tion 483 to corporate reorganizations, citing among other factors, the potential for abuse in reorganizations. Several of these holdings had been based on findings that because the contingent payments in question did not occur on the effective date of reorganization but on the date of the ultimate transfer, they were deferred payments under section 483. The courts had not yet identified, however, the specific elements in contingency provisions that created the potential for abuse, nor had they enunciated clearly the criteria used to detemine whether deferred payments "occurred" on the effective date of reorganization.

III. THE INSTANT OPINION

The instant court initially enumerated the objective requirements for applying section 483 to deferred payments.[46] Reviewing the legislative history of the section, the court determined that Congress intended courts to apply section 483 whenever these requirements are present[47] without probing into the specific facts of the transaction or the subjective intent of the parties to determine if any abuse would result.[48] Since petitioners had conceded that if the ultimate transfer were a "payment," the transaction would meet the objective criteria of section 483,[49] the court focused on petitioners' contention that the ultimate transfer of additional shares did not constitute a "payment."[50] The court determined that on the effective date of the reorganization, petitioners had so few indicia of ownership of the shares ultimately transferred[51] that payment had not occurred on that date. Moreover, the court found that since on the effective date of reorganization, the ultimate transfer depended

46. Solomon v. Commissioner, 570 F.2d at 32-33. The court stated that § 483 required a portion of any payment deferred more than six months to be treated as interest when the payment constituted all or a part of the purchase price under a contract for the sale or exchange of property, which deferred payment for more than one year and provided for no interest or inadequate interest. *Id.*

47. *Id.* at 34. The court found that the presence of these objective criteria usually evidenced a potential for abuse and concluded that Congress had opted for a "broad prophylactic approach," under which § 483 would apply whenever the requisite criteria were present, regardless of the subjective intent of the parties. *Id.* at 33.

48. *Id.* at 34. The court felt that determining the subjective intent of the parties would pose a difficult if not insurmountable problem. *Id.*

49. *Id.*

50. *Id.* at 34.

51. *Id.* The court noted that petitioners were not entitled to vote the shares, nor to receive and pay taxes on dividends. Also, the court cited Revenue Ruling 70-120 with respect to the relation between rights transferred on the effective date of reorganization and the determination of when payment occurred. The court did not expressly rule, however, as to the validity of that Ruling. *Id.; see* note 35 *supra* and accompanying text.

on subsequent conditions, petitioners had in substance received an "evidence of indebtedness,"[52] which did not constitute a "payment."[53] The court therefore concluded that because the petitioners received "payment" on the date of ultimate transfer, not on the effective date of reorganization, and because the other criteria of section 483 concededly were met, section 483 applied.[54]

In addition to finding that the transfer in question met the objective requirements of section 483, the court enunciated a policy for applying section 483 to contingency-provision transfers.[55] The court pointed out that notwithstanding the parties' intent, petitioners could have demanded additional shares to compensate them for foregoing dividend and other ownership rights[56] during the contingency period in the shares ultimately transferred. Thus the court used the potential for abuse present in reorganizations utilizing contingency provisions, not the actual intent of the parties, as the justification for applying section 483.[57]

The court also addressed petitioners' contention that applying section 483 to impute interest, taxable as ordinary income, conflicts with the Code's reorganization provisions, which are designed to make the transaction tax-free.[58] The court rebutted this contention by noting that section 354(a)(1),[59] which affords the shareholders "tax-free" treatment in a reorganization, states that "no gain or loss shall be recognized" on the exchange of stock, but does not purport to preclude the recognition of other forms of income.[60] Finding that

52. 570 F.2d at 34. The court reasoned that on the effective date of the reorganization, petitioners received a conditional promise to transfer additional shares that, in effect, constituted an evidence of indebtedness.

53. *See* note 42 *supra* and accompanying text.

54. 570 F.2d at 34.

55. *Id.* The policy behind § 483 is to prevent the conversion of interest into capital gain in the course of sales of capital assets. The court recognized a potential for a similar conversion in reorganizations employing contingency provisions. *Id.; see* note 20 *supra* and accompanying text.

56. The court did not state what constituted "other ownership rights," nor did it expressly equate foregone dividends and "other ownership rights" to interest. Moreover, the court did not explain how petitioners' receiving additional shares to compensate them for foregoing dividends and "other ownership rights" created a potential for abuse, but it did indicate that dividends and "other ownership rights" are the elements present in a reorganization which create a potential for abuse. *Id.* For an analysis of how receiving additional shares may compensate for these elements, see note 72 *infra* and accompanying text.

57. 570 F.2d at 34. The court also rejected an argument based on *Carlberg* for reasons similar to those cited by the *Jeffers* court. *Id.* at 34-36; *see* note 42 *supra* and accompanying text.

58. 570 F.2d at 36.

59. *See* text accompanying note 8 *supra.*

60. 570 F.2d at 36.

interest is not "gain,"[61] the court concluded that the imputation of interest under section 483 does not conflict with section 354.[62] Furthermore, the court rejected petitioners' broader argument that the imputation of interest under section 483 conflicts with the Code's general purpose to extend the benefits of nonrecognition treatment to reorganizations utilizing contingency provisions. The court found that the purpose of nonrecognition treatment is to defer recognition of gain when taxpayers merely adjust the corporate structure of their property while maintaining a continuing interest therein.[63] On the other hand, the court asserted that the purpose of section 483 is to prevent the conversion of ordinary income into capital gain.[64] Treating a portion of the additional shares as interest and taxing it as such therefore was not inconsistent with the tax-free treatment of the portion received by taxpayers "in exchange" for their stock in the acquired corporation.[65] Finding no conflict between section 483 and the Code provisions applicable to reorganizations, the court held that section 483 applied to the transaction in question.

