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NOTES

Discretionary Commodities Trading Account as a Security: Is There a Common Enterprise?

Thomas C. Marshall brought suit against Lamson Brothers & Co. alleging that he had opened a discretionary commodities trading account with the Lamson Company over which the defendant company had full managerial responsibility. Marshall further claimed that he acted in reliance on the representations of Lamson's employee that substantial profits could be made and that the account would be managed so as to limit losses to approximately four hundred dollars. The account was opened in July 1970 and Marshall was advised on July 29, 1970, that his commodities account was dissipated. Marshall's complaint, which alleged violations of the Securities Act of 1933 and the Securities Exchange Act of 1934, was challenged by a motion to dismiss on the grounds that no security within the meaning of the Securities Acts¹ was involved. *Held, motion to dismiss denied*: The discretionary commodities trading account is an investment contract, and, thus, a security within the meaning of the federal securities acts. *Marshall v. Lamson Bros. & Co.*, 368 F. Supp. 486 (S.D. Iowa 1974).

I. INVESTMENT CONTRACTS WITHIN THE SECURITIES ACTS

The Securities Act of 1933² was enacted for the purposes of providing investors with basic information about the character of securities and to prohibit misrepresentation and fraud in the offering or secondary sale of those securities.³ Congress intended the Acts to cover a wide variety of investment opportunities and, accordingly, defined a security in "broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."⁴ As defined in section 2(1) of the 1933 Act, a security is "any note, stock, treasury stock, bond . . . certificate of interest or participation in any profit sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security' . . ."⁵

The Supreme Court first interpreted the "investment contract" language of the 1933 Act in *SEC v. C.M. Joiner Leasing Corp.*,⁶ where an offering of

1. Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1970); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970). It is necessary for any relief under the Securities Acts to prove that a "security" is involved. *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943).

2. Securities Act of 1933, §§ 1-212, 15 U.S.C. §§ 77a-bbbb (1970).

3. Securities Act of 1933, ch. 38, 48 Stat. 74 (enacting clause).

4. H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

5. Securities Act of 1933, § 2(1), 15 U.S.C. § 77(b)(1) (1970) (emphasis added). An almost identical definition of a security is provided in Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970).

6. 320 U.S. 344 (1943).

leasehold rights was held to be a security within the meaning of the Act.⁷ The Court avoided articulating a general test for determining the existence of an investment contract and held that the particular factual setting brought the case within the ambit of the 1933 Act. In so doing the court looked to the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect . . . [rather than] the nature of the assets back of a particular document or offering."⁸

Three years later, in the leading case of *SEC v. W.J. Howey Co.*⁹ the Supreme Court again found the existence of an investment contract. *Howey* involved the sale of tracts in a citrus grove development coupled with an optional agreement whereby the seller was to cultivate the tract, market the produce, and remit the net proceeds to the investor. The Court stated that neither the Securities Act of 1933 nor its legislative history defined "investment contract," and thus concluded that Congress used a term the only definition of which was in judicial interpretations of state blue sky securities laws.¹⁰ Relying on the applicable state interpretation of the term and the fact situations to which the definition had been applied,¹¹ the Court stated that the test for an investment contract should be "whether the scheme involves an investment of money in a *common enterprise* with profits to come solely from the efforts of others."¹² Although *Howey* went beyond *Joiner* in enunciating a test for an investment contract, the Court clearly warned against a rigid application of the formulation, stating that the test "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."¹³

Although the *Howey* definition has been literally applied to determine whether a security exists,¹⁴ several courts have recognized the inadequacy of

7. *Id.*

8. *Id.* at 352-53. The Court, refusing to adopt a strict or liberal approach to statutory interpretation, construed the words of the Act so as to carry out the generally expressed legislative policy, stating that "the reach of the Act does not stop with the obvious and commonplace." *Id.* at 351.

9. 328 U.S. 293 (1946).

10. *Id.* at 298.

11. The court relied upon the definition established by the Supreme Court of Minnesota in *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920). An investment contract was deemed to be a contract or scheme for "[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment" 177 N.W. at 938.

12. 328 U.S. at 301. The Court initially used the quoted language to describe the facts presented by the state cases in which it had uniformly been held that an investment contract existed. Subsequently, the same language was cast in terms of a comprehensive test for an investment contract. The Court claimed, however, to be enunciating an old test which was necessarily the basis of the earlier *Joiner* decision and lower federal court cases. *Id.* at 299.

The *Howey* test, which involved an interpretation of the Securities Act of 1933, was held applicable to the Securities Exchange Act of 1934 in *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

13. 328 U.S. at 299.

14. *See, e.g.*, *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970); *Gallion v. Alabama Mkt. Centers*, 282 Ala. 679, 213 So. 2d 841 (1968); *Georgia Mkt. Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969); *Koscot Interplanetary, Inc. v. King*, 452 S.W.2d 531 (Tex. Civ. App.—Austin 1970), *error ref. n.r.e.*

a mechanical application of *Howey*. The existence of an investment contract has been found by courts which have refused to apply literally the *Howey* requirements that there be an expectation of profits¹⁵ and that those profits be derived *solely* from the efforts of those other than the investor.¹⁶ The SEC has taken the position that the investment contract analysis developed in *State Commissioner of Securities v. Hawaii Market Center, Inc.*¹⁷ is applicable under the federal securities laws.¹⁸ In *Hawaii Market Center* the Supreme Court of Hawaii held a pyramid selling scheme to be an investment contract without resort to the *Howey* definition but rather by examining the economic realities of the promotion through a "risk capital" analysis.¹⁹ Thus, while *Howey* continues to provide the commonly accepted test for the investment contract under the federal securities acts,²⁰ the concept of the investment contract has been expanded considerably beyond a narrow reading of that test.

II. DISCRETIONARY COMMODITIES ACCOUNTS AND THE COMMON ENTERPRISE REQUIREMENT

The courts have frequently found an investment contract to exist in situations involving the sale or lease of property under an agreement whereby the seller or lessor continues to manage and control the property.²¹ The courts have reasoned that the true nature of these arrangements is the existence of an enterprise operating on capital furnished by a group of investors

15. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 194 (1961) (sales of country club memberships to generate capital with which to develop the country club were held to be securities through the court's emphasis on the risk of loss to the investor rather than on the investor's expectation of profits).

16. *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973) (pyramid selling scheme held to be an investment contract despite selling efforts of the investors through the court's emphasis on the fact that the essential managerial decisions were made by persons other than the investors); *accord*, *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *Mitzner v. Cardet Int'l, Inc.*, 358 F. Supp. 1262 (N.D. Ill. 1973).

17. 52 Hawaii 642, 485 P.2d 105 (1971).

18. SEC Securities Act Release No. 5211, Exchange Act Release No. 9387 (Nov. 30, 1971).

19. 485 P.2d at 109. The "risk capital" analysis adopted by the Supreme Court of Hawaii was suggested by Professor Coffey in his article analyzing the essential economic characteristics of security transactions. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967). The test adopted, in essence, provides that an investment contract exists when an investor furnishes initial value to a promoter, subjecting that value to the risks of an enterprise with the reasonable expectation of benefit induced by the promoter's representations, and retaining no actual or practical control over the managerial decisions of the enterprise. 485 P.2d at 109.

20. See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *SEC v. MacElvain*, 417 F.2d 1134 (5th Cir. 1969), cert. denied, 397 U.S. 972 (1970); *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635 (9th Cir. 1969).

21. See, e.g., *Kemmerer v. Weaver*, 445 F.2d 76 (7th Cir. 1971) (sale of beavers); *Continental Marketing Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967), cert. denied, 391 U.S. 905 (1968); *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), cert. dismissed, 347 U.S. 925 (1954) (sale of tract of land devoted to citrus production); *SEC v. Orange Grove Tracts*, 210 F. Supp. 81 (D. Mass. 1962) (sale of units of citrus grove); *SEC v. Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940) (sale of foxes); *SEC v. Pyne*, 33 F. Supp. 988 (D. Mass. 1940) (sale of shares in fishing boats); *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill. App. 331 (1930) (sale of farm land to be paid for with crops raised by vendor).

who are attracted by the prospect of participating in a highly profitable venture. The facts of these cases are similar to the *Howey* situation in that all involve a common enterprise operated by persons other than the investor.²² However, the courts have not limited the situations giving rise to investment contracts to those which parallel the facts of *Howey*.²³

The courts which have considered whether a discretionary commodities trading account is a security²⁴ are in conflict as to whether a common enterprise is a necessary element of the investment contract. In *Maheu v. Reynolds & Co.*,²⁵ where a discretionary commodities account was held to be a security, the court purportedly relied upon the *Howey* definition but found that an investment contract may exist even in the absence of a common enterprise or a pooling of funds among investors.²⁶ However, several cases decided since *Maheu* have stated that no security is involved in the discretionary commodities account situation since no common enterprise exists.²⁷ In *Milnarik v. M-S Commodities, Inc.*²⁸ an investor had deposited funds with a commodities broker, giving the broker full discretion to invest in commodities futures.²⁹ In applying the *Howey* test to the facts of the case, the court found that in the absence of a pooling arrangement among investors there was no common enterprise.³⁰ Thus, in contrast to *Maheu*, the recent

22. See cases cited note 21 *supra*.

23. See, e.g., *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973) (pyramid selling scheme). See also Note, *Resurrecting the Spirit of the Securities Act of 1933*, 27 Sw. L.J. 554 (1973).

24. It is generally held that commodities futures contracts, as distinguished from a commodities trading account, are not securities. See, e.g., *McCurnin v. Kohlmeyer & Co.*, 347 F. Supp. 573 (D. La. 1972), *aff'd*, 477 F.2d 113 (5th Cir. 1973); *Schwartz v. Bache & Co.*, 340 F. Supp. 995 (S.D. Iowa 1972); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968); *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359 (S.D.N.Y. 1966).

25. 282 F. Supp. 423 (S.D.N.Y. 1967); *accord*, *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968).

26. Although *Maheu* involved a joint account, the opinion clearly rests on the position that a pooling of funds is not necessary for the investment contract and makes no attempt to classify the joint account as a pooling arrangement. The court relied upon the statement of Professor Loss in his discussion of investment contracts, "the line [between what is a security and what is not] is drawn * * * where neither the element of a common enterprise nor the element of reliance on the efforts of another is present." *Maheu v. Reynolds & Co.*, 282 F. Supp. 423, 429 (S.D.N.Y. 1967), quoting 1 L. Loss, *SECURITIES REGULATION* 491 (2d ed. 1961).

27. *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972); *Stuckey v. duPont Glore Forgan, Inc.*, 59 F.R.D. 129 (N.D. Cal. 1973); *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd*, 491 F.2d 752 (3d Cir. 1973).

28. 457 F.2d 274 (7th Cir. 1972).

29. In the discretionary commodities trading accounts under discussion the broker does not share in any profits generated but receives only a commission on the commodity transactions. Trading accounts involving a contract whereby the investor and the broker are to split profits are considered classic examples of a security as a "certificate of interest or participation in a profit-sharing agreement." 1 L. Loss, *supra* note 26, at 489. See, e.g., *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935); *People v. White*, 124 Cal. App. 548, 12 P.2d 1078 (1932); *State v. Hofacre*, 206 Minn. 167, 288 N.W. 13 (1939). See also *SEC v. Addison*, 194 F. Supp. 709 (N.D. Tex. 1961); *First Nat'l Sav. Foundation, Inc. v. Samp*, 274 Wis. 118, 80 N.W.2d 249 (1956).

30. The court of appeals adopted the language of the district court, stating, "[i]n essence, this contract creates an agency-for-hire rather than constituting the sale of a unit of a larger enterprise. . . . Each contract creating this relationship is unitary in nature and each will be a success or failure without regard to the others." *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 277 (7th Cir. 1972).

A distinguishable situation exists where the funds of the plaintiffs are pooled in an

cases have found that no security was involved in discretionary commodities accounts because the *Howey* test for an investment contract was not met.

III. MARSHALL V. LAMSON BROS. & CO.

The district court for the Southern District of Iowa focused on two questions in determining that a discretionary commodities trading account is a security as defined in the 1933 and 1934 Securities Acts. The initial question for the court was whether a common enterprise is a necessary element of an investment contract. Having found that the common enterprise is required, the second question was whether such a requirement is satisfied by a discretionary commodities trading account.

Confronted with conflicting lines of authority,³¹ the court in *Marshall* found the common enterprise essential for the existence of an investment contract "[i]n view of the emphasis placed on 'common enterprise' in *Howey* and its repeated use as a criterion of investment contract in subsequent cases"³² Considering the second question, the court noted that the term "common enterprise" is not defined in *Howey*.³³ In interpreting this element of the *Howey* test, the court followed the approach taken by the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises, Inc.*,³⁴ which dealt with the *Howey* requirement that profits come "solely" from the efforts of others.³⁵ As in *Turner*, the court in *Marshall* chose to give the *Howey* test a broad reading rather than interpreting it as "a strict or literal limitation on the definition of an investment contract."³⁶ Thus, in *Marshall*, the *Howey* test was adopted but was interpreted in light of the more general aspects of *Howey* and *Joiner* which provide a flexible approach for determining the scope of the investment contract. Upon examining the cases on which *Howey* relied, the court discovered that several of those cases involved no pooling of funds,³⁷ indicating that a pooling arrangement was not necessary for the

account for commodities trading. Such an arrangement has been held to be an investment contract in *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968).

31. See notes 25-30 *supra* and accompanying text.

32. 368 F. Supp. at 488. The court relied on *Tcherepnin v. Knight*, 389 U.S. 332, 338 (1967); *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65, 72 n.13 (1959); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 481 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); *Continental Marketing Corp. v. SEC*, 387 F.2d 466, 470 (10th Cir. 1967).

33. 368 F. Supp. at 488.

34. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

35. *Turner* held that the test for determining whether the efforts of others are sufficient to constitute an investment contract under *Howey* should be "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *Id.* at 482. The court stated that its holding represented no real departure from the *Howey* definition. *Id.* at 483. It explained that the *Howey* requirement that profits come "solely" from the efforts of others was a qualification which exactly fitted the circumstances in *Howey*. *Id.* at 481. In *Marshall*, however, the court apparently assumed that *Howey's* common enterprise requirement was intended to be broader than a mere description of the facts of that case.

36. 368 F. Supp. 486, 488 (S.D. Iowa 1974).

37. See *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill. App. 331 (1930) (sale of distinct parcels of land with purchase price to come from crops grown by seller on that parcel held to be an investment contract despite absence of co-mingling of crops); *State v. Evans*, 154 Minn. 95, 191 N.W. 425 (1922) (contractual relationship between pro-

satisfaction of the common enterprise requirement.³⁸ Having determined that *Howey* did not limit the investment contract to situations involving a pooling of funds, the court found no reason to impose such a requirement on discretionary commodities accounts. The court found that the protection afforded the investor under the Securities Acts provides no basis for a distinction between the single investor who commits his funds to a promoter and "those hapless capitalists who are not alone in their misfortune."³⁹

To complete its interpretation of *Howey's* common enterprise requirement, the court speculated that the use of the phrase "common enterprise" may have been "nothing more than an attempt to require some sort of 'business' interest in an investment contract . . . to distinguish investment contracts from such passive investment opportunities as time saving accounts in banks."⁴⁰ This interpretation led the court to conclude that the common enterprise requirement is satisfied when a broker engages in commodities trading on behalf of the investor furnishing the funds for such activity. The court considered its interpretation of the *Howey* definition consonant with the principle that "the '33 and '34 Acts are remedial legislative acts which should be construed broadly to effectuate their purpose and with what can only be described as the continually expanding reach of federal regulation of securities transactions"⁴¹

The words "common enterprise" have a variety of possible meanings but the interpretation of the phrase as merely a requirement of a "business interest" finds little support in *Howey*. Although the court seemed to stretch this "common enterprise" language beyond any reasonable interpretation of the words rather than merely adopting a new test which would be applicable to situations involving no common enterprise, the court reached a judicious result. The court in *Marshall* soundly concluded that the policy of the Securities Acts would be poorly served by protecting only those investors who have pooled their funds in a trading account while denying coverage to the single investor maintaining an otherwise identical account.⁴²

motor and purchaser of land with no pooling of property or funds constituted investment contracts).

38. The court found support in Professor Loss' discussion of investment contracts where he stated, "[i]n all these cases proof of some sort of pooling arrangement among investors . . . helps, but it is not essential." 368 F. Supp. at 489, quoting 1 L. Loss, *supra* note 26, at 489. The rationale of *Milnarik* is that in the discretionary commodities account situation the common enterprise element can only be satisfied where a pooling arrangement exists. See note 30 *supra* and accompanying text. Similarly, the court in *Maheu*, which held the common enterprise unnecessary, may also have considered the term "common enterprise" to mean a pooling of funds. Assuming that an investment contract may exist without a pooling arrangement, see note 37 *supra* and accompanying text, the conclusion would follow that a common enterprise is not required. However, in *Marshall* the court recognized a distinction between the terms, and found that *Howey* requires the existence of a common enterprise but not necessarily a pooling of funds.

39. 368 F. Supp. at 489.

40. *Id.* See also Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 162 (1971), which proposes a new test for the investment contract, requiring that the investment be in a "venture" as opposed to a "common enterprise." The description of a "venture," as a "concerted effort to bring about some particular result or group of results," seems consistent with the *Marshall* interpretation of a common enterprise. 368 F. Supp. at 489.

41. 368 F. Supp. at 489.

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

IV. CONCLUSION

The significance of the *Marshall* case is found in two aspects of the decision. First, by adhering to the *Howey* test, the court set a precedent for finding a discretionary commodities account to be a security without departing from the most commonly accepted test for an investment contract. Such a decision conflicts with several recent cases, such as *Milnarik*, which found that the trading accounts involved failed to meet the *Howey* test.⁴³ The contrast between the *Marshall* and the *Milnarik* interpretations illustrates the second significant aspect of the decision, that is, the broad interpretation of *Howey* in an attempt to effectuate the purpose of the Securities Acts. When given a literal interpretation, the *Howey* test proves inadequate as a means of achieving the protection intended by the federal securities legislation. While many transactions easily fall within the ambit of the *Howey* definition, the language of the case may also be read to exclude other situations which should properly be considered investment contracts. The *Marshall* decision, in conjunction with *SEC v. Glenn W. Turner Enterprises, Inc.*,⁴⁴ expands the application of the term "investment contract" well beyond the situations literally described by *Howey*. The effect of these decisions is to shift the analysis from an application of the *Howey* language to an examination of the facts of each case to determine whether the investment scheme is within the parameters of the Securities Acts. Recognition that the *Howey* test should be treated as merely a description of one of the various types of investment contracts would obviate the need for extremely broad interpretations of the definition. However, as long as *Howey* is accepted as providing the comprehensive test for an investment contract, cases such as *Marshall* will continue to interpret that test broadly and thereby implement the policy of federal regulation of securities.

David J. Graham

Employee Covenants Not To Compete: The Justin Bootstrap Doctrine

Soon after Joe Yost and Roger Souder left managerial positions with Justin Belt Company, they were hired by Tony Lama Company. About a month later, Justin filed suit against Yost and Souder for damages and injunctive relief, alleging conspiracy and a breach of confidential relations arising out of their previous employment with Justin. A settlement was reached. Included in the settlement agreement was a covenant which restricted Yost and Souder from engaging in any phase of the business of manufacturing

43. See notes 27-30 *supra* and accompanying text.

44. 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

boots.¹ Other provisions of the settlement agreement allowed them to enter the belt business with Tony Lama. Two years later Yost and Souder filed suit for declaratory judgment, praying that the settlement agreement be declared unenforceable and, in the alternative, that the agreement be reformed to prohibit their entrance into the boot business for only two years. Justin cross-claimed, alleging breach of the settlement agreement, and sought injunctive relief. The trial court reformed the agreement to provide that Souder would not enter the boot business any place west of the Mississippi River for a period of seven years, and issued an appropriate injunction.² The court of civil appeals reversed,³ holding the settlement agreement void as a contract in unreasonable restraint of trade.⁴ The Supreme Court of Texas granted writ of error. *Held, reversed*: A covenant not to compete may properly be made part of an agreement in settlement of a pending lawsuit. A covenant not to compete which is unlimited in time and area is not void but may be reformed so as to include reasonable restraints as to time and area, and may, as reformed, be enforced by the courts. *Justin Belt Co. v. Yost*, 502 S.W.2d 681 (Tex. 1973).