IV. Comment

The instant opinion provides an analysis that may be helpful to taxpayers who wish to avoid the application of section 483 to their reorganization plans. Previous revenue rulings,[66] regulations,[67] and

61. *Id.* The court found that gain, as defined by § 1001(a), does not include interest income; therefore the recognition of interest income is not inconsistent with the nonrecognition of gain in a reorganization. *Id.*

62. *Id.* Petitioners also contended that applying § 483 would conflict with § 1223. Section 1223 provides that when property is "received in exchange" and its basis is determined by the property that was given for it, the bolding period of the property received includes the holding period of the property given. Petitioners argued that treating the shares transferred under the contingency provision as being received on the ultimate transfer date would conflict with § 1223. The court rejected this argument by stating that § 1223 need not be applied for all purposes of the Code, but only for the purpose of sections that require a determination of holding period, and then only to shares "received in exchange." Thus the court held that the shares received as principal, though they were to have a holding period based on the shares exchanged for them, could be regarded as being received as payment on the transfer date. With respect to the sbares that constituted interest, the court found no conflict with § 1223 because they were not "received in exchange" and therefore were not covered by § 1223. *Id.* at 36-37.

63. *Id.* at 37.

64. *Id. See* note 20 *supra* and accompanying text.

65. 570 F.2d at 37. Finally, the court rejected petitioners' argument based on *Fox*, noting that *Fox* was based solely on a finding of conflict between § 483 and the specific provisions of § 71. *Id.* at 38; *see* note 37 *supra* and accompanying text. The court found no such conflict between § 483 and the Code provisions applicable to the case at bar.

66. *See* notes 34 & 35 *supra* and accompanying text.

67. *See* notes 27 & 28 *supra* and accompanying text.

case law had declared section 483 applicable to reorganizations, a fact routinely noted in numerous texts.[68] The instant court, consistent with authority, held section 483 applicable to the reorganization in question, yet the court's analysis went beyond existing precedent by identifying the elements in reorganizations that create the potential for abuse[69] frequently cited as a justification for the application of section 483.[70] The case also indicated the requirements that taxpayers must meet in order to prevent the transfer of additional shares under a contingency agreement from constituting a "payment" under section 483.[71] The court suggested that the potential for abuse present in reorganizations employing contingency provisions is similar to that present in the sale of a capital asset, analogizing the dividends and "other ownership rights" foregone by taxpayers to interest in the sale of a capital asset.[72] By identifying,

68. *See, e.g.*, B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14-144 (1971).

69. 570 F.2d at 34.

70. *See* notes 41 & 45 *supra* and accompanying text.

71. 570 F.2d at 34.

72. As previously noted, *see* note 20 *supra* and accompanying text, Congress enacted § 483 in response to the concern that interest could be converted into capital gain in the sale of capital assets. If, in the sale of a capital asset, the seller demands a higher price to account for interest, the interest so accounted for is converted into capital gain. This results in the conversion of an item, interest, which is taxed as ordinary income, into capital gain, which is taxed at a more favorable rate. Therefore, when a contract for the sale of a capital asset under which the payments are deferred does not provide for interest, a potential for abuse—the conversion of ordinary income into capital gain—exists.

The instant court found that in reorganizations using contingency provisions, the shareholders of the acquired corporation could demand additional shares in return for foregoing, during the contingency period, dividends and "other ownership rights" incident to the shares ultimately received. Since § 354 provides that no gain is recognized on the receipt of stock in the acquiring corporation in exchange for stock of the acquired corporation, without the application of § 483 or an analagous provision, the parties to a reorganization would be able to convert the shares received as "compensation" for foregoing dividends and other ownership rights into shares "received in exchange." Treating such shares as "received in exchange" would reduce the per-share basis in all the shares received in the reorganization, and capital gain ultimately would be recognized if and when the shares so received were sold.

Since shares "received in exchange" are ultimately taxed as capital gain, to determine if the conversion of shares received as "compensation" into shares "received in exchange" results in the conversion of ordinary income into capital gain, it is necessary to determine at what rate compensation for dividends and "other ownership rights" should be taxed. Dividends are taxed as ordinary income. Therefore, compensation for foregoing dividends also should be taxed as ordinary income. The instant court did not define what "other ownership rights" includes, but probably the right to sell the shares and the right to vote the shares are the most important. Regardless of the exact make-up of "other ownership rights," taxpayers in essence are assigning these rights for the duration of the contingency period for a fee. Because such fees fall under no exclusion of the Internal Revenue Code, they would be included in gross income under § 61 and would be taxed as ordinary income. Thus, the conversion, by means of a reorganization transaction, of shares received as "compensation" into shares "received in exchange" would result in the conversion of ordinary income into albeit sketchily, the elements in reorganizations that are analogous to interest in the sale of capital assets, the court provided a target of trouble spots at which taxpayers can aim their efforts in structuring reorganizations. For example, taxpayers could structure a plan of reorganization so that the transfer of additional shares under a contingency provision would include the transfer of any dividends that would have accrued to those shares during the contingency period.[73] Accounting for other ownership rights, however, is not so easy. The court did not expressly identify these ownership rights,[74] but taxpayers could account for them by providing that any transfer of additional shares would include a set per-share amount to compensate taxpayers for foregoing all rights other than dividends during the contingency period.[75] Thus taxpayers, by accounting for the interest analogues, may eliminate the potential for abuse the instant court used to justify the application of section 483.[76] Since no statutory authority supports this approach, however, the result is far from certain.

In analyzing the "payment" issue, the court determined that

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capital gain. Consequently, when a reorganization plan provides for no "interest" on additonal shares transferred under a contingency provision, the same kind of potential for abuse, the conversion of ordinary income into capital gain, as is present in the sale of a capital asset is present in a reorganization. Moreover, dividends and "other ownership rights" play the role in reorganizations that interest plays in the sale of a capital asset.

73. By providing for the inclusion of dividends in the ultimate transfer, taxpayer would realize income to the extent of the dividends, which would be taxed as ordinary income. If, however, the dividends combined with the compensation for "other ownership rights" are less than the minimum interest required by § 483, a saving to the taxpayer could result. *But see* note 76 *infra.*

74. *See* notes 56 & 72 *supra.*

75. As previously noted, *see* note 72 *supra,* the court did not define what constituted "other ownership rights," but if taxpayers make a good faith effort to provide compensation for these rights in their plan of reorganization, the court likely will find that the "other ownership rights" element of the interest analogue was adequately provided for.

76. In addition, § 483 requires as a prerequisite to the imputation of interest the finding that an inadequate rate of interest has been provided for in the contract. I.R.C. § 483(c). Specifically, it requires that a statutory fixed rate of interest set hy the Secretary be imputed if a minimum fixed rate, also set by the Secretary, is not provided for in the contract. If the rate of "interest" calculated by accounting for the interest analogues meets or exceeds the minimum fixed rate, a court likely would find that imputation of the statutory fixed rate was not required. If, however, by providing for "interest" in this manner the rate so calculated was less than the minimum fixed rate, it is less likely that the court would find that imputation of the statutory rate was not required. Unless the court found that eliminating the potential for abuse was sufficient to prevent the application of § 483, or found that notwithstanding the taxpayer's failure to provide for the minimum fixed rate adequate "interest" was provided for, the court would probably find § 483 applicable. Of course, taxpayers could provide for the minimum fixed rate of interest required by § 483, a rate of 6%, and thereby prevent the application of the 7% statutory fixed rate, but the use of a predetermined rate does not comport with the economic reality of a reorganization.

no payment occurred on the effective date of reorganization because on that date petitioners received few rights in the shares ultimately transferred. While neither expressly ruling that a transfer of substantial rights on the effective date of reorganization would result in a finding that payment occurred on that date nor defining what constituted a transfer of substantial rights, the court did cite for comparison Revenue Ruling 70-120.[77] Since the court's payment analysis is compatible with that of the ruling, and since the court expressly referred to it, taxpayers can be fairly confident in structuring their reorganizations according to the plan outlined therein.[78]

Although the court provided some guidance by which taxpayers structuring reorganization plans may avoid the application of section 483, the court did not deal satisfactorily with the propriety of applying section 483 to reorganizations. Undeniably, as the court found, the wording and legislative history of section 483 are broad enough to make it applicable to reorganizations. Section 483 was designed, however, to deal with the conversion of interest into capital gain in sales of capital assets.[79] Accordingly, Congress adopted the solution of imputing a predetermined rate of interest when no interest or inadequate interest is provided. This solution comports with the economic reality of sales contracts when the payments are made in the form of money.[80] When, however, the payments are not in cash, but in the form of stock, the imputation of a predetermined rate of interest is inappropriate. Money is fungible, and a rate of interest that is appropriate for any money is appropriate for all money. All stock is not the same, however, and a rate that may be appropriate for some stock may be totally unrealistic for other

77. 570 F.2d at 34; *see* note 51 *supra* and accompanying text. Revenue Ruling 70-120 states that when taxpayers place shares that might ultimately be required to meet the contingency provisions in an escrow account with the shareholders of the acquired corporation having the right to receive dividends and vote the shares, the shares released from escrow to such shareholders would not be subject to § 483. *See* note 35 *supra* and accompanying text.

78. Revenue Ruling 70-120 further provides, however, that the shares not needed to meet the contingency provisions must be retransferred to the acquiring corporation, but does not state the tax consequences of retransfer. For a treatment of retransfer to the acquiring corporation, see BITTKER & EUSTICE, *supra* note 68, at 14-145.

79. *See* note 20 *supra* and accompanying text.

80. Deputy v. duPont, 308 U.S. 488 (1940) defined interest as "compensation for the use or forbearance of money." *Id.* at 498. The usual metbod of determining the amount of compensation for the use of borrowed money is to multiply an interest rate by the amount borrowed. Section 483(b) authorizes the Secretary of tbe Treasury to determine the interest rate to be imputed under § 483 when the sales contract has provided for an inadequate rate or no rate of interest. Thus when money payments are involved, the application of § 483 comports with the normal method of calculating the compensation required.

stock.[81] Moreover, taxpayers who attempt to provide a realistic interest rate by basing the compensation on dividends and other ownership rights foregone during the contingency period run the risk that when the stock ultimately is transferred, the rate so provided will not meet the minimum rate required under section 483, resulting in the imputation of the statutory rate.[82] Other taxpayers who choose to follow the procedure outlined in Revenue Ruling 70-120 also face uncertain results.[83] Thus, although section 483 technically is broad enough to apply to reorganizations, forcing its application to transactions it was not designed to cover has left taxpayers with uncertain and inadequate options for the construction of reorganization plans.