I. THE RULE OF REASON AS APPLIED TO EMPLOYEE COVENANTS

Traditionally, employee covenants, by which an employee agrees not to compete with the employer after termination of employment,⁵ have been included in employment contracts, or made during an existing employment.⁶

1. The agreement also provided that Yost and Souder would not copy Justin belts, communicate any confidential information, criticize Justin or its products, use any of Justin's "special" equipment or techniques, or engage in any unfair trade practice. Yost and Souder, along with Tony Lama Company, further agreed that they would not employ any person who would be employed by Justin after Feb. 16, 1970. *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 682-83 n.1 (Tex. 1973).

2. Yost was general manager of the belt-making branch of Justin. Souder was general manager of the boot-making branch. The covenant restricting entrance into the boot business was enforced against Souder only, while the remainder of the agreement was enforced against Yost, Souder, and Tony Lama. The opinion of the Supreme Court of Texas states that both Yost and Souder were enjoined from making boots, however under no authority could the trial court have done so. Yost had never worked in the boot business and restricting him from making boots would not serve to protect any "legitimate interest" of Justin. See note 20 *infra* and accompanying text. See also *Arthur Murray Dance Studios, Inc. v. Witter*, 62 Ohio L. Abs. 17, 28, 105 N.E.2d 685, 691 (C.P. 1952).

3. *Yost v. Justin Belt Co.*, 488 S.W.2d 850 (Tex. Civ. App.—Fort Worth 1972), *rev'd*, 502 S.W.2d 681 (Tex. 1973). The covenant was held void as an employee covenant not ancillary to an existing employment or contract of employment. See RESTATEMENT OF CONTRACTS § 515(e) (1932) [hereinafter cited as RESTATEMENT] (cited as controlling by the court).

4. Although the court held the agreement void, it did reform the trial court's injunction, basing its decision upon the implied obligations of employees not to divulge confidential information and not to interfere with contractual relations between Justin and other employees. For a full discussion of such employee torts see W. PROSSER, TORTS § 129, at 945, § 130 (4th ed. 1971). See also RESTATEMENT OF TORTS §§ 708, 711-12 (1938); Hannigan, *The Implied Obligation of an Employee*, 77 U. PA. L. REV. 970 (1929).

5. Such agreements will hereinafter be termed "employee covenants." A parallel situation involves restrictive covenants ancillary to the sale of business good will. See Blake, *Employee Agreements Not To Compete*, 73 HARV. L. REV. 625, 646-48 (1960) [hereinafter cited as Blake] for a comparison of the two types of noncompetition agreements.

6. Although *Justin* involves the more unique situation in which the employee covenant was consummated after the employment was terminated, it will be necessary to discuss the traditional type of covenant as well.

That such covenants are a restraint of trade is self-evident, in that they tend to reduce the mobility of workers, thus lessening personal freedom and diminishing competition and industry-wide dissemination of information.⁷ However, by assuring himself that his employee will not vanish and take with him information that would tend to injure him, an employer is more likely to give his employee a higher degree of responsibility, resulting in both the stimulation of the employee and the betterment of the enterprise. In view of the advantages and disadvantages of these covenants, the courts have resorted to a balancing approach in assessing their enforceability, pitting the interests served against the interests thwarted. This balancing approach has been developed by a long line of cases⁸ and has been referred to as the "rule of reason."⁹

At common law employee covenants were void as against public policy,¹⁰ not because of the inequities that might flow from such agreements, but because they breached the rigid rules of the guild system.¹¹ However, the transition to the market economy carried with it a recognition that such agreements could be favorable to the public interest,¹² as productivity was found to be best served by allowing the entrepreneur considerable freedom in his market strategy,¹³ even though in so doing he might diminish his employees' freedom. In such an environment employee covenants presented a real problem, the courts being forced to weigh market freedom against freedom of contract. The question became, when may a man contract away his economic freedom.¹⁴

Throughout the 18th and 19th centuries employee covenants *limited in*

7. See 6A A. CORBIN, CONTRACTS § 1380 (1962) [hereinafter cited as CORBIN]. See also Blake 627.

8. See the cases discussed in the remainder of this section. The development of the "rule of reason" in England is discussed at length in *Davies v. Davies*, 36 Ch. D. 359 (1887). Development of the rule in America is discussed in *Arthur Murray Dance Studios, Inc. v. Witter*, 62 Ohio L. Abs. 17, 105 N.E.2d 685 (C.P. 1952), and *Eaton, Contracts in Restraint of Trade*, 4 HARV. L. REV. 128 (1890).

9. Blake 649.

10. The first reported decision concerning an employee covenant is *The Dier's Case*, Y.B. Pasch. 2 Hen. 5, f. 5, pl. 26 (1414).

11. The earliest cases of employee covenants arose from agreements in which one would agree that, after his term of apprenticeship had run, he would not practice his trade in the same city or area as his master. Such an agreement flew in the face of the guild system because after the term of apprenticeship one was no longer bound to his master. Such an agreement did bind the apprentice to his master after his term had run and was viewed as an unscrupulous method by which the master could extend the term of apprenticeship. For a more complete discussion of the guild system, see 8 W. HOLDSWORTH, HISTORY OF ENGLISH LAW 56-62 (2d ed. 1937).

12. "So for a valuable consideration, and voluntarily, one may agree that he will not use his trade; for *volenti non fit injuria*." *Broad v. Jollyfe*, Cro. Jac. 596, 79 Eng. Rep. 509 (K.B. 1621).

13. See generally A. SMITH, THE WEALTH OF NATIONS 118-27 (Mod. Lib. ed. 1937).

14. In the most oft-cited case concerning covenants not to compete, *Mitchell v. Reynolds*, 1 P. Wms. 181, 190, 24 Eng. Rep. 347, 350 (Q.B. 1711), the court noted that employee covenants should be viewed with care because of the "great abuses" that they are subject to by unethical employers. Stating that there was a presumption that all restraints of trade were invalid, the court nevertheless held that it was the best interest of the public policy that "[A] man may, upon a valuable consideration by his own consent, and for his own profit give over his trade . . ." and that a limited restraint of trade [limited in time and/or area] would be enforced by the courts when "just and honest." *Id.* at 186, 197, 24 Eng. Rep. at 349, 352. See note 18 *infra* for a further discussion of *Mitchell*.

time and area were generally upheld on a strong freedom of contract basis,¹⁵ while *general* restraints of trade were void.¹⁶ The sole considerations were the duration and the expanse of the particular restraint. In a famous English case, *Herbert Morris v. Saxelby*,¹⁷ the court noted that the "general-limited" test¹⁸ was merely one rule of reasonableness to be applied to the particular facts of each case, thereby doing away with previous arbitrary distinctions based solely upon whether a particular covenant was "general" or "limited." The court went further to require first, that the employer must show that the restraint provided by the covenant is reasonable, taking into account the interests of both employer and employee, and, second, that the covenant must protect some legitimate interest of the employer and must not serve solely to limit the employer's future competition. The holding in *Herbert Morris* was soon followed by the American courts,¹⁹ and the rule of reason has since been uniformly applied.²⁰

A. Severability and Reformation

An employer can now be assured that any "reasonable" restraint which he includes in his employment contract will be upheld in the courts.²¹ But,

15. The history of the English treatment of employee covenants is extensively discussed in *Davies v. Davies*, 36 Ch. D. 359 (1887).

16. It is a general rule of law . . . that all contracts in general restraint of trade are illegal and void . . . general restraints upon trade have a tendency to promote monopolies and to discourage industry, enterprise, and just competition, and thus do mischief to the party by the loss of his livelihood and the subsistence of his family, and mischief to the public, by depriving it of the devices and labors of a useful member.

Kerr, *Contracts in Restraint of Trade*, 22 AM. L. REV. 873, 875 (1888).

17. [1916] 1 A.C. 688.

18. See *Blake* 638-39. The limited-general distinction was first developed in *Mitchell v. Reynolds*, 1 P. Wms. 181, 24 Eng. Rep. 347 (1711), which did not involve an employee covenant, but a covenant incidental to the sale of a bakery (good will). The *Mitchell* case distinguished good will covenants from employee covenants, but the distinction was seldom given more than lip-service by the courts. Dicta in *Mitchell* stated that employee covenants required special consideration as well as limitations upon the restraint. See notes 35-40 *infra* and accompanying text.

19. Compare the distinction in note 18 *supra* with the development of Professor Williston's treatment of employee covenants. In the 1920 edition of his treatise on contracts, Professor Williston stated that "the distinction [between employee covenants and covenants ancillary to sale of good will] seems unadvisable as a positive rule of law." 3 S. WILLISTON, *CONTRACTS* § 1643 (1920) [hereinafter cited as WILLISTON]. However, in a later edition he made note of the then current trend in America: "[T]here is a tendency in the United States to follow the English courts in differentiating between contracts in restraint of trade and contracts in restraint of employment." 5 *id.* § 1643 (rev. ed. 1937). In 1932 the *Restatement* also recognized different tests of "reasonableness" to be applied to the two types of covenants. RESTATEMENT § 515, comment *b*.