JOSEPH W. GIBBS

Torts—Independent Contractors—Employer Is Liable for Tortious Conduct of His Financially Irresponsible Independent Contractor

I. FACTS AND HOLDING

Plaintiff construction worker[1] sued the developer of a shopping

81. When stock involved in a reorganization is yielding high dividends or the ownership of the stock represents significant control of the acquiring corporation, the amount that stockholders can demand for foregoing ownership is high. When, however, the stock is paying low dividends ownership of the shares represents only a nominal percent of control, the amount that can be demanded for foregoing ownership is correspondingly low. Thus a predetermined, uniform rate cannot be appropriate in both cases. Additionally, if the acquiring corporation pays nontaxable stock dividends, the transferring of additional shares to compensate for foregone dividends does not result in abuse since the receipt of stock dividends causes the same adjustment to basis and creates the same potential for the recognition of capital gain as the transfer of additional shares. In such a case, imputing interest at the same rate required for cash dividend stocks is inappropriate.

82. If taxpayers provide for compensation based on a factor, such as dividends, that may vary, the taxpayer may find upon ultimate transfer of the shares that the compensation was insufficient to meet the minimum interest required by § 483. Thus, notwithstanding efforts to provide for "interest" in accord with the instant court's analysis, taxpayer would be subject to the provisions of § 483. Conversely, if a taxpayer knows that the dividends accruing during the contingency period will exceed the rate imputed under § 483, he would be wise to provide for no compensation and accept the rate prescribed by § 483.

83. As previously noted, the tax consequences on retransfer to the acquiring corporation of the shares not needed to meet the contingency provisions are not clear. In addition, the method outlined in the ruling requires that shareholders receive the right to vote and receive dividends on *all* shares that are placed in escrow to meet the contingency provision, even though only a portion thereof might actually be transferred to them. The acquiring corporation is therefore required to issue and pay dividends on shares it may never transfer, dividends it may currently need to retain for operational capital.

1. Plaintiff was employed by Wood-Pine Corporation, a paving subcontractor.

center project[2] to recover damages for injuries caused by the negligence of a subcontractor's employee.[3] Stating that denial of his claim would bar recovery,[4] plaintiff asserted that defendant was liable for failure to insist upon a financially responsible independent contractor.[5] Defendant sought summary judgment on the ground that it could not be held liable for the tort of an independent contractor. Determining that the financial status of an independent contractor was not a valid consideration for imposition of employer liability, the United States District Court for the District of New Jersey granted summary judgment for the developer.[6] On appeal to the Third Circuit Court of Appeals, *held*, reversed and remanded. An employer who fails to exercise reasonable care to engage a financially responsible independent contractor is not immune from liability for the tortious conduct of an independent contractor who is financially incapable of responding to judgments. *Becker v. Interstate Properties*, 569 F.2d 1203 (3d Cir. 1977).

II. LEGAL BACKGROUND

All rules affecting the master-servant relationship derive from the historic legal principle that employers are liable for the tortious conduct of their employees occurring in the course of employment.[7] *Respondeat superior,* which imputes employee negligence to the employer, is not premised on fault. Instead, because the employer has the right to select, control, and dismiss employees[8] and because he is assumed to be in a better financial position to respond to judgments,[9] the employer is held vicariously liable for tortious acts of his employees within the scope of employment.

2. Defendant I.P. Construction Corporation was the owner and general contractor of the project.

3. Defendant hired Wood-Pine to pave the shopping center, and Wood-Pine then contracted with Windsor Contracting Corporation to provide trucks and drivers for the paving job. A driver employed by Windsor injured plaintiff.

4. Windsor's minimal capitalization and automobile liability insurance coverage of only $10,000 effectively rendered it judgment proof.

5. Although defendant's control over Wood-Pine was sufficient to constitute an employer-employee relationship, the parties stipulated that Windsor was an independent contractor.

6. Becker v. Interstate Properties, No. 74-430 (D.N.J. Sept. 27, 1976).

7. The roots of the *respondeat superior* doctrine have been traced to primitive Germanic legal thought, with its essence emerging in the dicta of Lord Holt in the 1700's. Wigmore, *Responsibility for Tortious Acts,* 7 HARV. L. REV. 315 (1894). *See generally* W. PROSSER, LAW OF TORTS § 69 (4th ed. 1971) [hereinafter cited as PROSSER].

8. *See, e.g.,* Elliason v. Western Coal & Coke Co., 162 Minn. 213, 215, 202 N.W. 485, 486 (1925).

9. *See, e.g.,* Morris, *The Torts of an Independent Contractor,* 29 ILL. L. REV. 339, 340 (1934).

One of the earliest cases[10] to distinguish an employee from an independent contractor theorized that the independent contractor did not serve merely as an extension of the employer, but conducted its own enterprise with full control over the manner in which the work was to be done.[11] From this distinction the independent contractor exception to the *respondeat superior* doctrine developed.[12] Because the independent contractor controls prosecution of the enterprise and is considered as capable as its employer at avoiding risks[13] and bearing the costs arising from those risks,[14] the courts have held it responsible for its own acts and omissions.[15] Consequently, the employer has received immunity from liability for the tortious conduct of an independent contractor.[16]

The validity of the traditional independent contractor doctrine has been questioned by a growing tendency to regard the independent contractor as a device created by lawyers to provide the employer with undeserved immunity.[17] The bases of the rule have been criticized as superficial reactions to a loss already incurred, failing as common sense attempts to distribute the loss fairly.[18] Several arguments have been posited to support this criticism. An enterprise for which work is performed by an independent contractor continues as the employer's since he remains the primary party benefited. He selects the independent contractor and is free to insist upon one that is competent and financially responsible. If the employer is held liable on a judgment rendered against the indepen-

10. Bush v. Steinman, 126 Eng. Rep. 978 (K.B. 1799).

11. One commentator, distinguishing between the independent contractor and the employee, has characterized the former as "the small business man incarnate, the last stubborn refuge of rugged individualism." Steffen, *Independent Contractor and the Good Life*, 2 U. CHI. L. REV. 501, 518 (1935).

12. Robbins v. Chicago, 71 U.S. (4 Wall.) 657 (1867), is the earliest acknowledgment of the rule by the United States Supreme Court.

13. *See* Douglas, *Vicarious Liaiblity and Administration of Risk I*, 38 YALE L.J. 584, 598 (1935).

14. *Id.* at 599 (concerning equal ability of employer and independent contractor to obtain liability insurance). *See also* Morris, *supra* note 9, at 341, wbich indicates that independent contractors as a class are assumed not to be judgment proof.

15. Morris, *supra* note 9, at 342-43, suggests that those who bave insufficient means to discharge tort obligations arising during the prosecution of an enterprise should be prevented from undertaking such an enterprise as an independent contractor.

16. *See, e.g.*, Blake v. Ferris, 5 N.Y. 48, 58 (1851), in which the court stated that holding an employer responsible for the conduct of a man over which the employer exercises no control would "push the doctrine of respondeat superior beyond the reason on which it is founded." *See generally* PROSSER, *supra* note 7, § 71; RESTATEMENT (SECOND) OF TORTS § 409 (1965) [hereinafter cited as RESTATEMENT].

17. *See* Steffen, *supra* note 11, at 501.

18. *See* Harper, *The Basis of the Immunity of an Employer of an Independent Contractor*, 10 IND. L.J. 494, 500 (1935).

dent contractor, he may demand indemnity from the independent contractor and also protect himself with insurance.[19] Thus facts and experience often undermine such practical considerations as risk prevention and cost of risk bearing,[20] which are argued in support of the rule.

These criticisms of the status of the independent contractor and the bases of the rule have created exceptions so numerous and extensive as to cast doubt upon the validity of the rule.[21] The circumstances in which an employer will be held liable for the acts of an independent contractor typically are divided into four categories: the employer retains control over the independent contractor;[22] the activity engaged in is inherently dangerous;[23] the independent contractor performs a nondelegable duty of the employer;[24] and the employer negligently hires an incompetent independent contractor.[25]

The last exception, which requires reasonable care in the selection of a competent independent contractor, historically has contemplated a contractor possessing the knowledge, skill, experience, and equipment necessary to perform without creating unreasonable risks.[26] Although an employer who intentionally selects a financially irresponsible independent contractor is liable for that independent

19. Insurance generally is considered a normal cost of doing business. *See, e.g.*, PROSSER, *supra* note 7, § 71, at 468.

20. *See* notes 13-15 *supra* and accompanying text. Extensive analysis has been given to the policies underlying distributive justice, which require placement of liability with the party best able to prevent enterprise risks and bear the cost of those risks by shifting (through insurance) and distributing (by passing costs on to the public through increased prices) those costs. *See, e.g.*, Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); Douglas, *supra* note 13.

21. *See generally* PROSSER, *supra* note 7, § 71; RESTATEMENT, *supra* note 16, §§ 410-429. Pacific Fire Ins. Co. v. Kenny Boiler & Mfg. Co., 201 Minn. 500, 503, 277 N.W. 226, 228 (1937), stated that "the rule is now primarily important as a preamble to the catalog of its exceptions."

22. *See* PROSSER, *supra* note 7, § 71, at 469-70.

23. *See* PROSSER, *supra* note 7, § 71, at 472-74; RESTATEMENT, *supra* note 16, § 427. The leading case on this exception is Bower v. Peate, 1 Q.B. 321 (1876). *See also* Wallach v. United States, 291 F.2d 69 (2d Cir. 1961).

24. *See* Chapman, *Liability for the Negligence of Independent Contractors*, 50 LAW Q. REV. 71, 75 (1934), which explains the exception as follows: "If I am under a duty to a person . . . I am liable if that duty is not performed and damage thereby results, and I cannot evade that liability by delegating the performance of the duty to an independent contractor." *See also* PROSSER, *supra* note 7, § 71, at 470-72.

25. *See* Mooney v. Stainless, Inc., 338 F.2d 127 (6th Cir. 1964). *See also* PROSSER, *supra* note 7, § 71, at 469; RESTATEMENT, *supra* note 16, § 411. For a discussion of limitations on employers' liability for injuries to employees caused by incompetent independent contractors, see Lipka v. United States, 369 F.2d 288, 292-93 (2d Cir. 1966).

26. *See, e.g.*, PROSSER, *supra* note 7, § 71, at 469; RESTATEMENT, *supra* note 16, § 411, Comment a.

contractor's torts,[27] no court has explicitly ruled that negligent hiring of an insolvent and uninsured independent contractor constitutes a violation of the employer's selection duty. Courts and commentators, however, have suggested inclusion of financial irresponsibility as an element of incompetence for purposes of the negligent selection exception, criticizing simple lack of knowledge as an insufficient justification for employment of a judgment-proof independent contractor.[28] In 1959 *Majestic Realty Associates Inc. v. Toti Contracting Co.*[29] stirred considerable interest by suggesting inclusion of financial responsibility under the competence requirement. Although not basing its holding on this rationale,[30] the New Jersey Supreme Court indicated that, as between the innocent victim and the employer, distributive justice[31] required the employer to bear the costs of the injury caused by the uninsured independent contractor since he was in a better position to anticipate such costs and distribute them to the public.[32]

Several courts have acknowledged the *Majestic* dictum, but none has directly supported it. *Matanuska Electric Association, Inc. v. Johnson,*[33] in which the independent contractor was insolvent and had failed to procure statutorily required workmen's compensation insurance, gave extensive consideration to the notion that financial responsibility is an attribute of incompetence. The lower court decided that financial ability to respond in damages represented an

27. *See, e.g.,* Holbrook, Cabot & Rollins Corp. v. Perkins, 147 F. 166 (1st Cir. 1906); Lawrence v. Shipman, 39 Conn. 586 (1873).