20. See, e.g., cases cited *infra* note 21 and RESTATEMENT §§ 514-16. For a full discussion of factors used to determine whether a restraint is reasonable, see Comment, *Contracts in Restraint of Trade: Employee Covenants Not To Compete*, 21 ARK. L. REV. 214 (1967). See also *Arthur Murray Dance Studios, Inc. v. Witter*, 62 Ohio L. Abs. 17, 105 N.E.2d 685 (C.P. 1952) (setting forth 41 "tests" for reasonableness).

21. See, e.g., *Budget Rent-A-Car Corp. of America v. Fein*, 342 F.2d 509, 514 (5th Cir. 1965); *United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 282 (6th Cir. 1898); *Keller v. California Liquid Gas Corp.*, 363 F. Supp. 123, 127 (D. Wyo. 1973); *Short v. Fahrney*, 502 P.2d 982, 984 (Colo. App. 1972); *House of Vision, Inc. v. Hiyane*, 37 Ill. 2d 22, 225 N.E.2d 21, 24 (1967); *Wissman v. Boucher*, 150 Tex. 326, 331, 240 S.W.2d 278, 280 (1951); *Orkin Exterminating Co. v. Wilson*, 501 S.W.2d 408, 410-11 (Tex. Civ. App.—Tyler 1973), *error dismissed*.

since employee covenants are almost always negotiated before termination of employment, neither the employee nor the employer can accurately forecast what a "reasonable" restraint will be when the time comes to seek enforcement. In an early case²² a restrictive covenant provided the covenantor would not compete in any area near the employer's store or any other shop that the employer "shall think proper to remove to."²³ The court, holding the restraint too general, severed the latter clause and enjoined the employee from competing only in the area of the employer's existing shop. The court, using what has been referred to as the "blue pencil" test,²⁴ assumed that the parties intended a reasonable restraint and enforced the covenant, but only after eliminating the unreasonable portion of the writing.²⁵

Most jurisdictions, including Texas, have adopted the doctrine of reformation (as opposed to the "blue pencil" test)²⁶ when dealing with employee covenants. Using this doctrine, the courts have issued injunctions which were narrower than the terms of the covenant even though the language of the covenant itself provided no basis for severance.²⁷ Though there are persuasive arguments to the contrary,²⁸ this appears to be the most equitable rule. Where it appears that the parties intended to formulate a reasonable

22. *Chessman v. Nainby*, 2 Str. 740, 93 Eng. Rep. 819 (K.B. 1726).

23. *Id.*

24. If the covenant can be severed as written, the court will strike out the unreasonable portion with a judicial "blue pencil," thereby leaving only the reasonable terms of the agreement.

25. This case was decided only a few years after *Mitchell v. Reynolds*, 1 P. Wms. 181, 24 Eng. Rep. 347 (Q.B. 1711), which held that "general" restraints of trade were void. It is submitted that the decision would be similar using today's rule of reason. See, e.g., *Hill v. Central West Public Serv. Co.*, 37 F.2d 451 (5th Cir. 1930) (restraint throughout Texas enforced as to city of Dallas); *Weatherford Oil Tool Co. v. Campbell*, 161 Tex. 310, 340 S.W.2d 950 (1960) (The covenant restrained employee from competition "where [the employer] may be operating or carrying on any business . . ." *Id.* at 312, 340 S.W.2d at 951. The court held it was proper to cut down the restraint to a reasonable area.). *Contra*, *Thomas v. Coastal Indus. Servs., Inc.*, 214 Ga. 832, 108 S.E.2d 328 (1959) (restraint naming 46 counties, where employee had contacts in only 31 counties, held void as a whole).

26. The *Restatement* adheres to the "blue pencil" test. RESTATEMENT § 518. Corbin notes that § 518 is a result of the belief that the blue pencil test supported the greater weight of authority in 1932, but that this is no longer the case. 6A CORBIN § 1390, at 69. Williston, who drafted § 518, agrees that it no longer represents the majority rule. 14 WILLISTON § 1647C, at 293-94 (3d ed. 1972).

27. E.g., *Denny v. Roth*, 296 S.W.2d 944 (Tex. Civ. App.—Galveston 1956), *error ref.* Some jurisdictions still utilize the "blue pencil" test. E.g., *Interstate Fin. Corp. v. Wood*, 69 F. Supp. 278 (E.D. Ill. 1946) (applying Illinois law); *John Roane, Inc. v. Tweed*, 33 Del. Ch. 4, 89 A.2d 548 (Sup. Ct. 1952); *Wisconsin Ice & Coal Co. v. Lueth*, 213 Wis. 42, 250 N.W. 819, 821 (1933), wherein the court stated: "[I]f the contract itself furnishes no basis for dividing the territory to which the restriction applies, the restrictive covenant is void . . ." Still other jurisdictions refuse any severance or reformation of any covenant held unreasonable. *Welcome Wagon, Inc. v. Morris*, 224 F.2d 693 (4th Cir. 1955); *Sonotone Corp. v. Baldwin*, 227 N.C. 387, 42 S.E.2d 352 (1947).

28. One objection is that, if reformation is universally allowed, the employer will attempt to write overly broad restrictions in his employment contracts, knowing that he will nevertheless be awarded a reasonable restriction should he decide to take it into court. For every covenant that finds its way into court, there are hundreds that do not, and there are hundreds of employees bound by unreasonable contracts, not knowing whether to change occupations or breach the contract and face the expense of a lawsuit. Respondent's Motion for Rehearing at 5-7, *Justin Belt Co. v. Yost*, 502 S.W.2d 681 (Tex. 1973). See also *Blake* 682.

restriction,²⁹ the court will act in the balanced interests of both parties by issuing an injunction to protect what turns out to be reasonable at the time enforcement is sought. By taking notice of uncertainty at the time of the contract, the court can more readily enforce the intended relationship of that agreement. The best-reasoned Texas decision on the point of reformation is *Spinks v. Riebold*.³⁰ The employee had agreed to a covenant restricting post-employment competition in a tri-state area, but at the time of the cessation of employment the employer's business covered only portions of Texas. Acknowledging that the parties intended a reasonable restraint, the court stated:

[A]t the time the contract was entered into, so far as we know, it may have been contemplated by the parties that [the employer's] business would eventually cover the entire three states, and if that had been true at the time [the employee] severed his employment . . . then the provision . . . would not necessarily have been unreasonable.³¹

Finding that the tri-state restraint was unreasonable, the court reformed the agreement to provide for a restraint only in those areas in which the employer's business was carried on at the time employment was terminated: that is, it conformed the restraint to what turned out to be reasonable years after the covenant was executed.

B. *Consideration and the Ancillary Rule*

Every employee covenant has inevitable effects which in some degree oppose community values, that a man should not be obliged to barter away his personal freedom and that any degree of servitude is distasteful. But, the need for efficient business organization must be balanced against these considerations. Efficient division of labor and specialization cannot take place unless the risk of loss of entrusted information can be minimized. Because each employee covenant involves a conflict of social and political maxims of freedom and economic maxims of efficiency it is not in every situation that an employee covenant can be enforceable. The courts will not allow a man to barter his economic freedom unless the purpose of his doing so can be justified as a protection of his employer's economic interests. The *Restatement of Contracts*, in its "ancillary rule," recognizes only two situations in which that purpose is present: in the contract for employment and during employment.³² The *Restatement* rule is valid insofar as it goes, provided business risks are present or contemplated. A recent case³³ which held void a covenant made ancillary to an existing employment (valid under the *Re-*

29. The principal case is not such an agreement. At the time of the settlement, Justin was, or should have been, fully aware of what protection was warranted and, therefore, reasonable. See the discussion at notes 49-52 *infra* and accompanying text.

30. 310 S.W.2d 668 (Tex. Civ. App.—El Paso 1958), *error ref.*

31. *Id.* at 670.

32. The *Restatement* states that an employee covenant is unreasonable and therefore unenforceable if it "is not ancillary . . . to an existing employment or contract of employment." *RESTATEMENT* § 515(e).

33. *McCombs v. McClelland*, 223 Ore. 475, 354 P.2d 311 (1960).

statement's ancillary rule) is illustrative. The defendant had worked for the plaintiff for a period of years when she signed an employee covenant. The court held that even though the covenant was made pursuant to an existing employment, there was no sufficient consideration in that the employer failed to promise any future employment, increased wages or increased responsibility, and the covenant was, therefore, void.³⁴ Essentially, the transaction involved did not give rise to any risks on the part of the employer. Thus, the "ancillary rule" can be viewed as a matter of consideration. For a valid covenant not to compete, the consideration must be more than "adequate;" it must be "special"—a transfer of some interest worthy of protection by the covenant.³⁵

In employee situations the usual interests worthy of protection are trade secrets which will be learned in the course of future employment,³⁶ but there are others. For example, in *DeLong Corp. v. Lucas*³⁷ a settlement agreement provided that the defendant would not engage in the sale of oil equipment in competition with the plaintiff. The court held that the relinquishment of the plaintiff's cause of action by the settlement agreement was sufficient consideration for the covenant not to compete in that the covenant was necessary to protect the plaintiff's trade secrets which were no longer protected by the right to sue his former employee.³⁸

Construing the "ancillary rule" as a rule of consideration to be applied to employee covenants, a more precise statement of the rule would be that a covenant in restraint is valid only if incidental to the transfer of some interest worthy of protection by the covenant.³⁹ If no "protectable interest" is exchanged or is promised to be exchanged, the covenant is void.⁴⁰

II. JUSTIN BELT CO. v. YOST

It is settled law in Texas that reasonable covenants in restraint of trade

34. 354 P.2d at 315.

35. Corbin implies that there must be "special" consideration for employee covenants. "Therefore we must examine the *extent* and *character* of the consideration received by the promisor, even though we do not do so in ordinary contract cases." 6A CORBIN § 1395, at 108 (emphasis added). See also note 18 *supra*.

36. RESTATEMENT § 515(e).

37. 176 F. Supp. 104 (S.D.N.Y. 1959), *aff'd*, 278 F.2d 804 (2d Cir.), *cert. denied*, 364 U.S. 833 (1960).