28. *See, e.g.,* Morris, *supra* note 9, at 344.

29. 30 N.J. 425, 153 A.2d 321 (1959).

30. The city Parking Authority employed an independent contractor to raze several buildings. During the demolition, the independent contractor negligently allowed a wall to fall on an adjacent building, causing extensive damage. Employer Parking Authority's employer-independent contractor immunity was denied because of the inherently dangerous nature of the work. *See* note 23 *supra* and accompanying text.

31. *See* note 20 *supra* and accompanying text.

32. The court stated:

> Inevitably the mind turns to the fact that the injured third party is entirely innocent and that the occasion for his injury arises out of the desire of the contractee to have certain activities performed. The injured has no control over or relation with the contractor. The contractee, true, has no control over the doing of the work and in that sense is also innocent of the wrongdoing; but he does have the power of selection and in the application of concepts of distributive justice perhaps much can be said for the view that a loss arising out of the tortious conduct of a financially irresponsible contractor should fall on the contractee.

30 N.J. at 432-33, 153 A.2d at 324-25.

33. 386 P.2d 698 (Alas. 1963). Matanuska Electric Association hired an independent contractor to bulldoze a right of way. An employee of the bulldozing contractor was badly injured by a falling tree dislodged by the bulldozer, and sought recovery against Matanuska because the independent contractor failed to provide workmen's compensation insurance.

aspect of competence no less important than skill or experience. On appeal, the Alaska Supreme Court rejected this holding, reasoning that the circumstances in that case did not justify an extension of the rule since more hardships likely would be created than would be alleviated.[34] The court emphasized the unfair burden that a rule requiring extensive policing of the independent contractor's financial status and insurance coverage would create for employers.[35] Although the court acknowledged that policy reasons eventually might mandate a rule guaranteeing compensation for victims, it indicated that the rule should be grounded on a strict liability theory because of the administrative difficulties inherent in a negligence standard.[36] Establishment of such a rule, the court held, is a duty of the legislature rather than the courts.[37] In *Coleman v. Silverberg Plumbing Co.*,[38] a California court of appeal addressed the issue whether strict financial responsibility should be applied to the employer-independent contractor relationship. In the absence of a bad faith hiring of an insolvent contractor to avoid liability,[39] the court considered the burden on the employer too great to justify

34. *Id.* at 702. The court explained:

> If the rule were extended to include financial responsibility no contractor could be employed with safety without insurance or a contractor's surety bond to cover the employer's potential liability in the event the contractor failed to abide by the law and provide for employee compensation, or if, after procuring insurance, the contractor permitted it to lapse, be cancelled, or lost coverage for any other reason.

Id. at 703. The court then noted that the majority of employers of independent contractors are salaried workmen and wage earners of modest means; therefore,

> No end of justice would appear to be served by a rule which in its largest application, would have the effect of transferring the hardship of injured workmen to persons of modest means and business experience who were only remotely connected with the fault or negligence that caused the injury and who had no control over the performance of the work by the independent contractor.

Id.

35. *Id.*

36. *Id.* The court stated that whether reasonable care was exercised in selection of the independent contractor depends upon the facts of each particular case, and that the facts surrounding the contractor's employment and competency are always judged in hindsight after a serious injury, when the usual sources of compensation are not available and personal hardship must result. Adding financial responsibility as an element of incompetence would create further confusion to the rule when there is "little enough certainty . . . as it presently reads." *Id.*

37. *Id.*

38. 263 Cal. App. 2d 74, 69 Cal. Rptr. 158 (1968). Silverberg, a plumbing contractor, hired independent contractor Stark Company to dig trenches for the placement of the plumbing. Coleman, an employee of Stark Company, was killed while operating a backhoe to dig the trenches. Coleman's wife sought recovery from Silverberg for negligently hiring an independent contractor (Stark Company) who did not procure workmen's compensation insurance.

39. *See* note 27 *supra* and accompanying text.

imposition of liability.[40]

The *Majestic* theory that selection of a competent contractor requires more than an evaluation of skill and experience was approved by the Appellate Division of the New Jersey Superior Court in *Bennett v. T&F Distributing Co.*[41] The court held the employer liable, however, not because the independent contractor was financially irresponsible, but because the employer was negligent in hiring an independent contractor with vicious propensities.[42] Relying heavily on *Majestic,* the court held that distributive justice dictated extension of the duty of reasonable care in the selection of contractors for the protection of innocent third parties, despite the investigative burden placed on employers.[43] Although *Majestic, Bennett,* and a considerable number of commentators have advocated severe restrictions on the use of the independent contractor rule,[44] no court has held employers liable for the tortious conduct of independent contractors that are financially incapable of responding to judgments.[45]

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40. 263 Cal. App. 2d at 80-82, 69 Cal. Rptr. at 162-63. The court relied heavily on *Matanuska,* stressing the burden of policing the contractor and again indicating that creation of such a rule was within the province of the legislature.

41. 117 N.J. Super. 439, 285 A.2d 59 (1971). A distributor of vacuum cleaners employed an independent contractor as a door-to-door salesman. In the course of his contact with a customer, the salesman committed an assault and battery upon her, for which he was given a seven to ten year sentence. The customer sued the vacuum cleaner distributor to recover damages resulting from the employer's negligent selection of a vicious salesman.

42. The independent contractor-salesman had an extensive criminal record, including an F.B.I. arrest record under two separate names. He had been convicted of larceny of automobiles, assault and battery, malicious mischief, and of being a disorderly person, and had been arrested and charged with possession of stolen property and assault with a deadly weapon.

43. 117 N.J. Super. at 445, 285 A.2d at 62.

44. *See, e.g.,* notes 17-20 *supra* and accompanying text. *See also* F. HARPER, LAW OF TORTS § 292, at 646 (1933) (stating that several factors combine to constitute "such a powerful argument for the liability of the employer of an independent contractor that it would seem highly desirable for the courts to adopt the rule of liability and confine nonliability to a few exceptional cases"); Morris, *supra* note 9, at 345 (indicating that "while it is usually desirable that a contractor be ultimately liable for his torts, in general, the contractee should be responsible to third persons").

45. In one of the few federal court cases considering the issue, Reid v. United States, 421 F. Supp. 1244 (E.D. Cal. 1976), the court dismissed on other grounds without comment on the negligent selection issue. RESTATEMENT, *supra* note 16, § 411, Comment g, indicates the prevailing attitude of the courts:

> Cases are lacking in sufficient number to deal with the question of whether the employer may ever be responsible to any third person for his failure to exercise care to employ a contractor who is financially responsible, and therefore able to respond, by liability insurance or otherwise, for any damages which he may inflict by his tortious conduct. The Institute expresses no opinion that there is, or that there is not, any obligation upon the employer.

III. THE INSTANT OPINION

In attempting to anticipate the course a New Jersey court would adopt in similar circumstances, the instant federal court undertook to interpret *Majestic* and reconcile its dictum[46] with New Jersey's traditional adherence to the independent contractor rule.[47] The court declined to apply mechanically the existing master-servant rules and their exceptions, but proposed instead to resolve the conflict by implementing the goals of New Jersey tort law.[48] The court thereby avoided the possible conclusion that the independent contractor alone could be held liable for the tort, a conclusion that effectively would have denied the victim compensation.

Extracting these tort laws goals from the distributive justice concepts propounded in *Majestic*,[49] the court identified three specific policies of New Jersey tort law that would be served by adopting *Majestic*. The court first acknowledged the need to place the burden of compensating negligent injury on the party best able to bear and distribute the loss.[50] The court found that when an employer is stable and profitable, carries substantial liability insurance, and is in a position facilitating the distribution of his own increased costs to the public, he is the proper party to absorb the loss.[51] As a second goal, the court recognized the desire to allocate liability to the party best able to control the factors producing a plaintiff's loss.[52] The court noted that the negligence causing the actual injury, typically the sole factor giving rise to a loss, constituted only one element of the loss-producing conduct in this case; defendant's failure to assure financial responsibility to compensate

46. *See* note 32 *supra* and accompanying text.

47. The district court's jurisdiction was based on diversity of citizenship. *Majestic* was the only New Jersey case dealing with the financial irresponsibility issue. *See* notes 29-32 *supra* and accompanying text.

48. *Matanuska* and *Coleman*, the two most significant cases rejecting the *Majestic* dictum in favor of traditional independent contractor rule theory, were distinguished. The *Coleman* decision was considered inapplicable because it attempted to base employer responsibility on strict liability grounds. *Matanuska*, while considering negligence as the possible basis for employer liability, was rejected on two grounds: first, because of the faulty presumption that such a liability rule would apply to all independent contractor situations, and second, because the plaintiff in *Matanuska* was an employee of the independent contractor, and thus had an opportunity to evaluate the contractor himself.

49. *See* note 32 *supra* and accompanying text. The court indicated that these policy considerations serve only to undergird the *Majestic* dictum, and the holding of the instant case, and that the financial irresponsibility-as-incompetence exception was intended to be instituted. 569 F.2d at 1213.

50. 569 F.2d at 1209. For a discussion of the justifications for shifting the burden to the party best able to bear and distribute the loss, see Calabresi, *supra* note 20, at 517-28.

51. 569 F.2d at 1210.

52. *Id.* at 1211.

for that injury combined with the negligence to produce plaintiff's loss.[53] Although neither party exercised control over the independent contractor's negligent conduct, the court concluded that the employer was in a better position to ascertain whether the independent contractor was insured sufficiently.[54] Finally, the opinion identified the placing of the costs of accidents on those benefiting from the activities producing the accidents as a third policy relevant to the instant case.[55] The court argued that employers receive undeserved advantages by hiring uninsured contractors; the independent contractor's reduced costs enable the employer to operate with less expense, while nonetheless retaining the immunity conferred by the independent contractor rule. The court reasoned that placing liability with the party benefited was an effective means of eliminating these advantages.[56] Thus, when the employer has superior ability to bear and distribute loss and to control the factors producing loss, and is the party primarily benefited by the activity engendering the loss, the court suggested that the employer might be the proper party to sustain that loss.[57]

IV. Comment

Although presenting convincing and worthy policy arguments for shifting the burden of loss from the victim to the employer, the instant court failed to clarify the rule suggested in *Majestic* and adopted here that financial irresponsibility is an aspect of incompetence for purposes of the independent contractor rule exception. Following suggestions made by the *Majestic* case and by numerous commentators,[58] the holding statement expands the exception to the independent contractor rule denying employers immunity for negligent selection of an independent contractor.[59] The subsequent rationale, however, based on the goals of tort law,[60] confuses the na-

53. *Id.* Morris, *Agency and Partnership,* 14 Rutgers L. Rev. 375, 379 (1960), indicates that assigning liability because of this failure to assure compensation should serve as an incentive to procure the necessary insurance.