38. 176 F. Supp. at 121; *accord*, *Worldwide Pharmacal Distrib. Co. v. Kolkey*, 5 Ill. App. 2d 201, 125 N.E.2d 309 (1955) (The employee sued the employer for wrongful discharge and breach of contract to transfer stock. The settlement provided that the employer would pay the employee \$4,000 and the employee agreed not to engage in the "bust developing" business in competition with the employer. The employee later marketed a competitive product. The court held that considering the "special circumstances," the covenant was valid.); *Novelty Bias Binding Co. v. Shevrin*, 342 Mass. 714, 175 N.E.2d 374 (1961) (restrictive covenant in post-employment restitution agreement held valid where restitution was of goods stolen during employment); *Chenault v. Otis Eng'r Corp.*, 423 S.W.2d 377 (Tex. Civ. App.—Corpus Christi 1967), *error ref. n.r.e.* (covenant not to compete incidental to a leave of absence agreement held valid).

39. This makes the *Restatement* provision incomplete, see note 32 *supra*, but it is in accord with the statement by Professor Williston: "[G]enerally it is only in cases where the restrictive promise is ancillary to some other transaction that its validity has been upheld." 14 WILLISTON § 1636, at 96 (3d ed. 1972).

40. *Compare Smith v. Kousiakis*, 172 S.W. 586 (Tex. Civ. App.—El Paso 1914), with the cases cited in notes 37-38 *supra*.

will be enforced by injunction,⁴¹ and in determining what is "reasonable" Texas has traditionally followed the majority of jurisdictions.⁴² *Justin* has taken the Texas law a step further in two instances, first by allowing enforcement of a contract executed after termination of the employment, and secondly by allowing reformation of a covenant originally unlimited in time or area.

The covenant in question was executed as part of a settlement agreement between Yost, Souder, and Justin, and was not dissimilar from those disputed in earlier cases in Massachusetts,⁴³ Illinois,⁴⁴ and New York.⁴⁵ The contract, of which the restrictive covenant was part, extinguished Justin's right to sue the two employees for wrongful activities arising out of their employment. Such an agreement certainly gave rise to a legitimate, protectable interest, closely related to the previous employment,⁴⁶ the risk of future conspiracy or breach of confidential relations. The restrictive covenant was directed at protecting such an interest; however, it incorporated unreasonable and unlimited restrictions.

As discussed previously,⁴⁷ the reasoning behind allowing reformation of covenants in restraint of trade is a result of the uncertainty that generally prevailed at the time the covenant was written. Taking notice of that uncertainty, the court will enforce what is considered the purpose of the agreement, a restraint which will adequately protect the employer without undue harm to the employee.⁴⁸ Texas has traditionally been liberal in allowing reformation, going so far as to say that it will be allowed even if a covenant is unreasonable in both time and area.⁴⁹ But, in all previous Texas cases the covenants which were reformed were executed at a time when neither party knew or could have known what would turn out to be reasonable.⁵⁰ Conversely, Justin knew or should have known what a reasonable restraint

41. The earliest case is *Gates v. Hooper*, 90 Tex. 563, 39 S.W. 1079 (1897), discussed in 3 TEXAS L. REV. 337 (1925). The first case enforcing an employee covenant is *Patterson v. Crabb*, 51 S.W. 870 (Tex. Civ. App. 1899), error dismissed *w.o.j.*

42. See note 20 *supra*. The court in *Justin* did not speak to the issue of reasonableness, but the court of civil appeals set forth several tests, citing *Williston* and the *Restatement*. *Yost v. Justin Belt Co.*, 488 S.W.2d 850, 853-55 (Tex. Civ. App.—Fort Worth 1972), *rev'd*, 502 S.W.2d 681 (Tex. 1973).

43. *Novelty Bias Binding Co. v. Shevrin*, 342 Mass. 714, 175 N.E.2d 374 (1961); see note 38 *supra*.

44. *Worldwide Pharmacal Distrib. Co. v. Kolkey*, 5 Ill. App. 2d 201, 125 N.E.2d 309 (1955); see note 38 *supra*.

45. *Delong Corp. v. Lucas*, 176 F. Supp. 104 (S.D.N.Y. 1959), *aff'd*, 278 F.2d 804 (2d Cir.), *cert. denied*, 364 U.S. 833 (1960); see text accompanying note 37 *supra*.

46. See note 40 *supra* and accompanying text.

47. See notes 24-26 *supra* and accompanying text.

48. See note 19 *supra* and accompanying text.

49. *Weatherford Oil Tool Co. v. Campbell*, 161 Tex. 310, 340 S.W.2d 950 (1960); *Lewis v. Krueger, Hutchinson & Overton Clinic*, 153 Tex. 363, 269 S.W.2d 798 (1954); *Spinks v. Riebold*, 310 S.W.2d 668 (Tex. Civ. App.—El Paso 1958), *error ref.* The statement of approval in all these cases was contained in dicta, because none of the cases involved a covenant which was unreasonable in both time and area.

50. See cases cited in note 49 *supra*. It should also be noted that "unreasonable" and "unlimited" are not synonymous. Unreasonableness depends upon the facts of each individual case, while employee covenants which are completely unlimited are generally unreasonable as a matter of law. See *Lewis v. Krueger, Hutchinson & Overton Clinic*, 153 Tex. 363, 365-66, 269 S.W.2d 798, 800 (1954).

would be, for, at the time of the contract, the parties' employment relationship was at an end.⁵¹

The court in *Justin* did not follow the traditional reformation rationale and allowed an unlimited restraint to be converted into a reasonable one. If the case is construed strictly, as holding that the force of a judicial settlement will be upheld regardless of negligence or overreaching by one of the parties, it would be a novel but sufferable addition to the law of compromise and settlement. However, if the case is construed so as to apply to employee covenants in general, it fails to comply with what has been, and should be, the law.⁵² As a general precept reformation has been utilized to cause the contract to reflect the intent of the parties. In contrast, the courts usually reform employee covenants so as to be consistent with the purpose of the covenant rather than the intent of the parties which is often unclear when the covenant is entered.⁵³ Where the purpose is clear, and there is no ground for uncertainty, reformation is improper.⁵⁴

III. CONCLUSION

The Texas employer can with little difficulty draft a covenant to be included in his employment contracts which will soften the risk of injury due to departing employees. Likewise, such a covenant could be agreed upon during the term of employment.⁵⁵ The employer who has failed to protect himself contractually during the term of employment is left only with the employee torts in his arsenal of remedies.⁵⁶ *Justin* offers an alternative to the litigation of tort actions via the judicial settlement. An employee covenant, included in a settlement agreement, will protect the interests of the employer, and will protect the employee from the expense of a lawsuit.⁵⁷

The Supreme Court of Texas in *Justin* has allowed reformation of an instrument, where at the time of the instrument's writing there was no mistake and no uncertainty. The court chose to write a new and different contract to replace a contract which the parties knew or should have known to have

51. See Blake 683.

52. In *Lewis v. Kreuger, Hutchinson & Overton Clinic*, 153 Tex. 363, 269 S.W.2d 798 (1954), the court reformed an employee covenant totally unlimited in time. It was, however, the opinion of the court that: "Even though it might be interpreted as promising never to practice in Lubbock County . . ." the contract lent itself to the construction that the parties "intended the restriction to prevail a reasonable length of time only." *Id.* at 366, 269 S.W.2d at 800. Chief Justice Calvert, concurring, questioned the wisdom of the court's rewriting both time and space provisions. He answered: "I think not; and yet we have taken the first step in that direction." *Id.* at 367, 269 S.W.2d at 800-01.

53. See note 30 *supra* and accompanying text.

54. See generally 13 WILLISTON § 1549 (3d ed. 1970).

55. Of course, the employer must transfer or promise to transfer something worthy of protection by the covenant. See notes 33-34 *supra* and accompanying text. A promise of increased wages would not be enough. 6A CORBIN § 1395.

56. See note 4 *supra*.

57. *Justin* states that contracts reasonable in time and area will be upheld when they are ancillary to "some permissible transaction." *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 684 (Tex. 1973). It is submitted that the term "permissible transaction" was intended by the court to include only transactions which involve a transfer of protectable interests, not "any transaction." See 6A CORBIN § 1395. See also note 39 *supra* and accompanying text, the relinquishment of an employer's cause of action for wrongful use of information obtained during previous employment involves such a transfer.

been unreasonable at its inception. Under such circumstances, *Justin* should not be construed to apply to employee covenants in general. The intent of the parties in setting forth the terms of the employee covenant was clear, but the covenant did not fairly serve the purpose of the settlement agreement. *Justin* should be construed to apply only to the law of compromise and settlement, holding that the purpose of a settlement agreement will be enforced to the extent that it is reasonable, irregardless of the parties' intent in setting forth the terms of the settlement.

B. Prater Monning, III

Houdaille Industries, Inc. v. Cunningham: Discovery of Experts' Reports in Texas

Houdaille Industries brought suit against Southwestern Laboratories in a Texas district court, alleging negligent performance of a paving design contract. Southwestern moved under Texas Rule of Civil Procedure 167 to discover certain reports and photographs which were made or taken by experts employed by Houdaille to investigate the cause for the failure of the paving. Because of Houdaille's objections to Southwestern's motion, trial judge Cunningham conducted an in camera review of the materials sought and ordered that two items be returned to Houdaille as privileged work product materials. Houdaille was ordered to produce three reports and a group of photographs for Southwestern's inspection. Believing that these materials were protected from discovery since the experts were not to testify as witnesses in chief,¹ Houdaille sought a writ of mandamus from the Texas Supreme Court to compel the trial judge to vacate his discovery order. At this point, Judge Cunningham voluntarily stayed his order so that issuance of the writ would be unnecessary. *Held, order modified*: The reports of experts who will not testify in any witness capacity are protected from discovery under the privilege proviso of rule 167, but experts' photographs unattached to a report are discoverable, regardless of whether or not the expert will testify. *Houdaille Industries, Inc. v. Cunningham*, 502 S.W.2d 544 (Tex. 1973).

I. DISCOVERY AND THE WORK PRODUCT LIMITATION

As the federal and state systems began to stress the notice function of pleading, pre-trial discovery emerged as a means to clarify issues and to de-

1. Houdaille unsuccessfully argued that rule 167 permits the discovery of the reports of experts who will testify in support of a party's case in chief, but protects the reports of experts who will be used only to rebut an opposing theory.

termine facts. The emphasis changed from one of secrecy, with a premium on cunning, to one of openness, with a stress on fairness.² Nevertheless, there still remained a basic tension "between the desire for orderly, efficient litigation within the context of a strict adversary system"³ and the remnants of the "sporting game" theory⁴ of justice. One aspect of this tension was resolved arguably in favor of the sporting theory by the United States Supreme Court in *Hickman v. Taylor*.⁵ *Hickman* considered the extent to which a party could discover statements of witnesses, or other information obtained by an adverse party's counsel in preparation for possible litigation after a claim had arisen. The Court concluded that this information, which had been reluctantly termed "work product" by the Ninth Circuit,⁶ was not discoverable absent a showing of necessity. In the sporting tradition, a lawyer's work and ingenuity would be granted a qualified privilege which would be lost only in "a rare situation."⁷ Essential to the Court's analysis was its perception of the purposes for discovery: "[T]o narrow and clarify the basic issues . . . and . . . [to ascertain] the facts, or information as to the existence or whereabouts of facts, relative to those issues."⁸ Given these policy justifications, the attorney's personal strategies or impressions would rarely, if ever, be discoverable, since they would not further the discovery goals, and also would contravene the policy behind the "orderly prosecution and defense of legal claims."⁹

Hickman was the basis for the trial preparation section of Federal Rule of Civil Procedure 26.¹⁰ In order for documents or other tangible materials "prepared in anticipation of litigation by a party or his representative"¹¹ to be discoverable, the opposing party must show that he "has substantial need of the materials in the preparation of his case and that he is unable without

2. In *United States v. Procter & Gamble Co.*, 356 U.S. 677, 682 (1958), the United States Supreme Court reasoned that discovery helps to "make a trial less a game of blindman's bluff and more a fair contest with the basic issues and facts disclosed to the fullest practicable extent." In *Hickman v. Taylor*, 329 U.S. 495, 501 (1947), the Court indicated that "civil trials in the federal courts no longer need be carried on in the dark." See generally Pike & Willis, *The New Federal Deposition-Discovery Procedure: I*, 38 COLUM. L. REV. 1179 (1938).

3. *Federal Discovery Rules: Effects of the 1970 Amendments*, 8 COLUM. J. OF LAW & SOC. PROBS. 623, 624 (1972).

4. LaFrance, *Work Product Discovery: A Critique*, 68 DICK. L. REV. 351, 356 (1964); see *Martin v. Reynolds Metals Corp.*, 297 F.2d 49, 56 (9th Cir. 1961).

5. 329 U.S. 495 (1947).

6. 153 F.2d 212, 223 (9th Cir. 1945).

7. 329 U.S. at 513.

8. *Id.* at 501; see *American Oil Co. v. Pennsylvania Petroleum Prods. Co.*, 23 F.R.D. 680 (D.R.I. 1959); *Great Am. Ins. Co. v. Murray*, 437 S.W.2d 264, 267 (Tex. 1969), citing 2A W. BARRON & A. HOLTZOFF, *FEDERAL PRACTICE AND PROCEDURE* § 641 (Wright ed. 1961); Long, *Discovery and Experts Under the Federal Rules of Civil Procedure*, 39 WASH. L. REV. 665 (1964).

9. 329 U.S. at 510. The Court refused to couch its analysis in terms of the attorney-client privilege, but instead stressed the potential demoralizing effects which such discovery would have on the legal system and on the lawyer's ability to serve the needs of his clients.

10. FED. R. CIV. P. 26(b)(3).

11. Though *Hickman* involved work product obtained directly by counsel, *Allmont v. United States*, 177 F.2d 971, 976 (3d Cir.), cert. denied, 339 U.S. 967 (1950), extended the *Hickman* reasoning to "all statements of prospective witnesses which a party has obtained for his trial counsel's use." Rule 26(b)(3) follows the *Allmont* logic.

undue hardship to obtain the substantial equivalent of the materials by other means."¹² As to mental impressions or legal theories of an attorney, the rule requires that the court protect against such disclosure and thus eliminates the possibility for discovery which was postulated in *Hickman*.¹³

The trend in Texas, and in many other states, followed the general progression of the federal rules,¹⁴ but with several specific distinctions. Federal rule 26, for example, establishes the scope for all forms of discovery and requires a showing of relevancy as a prerequisite to discovery. In Texas, rule 186a¹⁵ establishes the scope for depositions and interrogatories, but does not set the limitations for discovery under rule 167, which deals with production of documents and other tangible materials.¹⁶ Furthermore, rule 167 requires a showing of good cause¹⁷ rather than mere relevancy and also specifies that the material sought must contain or be reasonably calculated to lead to evidence.¹⁸ Finally, both rules 671 and 186a contain unique restrictive provisos. Under rule 167, the rights of discovery do not extend to "written communications passing between agents or representatives . . . of either party to the suit, or to other communications between any party and his agents, [or] representatives . . ." where made subsequent to the origination of the claim and in connection with it.¹⁹ Rule 186a contains a similar provision, as well as one preventing examinations from reaching the attorney's work product. The Texas rules allow no exceptions to permit disclosure of such matters, even upon a showing of substantial need and undue hardship. Having taken the basic framework of the federal rules, the Texas rules makers went a step farther by making the work product privilege absolute.²⁰

II. EXTENSION OF THE WORK PRODUCT PRIVILEGE TO EXPERTS' REPORTS

Following the same reasoning as that used to support the work product

12. FED. R. CIV. P. 26(b)(3).

13. See note 9 *supra* and accompanying text.

14. Thirty-four states, including Texas, have substantially adopted the general federal system of discovery. Note, *Discovery of Expert Information*, 47 N.C.L. REV. 401, 402 (1969).

15. TEX. R. CIV. P. 186a.

16. Rule 186a is titled "Scope of Examinations," but by its own words it seems limited to examinations such as depositions or interrogatories. TEX. R. CIV. P. 168, for example, which covers interrogatories to parties, is expressly limited by rule 186a. Rule 167, on the other hand, makes no reference to, and is apparently not governed by, rule 186a.

17. The good cause requirement was eliminated from the analogous FED. R. CIV. P. 34 in 1970.

18. Before the 1973 amendment, rule 167 required that the material sought contain evidence. For a discussion of the 1973 amendments to the Texas rules of discovery, see Keith, *Texas Rules of Civil Procedure*, 36 TEX. B.J. 401, 403-08 (1973).

19. TEX. R. CIV. P. 167.

20. Of the four states which were cited in Note, *supra* note 14, at 402, as having the most restrictive work product provisions, only two, Texas and Pennsylvania, still have such rules. PA. R. CIV. P. 4011d forbids all discovery which "would disclose the existence or location of reports, memoranda, statements, information or other things made or secured by any person or party in anticipation of litigation . . . other than information as to the identity or whereabouts of witnesses."

privilege, many federal and state courts considered reports of experts as similarly privileged matters prepared in anticipation of trial by representatives of a party.²¹ The privilege was based on either a work product,²² attorney-client privilege,²³ or unfairness²⁴ analysis. Federal rule 26(b)(4)(A) rejected these rationales as they related to the discovery of experts whom a party expects to call at trial.²⁵ The special treatment of testifying experts was justified as the only way to assure that the other party's advocate could engage the expert in an effective and intelligent cross-examination.²⁶ The rule allows a party to discover the facts or opinions of a non-testifying expert only upon "a showing of exceptional circumstances under which it is impracticable for the party seeking discovery to obtain facts or opinions on the same subject by other means."²⁷ Thus, the federal courts are to engage in balancing tests to assure that the work product and fairness policies are not contravened.

The Texas rules are more restrictive than the federal rules in regard to the treatment of experts' reports. The scope of examinations under rule 186a does not extend to the "mental impressions and opinions of experts used solely for consultation and who will not be witnesses in the case."²⁸ Simi-

21. See 4 J. MOORE & J. LUCAS, *MOORE'S FEDERAL PRACTICE* ¶ 26.66 (2d ed. 1974); C. WRIGHT & A. MILLER, *FEDERAL PRACTICE AND PROCEDURE: CIVIL* § 2029 (1970); Friedenthal, *Discovery and Use of an Adverse Party's Expert Information*, 14 STAN. L. REV. 455 (1962); Rylaarsdam, *Disclosure of Lay and Expert Witness Reports-Discovery vs. The Work Product and Attorney-Client Privileges*, 48 L.A. BAR BULL. 336 (1973).

22. See, e.g., *Carpenter-Trant Drilling Co. v. Magnolia Petroleum Corp.*, 23 F.R.D. 257 (D. Neb. 1959); *Empire Box Corp. v. Illinois Cereal Mills*, 47 Del. 283, 90 A.2d 672 (Super. Ct. 1952); *Ford Motor Co. v. Havee*, 123 So. 2d 572 (Fla. Dist. Ct. App. 1960).

23. See, e.g., *Cold Metal Process Co. v. Aluminum Co. of America*, 7 F.R.D. 684 (D. Mass. 1947); *City & County of San Francisco v. Superior Ct.*, 37 Cal. 2d 227, 231 P.2d 26 (1951). *But see* *Sachs v. Aluminum Co. of America*, 167 F.2d 570 (6th Cir. 1948).