54. 569 F.2d at 1211.

55. *Id.* at 1212.

56. *Id.*

57. In his dissent, Judge Hunter argued that the majority had predicted inaccurately what the state court would have decided in these circumstances, pointing out that no other court in the country had yet broken from the traditional independent contractor rule. Specifically, the inexactitude of the standard for imposing liability on the employer was criticized in that it limited the scope of duty to include only those whose financial capabilities and business acumen are more than "modest."

58. *See, e.g.,* Morris, *supra* note 9.

59. 569 F.2d at 1209.

60. *Id.* at 1209-12.

ture and extent of the employer's new duty. The rationale indicates an attempt to provide equitable, distributive justice based on criteria that in many instances are unrelated to negligence. For example, the ability to bear and distribute loss and the receipt of benefits from an activity producing loss, which provided the key support for the instant court's holding,[61] have little bearing on the issue of negligence in selection of the independent contractor responsible for the loss. The placement of the cost burden based on such policy is tantamount to strict liability for financially stable employers, arguably permitting a conclusion that whenever the independent contractor cannot fully compensate the injured party, its employer is negligent and thus liable for failing to hire an adequately insured independent contractor.

Even the numerous critics[62] of the independent contractor rule, however, do not suggest such a drastic modification.[63] The rule is justified by the numerous circumstances in which the employer has used reasonable care in selecting the independent contractor, or in which the employer could not be expected to inquire into the independent contractor's financial status.[64] The *Majestic* case and those that suggest placing responsibility upon the employer to assure a solvent or insured contractor cannot be interpreted as imposing upon the employer absolute responsibility for the financial status of the independent contractor. Rather, an attempt is being made to reduce the number of uncompensated accident victims by placing a duty on certain employers to exercise care in the selection of financially responsible independent contractors.

The confusion created by the instant court's extensive use of policy arguments to support the imposition of a new duty upon employers in the selection of independent contractors requires clarification to prevent future misinterpretation of the duty. Distributive justice concepts[65] do not define the employer's duty. Instead, these policy arguments are useful guidelines for determining when the duty exists. Furthermore, the mere existence of an uncompensated victim and an employer who is economically stable, able to distribute losses to the public, and in a position to ascertain the financial status of the independent contractor-tortfeasor does not

61. *See* note 45 *supra* and accompanying text.

62. *See, e.g.*, notes 17-20 *supra* and accompanying text.

63. *See, e.g.*, note 44 *supra* and accompanying text.

64. *E.g.*, Steffen, *supra* note 11, at 518, suggests the number of roles an independent contractor may serve: "he paints your house, repairs your automobile, washes your windows, bandles your collections, sells your real estate, procures your divorce and so on *ad infinitum.*"

65. *See* note 20 and notes 50-57 *supra* and accompanying text.

automatically dictate placement of liability on that employer. For example, a construction company may be required to exercise reasonable care to select financially responsible independent contractors, because of its unique supervisory relationship to its independent contractors. In contrast, if an individual jumps into a taxicab that subsequently runs over a third party, the passenger probably will not be held liable merely because the taxicab driver is insolvent and uninsured. Despite the existence of an employer-independent contractor relationship, distributive justice concepts simply do not require that a duty be imposed on passengers to inquire into the financial status of taxicab drivers. Thus the initial inquiry when a financially irresponsible independent contractor has injured a third party is whether the employer had a duty to inquire into that independent contractor's financial status. The distributive justice concepts propounded by the instant court should provide guidance in making that determination. Also beneficial is a consideration whether the third party could be expected to look to the employer for recovery, and whether the employer hired the independent contractor to assist in a profit-seeking activity rather than simply to perform a service.[66] These inquiries, though not an exhaustive list of probative factors, will assist in distinguishing between employers who do and those who do not have a duty to scrutinize the financial responsibility of their independent contractors.

Existence of the duty, however, does not automatically dictate liability. The duty placed upon the employer is one of reasonable care, compliance with which is a question of fact. Whether the employer can satisfy his duty by contractually requiring minimum capitalization or insurance coverage, or whether the employer must police his independent contractors to ensure financial responsibility not only at the time of the contract but also throughout its duration depends upon the surrounding circumstances.[67] Thus the tort victim of a financially irresponsible independent contractor must first prove that considerations such as the distributive justice concepts enunciated in *Majestic* and in the instant case require the employer to exercise reasonable care in selection of a solvent and insured

66. *See* note 64 *supra*. While equitable considerations would require a general contractor to be liable for the tortious conduct of his insolvent subcontractor, those same considerations do not apply to the individual who hires another to pave his driveway or paint his house, despite the existence of an employer-independent contractor relationship.

67. For example, one who hires an independent contractor who was previously adjudicated a bankrupt runs a greater risk of being held liable than one who deals with a reputable and financially stable independent contractor.

independent contractor. Second, the victim must demonstrate that the duty was not met if he is to recover from the employer.

The independent contractor rule has been acknowledged as a common sense attempt to distribute losses fairly.[68] The instant court recognized that in certain circumstances, granting an employer immunity from responsibility for the tortious conduct of his insolvent independent contractor simply is not sensible when it requires that a tort victim go uncompensated for his injuries. It thus proposed to alter the rule to accommodate those circumstances. This new exception should be interpreted with common sense as placing a duty of reasonable care only on certain employers who, because of their relationship to the independent contractor and their ability to bear and distribute losses, may properly be expected to exercise such care.

William Arthur Holby

68. *See* note 18 *supra* and accompanying text.