24. See, e.g., *Schuyler v. United Air Lines*, 10 F.R.D. 111, 113 (M.D. Pa. 1950), *aff'd*, 188 F.2d 968 (3d Cir. 1951); *Lewis v. United Air Lines Transp. Corp.*, 32 F. Supp. 21, 23 (W.D. Pa. 1940) (in which the court regarded the expert's report as being endowed with property rights); *McCarthy v. Palmer*, 29 F. Supp. 585, 586 (E.D.N.Y. 1939), *aff'd*, 113 F.2d 721 (2d Cir.), *cert. denied*, 311 U.S. 680 (1940). *But see* *Miller v. Harpster*, 392 P.2d 21 (Alas. 1964). In some cases opinions and conclusions have been distinguished from factual aspects of the report. See, e.g., *Walsh v. Reynolds Metals Co.*, 15 F.R.D. 376, 378 (D.N.J. 1954); *cf.* Comment, *Discovery of the Medical Malpractice Expert*, 6 WILLAMETTE L.J. 315 (1970). Many of these cases expressed concern about one party obtaining the report of an expert which has been paid for by his opponent, but rule 26(b)(4)(C) provides for the party seeking discovery to pay for or to share the expenses. (Under TEX. R. CIV. P. 186b the court may make a similar order.) The unfairness argument has had its effect on rule 26(b)(4)(B), since the fairly heavy burden of showing substantial need and undue hardship is placed on the party seeking the report of a non-testifying expert. See *Advisory Committee Notes to Proposed Amendments to the Federal Rules of Civil Procedure Relating to Discovery*, 48 F.R.D. 487, 504 (1970) [hereinafter cited as *Committee Notes*].

25. As to the problem of knowing in advance which witnesses will be called, an easy solution would be to grant the opposing party an extended period for discovery or a continuance whenever a party decides to call an expert whose report has not been produced previously.

26. *Committee Notes* 503.

27. FED. R. CIV. P. 26(b)(4)(B). Under no circumstances may a party obtain the names or opinions of experts who are only informally consulted. *Committee Notes* 504.

28. TEX. R. CIV. P. 186a. Under rule 186a, an opposing party may utilize discovery to secure the names of experts "having knowledge of relevant facts," unless the courts somehow rule that this information falls within the scope of the work product restric-

larly, under rule 167 a party may not discover communications between a party and his representative prepared in anticipation of litigation. Unlike the federal rules, the Texas rules make no allowance for exceptions to cover special circumstances.

Until recently, Texas courts have treated the reports of all experts as privileged communications between a party and his representatives.²⁹ In *State v. Ashworth*³⁰ the Texas Supreme Court held that the written report of a state-hired appraiser in an eminent domain case was immune from discovery. The court indicated that the appraiser could be called at trial by the party who did not hire him, although that course would obviously involve a great risk since the expert's silence would not necessarily mean that his report was favorable to the non-hiring party.

The restrictive nature of discovery in Texas was conclusively demonstrated in the case of *Ex parte Ladon*.³¹ In *Ladon* the Texas Supreme Court ruled that a list of passengers, which was compiled by a bus driver after an accident, was privileged as material procured for the purpose of investigation and defense. The driver was considered an agent for the bus company, a potential party to litigation.³²

In 1971 the Texas rules were amended to eliminate the *Ladon* situation, by making the identity and location of a potential witness or party discoverable.³³ In 1973 the rules were further amended to permit the discovery of the names and reports of testifying experts.³⁴ The question of how these modifications affected the discoverability of the reports of non-testifying experts was a matter of some speculation.³⁵ Rule 186a speaks specifically to this issue as it relates to discovery examinations, since it absolutely protects the mental impressions and opinions of non-testifying experts. Rule 167, however, does not make specific reference to experts in its work product section, so the privilege accorded to the reports of non-testifying experts has been somewhat unclear.

tions. Note that the rule 186a proviso protects from discovery the mental impressions and opinions of consulting experts, but it does not seem to cover examining an expert or a party as to facts within the expert's knowledge.

29. See, e.g., *Hodges v. State*, 403 S.W.2d 207 (Tex. Civ. App.—Texarkana 1966), *error ref. n.r.e.*, and *Shirley v. Dalby*, 384 S.W.2d 362 (Tex. Civ. App.—Texarkana 1964), *error ref. n.r.e.*, both condemnation cases in which the reports of persons employed by the state to investigate land values in the area were ruled immune from discovery by the condemnees; *Munden v. Chambless*, 315 S.W.2d 355 (Tex. Civ. App.—Dallas 1958), *error ref. n.r.e.*; cf. *Gass v. Baggerly*, 332 S.W.2d 426 (Tex. Civ. App.—Dallas 1960), wherein the court relied on the discovery restrictions as to written communications between a party and his representative to prohibit the introduction of a defendant's written statement at trial.

30. 484 S.W.2d 565 (Tex. 1972).

31. 325 S.W.2d 121 (Tex. 1959).

32. *Accord*, *Ex parte Hanlon*, 406 S.W.2d 204 (Tex. 1966), which involved a three-car accident where one car fled the scene. The plaintiff attempted to secure the name of the missing driver from the claims adjuster for the company that insured the second car. The court held the identity of the driver not discoverable, citing *Ladon* for authority.

33. TEX. R. CIV. P. 167; TEX. R. CIV. P. 186a.

34. *Id.*

35. See Sales, *Discovery Under the Texas Rules of Civil Procedure*, 37 TEX. B.J. 39, 41-42 (1974).

III. HOUDAILLE INDUSTRIES, INC. V. CUNNINGHAM

As relator³⁶ seeking a writ of mandamus,³⁷ Houdaille provided the impetus which led the Texas Supreme Court to clarify the state's position in regard to the discovery of experts' reports. The court concluded that the reports of non-testifying experts were absolutely protected under rule 167, but found that the reports of rebuttal witnesses and photographs unattached to reports were not protected from discovery.

Privilege and Testifying Experts. The court determined that the 1973 amendments to rules 167 and 186a liberalized the rules only to the extent of permitting a limited exception to the work product provisos by permitting discovery of the reports of testifying experts. As Houdaille persuasively argued, the district court's holding that the reports of non-testifying experts were not protected under rule 167 would have the effect of importing the federal rule into Texas "despite the clear decision of the Texas rule makers not to adopt Federal Rules."³⁸ Regrettably, however, the court did not consider the obvious question of why rule 167 does not expressly cover the subject of non-testifying experts, while rule 186a specifically prohibits the "disclosure of the mental impressions and opinions of experts used solely for consultation."³⁹ Had it considered the policy justifications behind the discovery of experts' reports, the court might have concluded that rule 167's proviso was not meant to apply to the reports of non-testifying experts. Rather than doing so, the court reverted to the work product treatment of experts' reports and held that the reports of non-testifying experts were privileged as written communications between a party and his representative.⁴⁰

If adequate preparation for cross-examination were the only justification for discovery of the reports of non-testifying experts, there would be no reason to permit the discovery of the reports of non-testifying experts, and the *Houdaille* court would have been correct in its strict analysis of rule 167. There are, however, several other purposes for discovery to which the court did not refer. First, opinions of experts may be regarded as evidence necessary to establish material facts.⁴¹ One party may hire all of the ex-

36. The term is used to refer to the person upon whose instance certain writs are issued.

37. TEX. REV. CIV. STAT. ANN. art. 1733 (1962). Many Texas cases have admitted the propriety of the writ of mandamus as a means to secure review of discovery orders, since they are interlocutory, and hence, not appealable. See, e.g., *Commercial Travelers Life Ins. Co. v. Spears*, 484 S.W.2d 577 (Tex. 1972); *State v. Ashworth*, 484 S.W.2d 565 (Tex. 1972); *Russell v. Young*, 452 S.W.2d 434 (Tex. 1970); *Maresca v. Marks*, 362 S.W.2d 299 (Tex. 1962); *Crane v. Tunks*, 328 S.W.2d 434 (Tex. 1959). Respondent Southwestern Laboratories urged in its brief that mandamus was improperly sought, since the trial judge had issued a valid order by exercising, but not abusing, his discretion. Respondent's Brief in Opposition to Mandamus at 3-7, *Houdaille Indus., Inc. v. Cunningham*, 502 S.W.2d 544 (Tex. 1973). In support of the position that a writ of mandamus will not lie unless a discretionary order of the trial judge is void, see *State Bd. of Ins. v. Betts*, 308 S.W.2d 846 (Tex. 1958). The court, however, rejected the argument that mandamus was improper with a brief statement that the court's authority was "well settled." 502 S.W.2d at 546. For a general discussion of the mandamus power of the Texas Supreme Court, see Norvell & Sutton, *The Original Writ of Mandamus in the Supreme Court of Texas*, 1 ST. MARY'S L.J. 177 (1969).

38. Realtor's Brief for Mandamus at 24.

39. TEX. R. CIV. P. 186a.

40. 502 S.W.2d at 548.

41. Friedenthal, *supra* note 21, at 473.

perts in a given field,⁴² and thereby effectively prevent his opponent from ever hearing an expert's findings without calling him to the stand.⁴³ Second, the openness which is a goal of modern discovery is contravened by the suppression of such reports. If experts' reports may be regarded as evidence, one party is being permitted to withhold relevant evidence at the other party's expense.⁴⁴ On the other hand, one must be somewhat persuaded by the argument that it is unfair to open up the report of an expert which was secured through a party's own funds and diligence. This is the type of situation where the courts should be permitted to fulfill a balancing function by weighing the purposes and need for the particular discovery against any unfairness which it might present. Unfortunately, the Texas rule, as interpreted by the court in *Houdaille*, does not allow for such flexibility.

Because of the basis for its opinion, the court did not reach the issue of Southwestern's justifications in seeking the reports. The fifteen-month time lag between the notice to Southwestern's agent of the paving's failure and its removal⁴⁵ represents the time in which both parties could have investigated the cause for the failure. Southwestern apparently made no effort to employ its own experts to make such an investigation.⁴⁶ Unless its justification was that there were no other competent experts available, discovery in this situation seemingly would have rewarded Southwestern's dilatoriness in pursuing its own investigation. In fact, it is unlikely that Southwestern would have been able to procure these reports even under the liberal federal rules, for although it may have been able to establish a substantial need for the reports, it probably would have been unable to show that it could not have obtained a substantial equivalent without undue hardship.⁴⁷

Experts as Rebuttal Witnesses. The court further held that the reports of experts who would appear in any witness capacity were discoverable. Again, the court's analysis was based on a strict rule interpretation. The fact that rule 167 referred to witnesses without distinguishing rebuttal witnesses from witnesses in chief was held to mean that no such distinction was implied.⁴⁸ *Houdaille* urged that the primary rationale for discovery of expert witnesses—to prepare for effective cross-examinations—does not extend to rebuttal witnesses because counsel obviously would be familiar with his own defensive theories, the only aspects of the case which the expert

42. This is a situation which would be especially likely to occur when the expertise sought is in an esoteric subject.

43. It is also unlikely that a party could discover the names of non-testifying experts hired by his opponent, for rule 186a requires only that the names of persons having "knowledge of relevant facts" (emphasis added) be revealed in a deposition.

44. See *United States v. Meyer*, 398 F.2d 66 (9th Cir. 1968); *Security Indus., Inc. v. Fickus*, 439 P.2d 172 (Alas. 1968). But see *United States v. Certain Parcels of Land, Etc.*, 15 F.R.D. 224 (S.D. Cal. 1954); *State v. Biggers*, 360 S.W.2d 516 (Tex. 1962).

45. The Southwestern agent was notified on April 15, 1971, written notice was mailed to Southwestern in February 1972, and the paving was totally removed by September 1972. Relator's Brief for Mandamus at 3, 4.

46. *Id.* at 4.

47. Furthermore, it is unlikely that Southwestern could have met the good cause requirement under rule 167 had the court reached this issue.

48. 502 S.W.2d at 548.

could discuss.⁴⁹ The court rejected that contention and again opted for strict interpretation over policy analysis.

Photographs as Privileged Materials. The final aspect of the case dealt with Houdaille's argument that photographs taken by its non-testifying experts were protected from discovery under rule 167 as written communications prepared by a party's representative.⁵⁰ Without citing a single authority, the court concluded that photographs are not written communications and hence are discoverable.⁵¹ Justice Pope based his dissent⁵² exclusively on this point, persuasively urging that photographs⁵³ are both written and communicative. Texas courts have accepted the written character of photographs in cases interpreting Texas Rule of Civil Procedure 281,⁵⁴ under which jurors may take "written evidence" into the jury room. Based on this analysis and the important fact that rule 167 protects not only written communications between the representatives of a party, but also shields from discovery "other communications between a party and his representatives," it seems that the rationale for the court's decision must have been that photographs were deemed to be non-communicative. Texas courts have never ruled directly on the communicative nature of photographs,⁵⁵ but it seems apparent that photographs are just as capable of conveying ideas as are words.⁵⁶ Again, although the court did not address the policy arguments behind its holding, it seems illogical to protect the reports of non-testifying experts while denying the same protection to photographs. The outcome on this point does serve the openness policy which discovery seeks to further, yet it seems inconsistent with the approach taken in regard to experts' reports. Finally, it is apparent that the potential effect of the court's ruling in this area can be diminished to a point of insignificance if expert photographers attach a report, no matter how brief or simplistic, to their photographs. According to the court's ruling,⁵⁷ the photographs would then become part of the report, and, if the expert were not testifying, they would be protected under the rule 167 proviso.

49. Relator's Brief for Mandamus at 29.

50. Southwestern argued unsuccessfully that the experts employed by Houdaille were not its "representatives." Respondent's Brief in Opposition to Mandamus at 13-14. Under the federal rules, discovery of photographs has been generally allowed. In state courts discovery of photographs has often been denied, sometimes on the grounds of privilege. See *Suezaki v. Superior Ct.*, 58 Cal. 2d 166, 373 P.2d 432, 23 Cal. Rptr. 368 (1962); *Stebelski v. Philadelphia Transp. Co.*, 6 Pa. D. & C.2d 627 (Phil. Co. No. 5 1956); *Annot.*, 95 A.L.R.2d 1061 (1964).

51. 502 S.W.2d at 549.

52. *Id.*

53. The word photograph is, as Justice Pope pointed out, of Greek origin and means light writing. 502 S.W.2d at 550.

54. See, e.g., *Texas Employers' Ins. Ass'n v. Crow*, 148 Tex. 113, 115, 221 S.W.2d 235, 236 (1949); *Dallas Ry. & Terminal Co. v. Durkee*, 193 S.W.2d 222 (Tex. Civ. App.—Dallas 1946), *error ref. n.r.e.* See also 2 C. McCORMICK & R. RAY, *TEXAS LAW OF EVIDENCE* § 1466 (2d ed. 1956).

55. In *Cutler v. Gulf States Util. Co.*, 361 S.W.2d 221, 224 (Tex. Civ. App.—Beaumont 1962), *error ref. n.r.e.*, the court made passing reference to the privileged nature of such photographs, but based its decision not to require their production on the fact that the appellee first sought the materials six years after the origination of the claim.

56. See *Cooper v. Mann*, 273 Ala. 620, 143 So. 2d 637, 639 (1962), wherein communication was defined to include "not only words uttered, but information conveyed by any other means."

57. 502 S.W.2d at 550.

IV. CONCLUSION

From its beginning as a tool of legal efficiency, discovery has reflected the tensions between the various interests which the legal process has sought to protect. A comparison of the federal rules with the discovery rules of Texas reflects the different types of responses which rules makers have made in an attempt to resolve these tensions. As *Houdaille* conclusively established, the Texas rules are based on relatively narrow policy goals which do not reflect the scope and flexibility of the federal rules. Although the Texas position is an arguably defensible one in terms of the risk of unfairness, it has been carried to an illogical extreme by according an absolute privilege to work product materials, including the reports of non-testifying experts. The hard and fast rules have tied the hands of judges in making case-by-case determinations of what is fair. Consequently, the courts have been forced to engage in their own processes of fine line drawing and strict word analysis, as epitomized in the *Houdaille* treatment of photographs. Unfortunately, however, unless the courts choose the path of policy analysis rather than that of strict interpretation, the rules as they now stand will continue to be read narrowly. The Texas Supreme Court apparently does not read rules 167 and 186a as vesting it with the ability to balance competing interests in this area of law. In an apparent reaction to the many ambiguities of *Hickman* and the vagaries of the federal rules, the Texas rules makers drew lines which were too sharp in a procedural area where the issues are too complex to be fitted logically into the narrow categories which the Texas rules suggest.

Barbara M.G. Lynn

Nathan Cummings: Tax Treatment of Repayments of Insider Profits

Nathan Cummings, a director and shareholder of Metro-Goldwyn-Mayer, sold 3,400 shares of MGM stock and reported the gain from the sale as a long-term capital gain on his 1961 federal income tax return. Within a period of six months Cummings repurchased a total of 3,400 shares of MGM stock in a series of transactions. In 1962 the SEC notified MGM that under section 16(b) of the Securities Exchange Act of 1934,¹ Cummings' profit

1. 15 U.S.C. § 78p(b) (1971) provides in part:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

from the sale and repurchase was recoverable by the corporation as "insider profit."² Cummings paid MGM the section 16(b) profit and deducted the payment as an ordinary loss on his 1962 federal income tax return.³ The Commissioner of Internal Revenue determined that the payment was a long-term capital loss, and Cummings contested this determination in the Tax Court. *Held*: Cummings' payment to MGM of alleged insider profit is an ordinary and necessary business expense under section 162(a) of the Internal Revenue Code of 1954. *Nathan Cummings*, 61 T.C. 1 (1973).⁴

I. HISTORY OF DEDUCTIONS FOR SECTION 16(b) PAYMENTS

Under section 16(b) of the 1934 Securities Exchange Act, a director, officer, or ten percent shareholder is an "insider,"⁵ and if he sells any of his stock in the corporation and repurchases the same corporation's stock within six months, the difference is recoverable by the corporation as insider profit.⁶ The stated purpose of the section is to prevent "the unfair use of information which may have been obtained by such beneficial owner."⁷ Usually the section 16(b) "short-swing profit" is recoverable upon a showing that the insider has engaged in the prohibited transactions, regardless of whether he actually used special information.⁸ When a corporation is notified by the SEC of an alleged violation, the corporation must then sue the in-

2. The profit derived from a sale or purchase in violation of § 16(b) is computed by matching the lowest purchases against the highest sales within six months. *See, e.g., Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). Actual gain on the original sale is irrelevant to calculation of § 16(b) profit, which may be recovered even if the transactions produce an overall loss. Section 16(b) liability also results when a sale is followed by a purchase within a six-month period. *See generally* 2 L. LOSS, SECURITIES REGULATION 1062-63 (2d ed. 1961), 3024-25 (Supp. 1969) [hereinafter cited as Loss].

3. Cummings argued in the Tax Court that the deduction was proper either as a business expense under INT. REV. CODE OF 1954, § 162(a), or as a business loss under *id.* § 165(a).

4. The Tax Court was affirming its previous holding in *Nathan Cummings*, 60 T.C. 91 (1973); an appeal has been docketed in the Second Circuit, *appeal docketed*, No. 74-1406 (2d Cir., Jan. 8, 1974).

5. Under § 16(b), a director, officer, or 10% beneficial owner must file with the Commission an initial statement "of the amount of all equity securities of such issuer of which he is the beneficial owner." 15 U.S.C. § 78p(a) (1971). Additionally, he must file a report with the Commission within ten days of the end of any month in which there has been a change in his ownership.

6. *See* note 2 *supra*.

7. 15 U.S.C. § 78p(b) (1971). According to the Senate Committee which reported the § 16(b) legislation, the purpose was to prevent directors, officers, and principal stockholders of a corporation from trading securities on the basis of information not available to the general public. S. REP. NO. 792, 73d Cong., 2d Sess. 9 (1934). *See also* REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, 77TH CONG., 1ST SESS. 13 (Comm. Print 1934), *cited in* Darrell, *The Tax Treatment of Payments Under Section 16(b) of the Securities Exchange Act of 1934*, 64 HARV. L. REV. 80, 91 (1950); STOCK EXCHANGE PRACTICES, REPORT OF COMM. ON BANKING AND CURRENCY, S. REP. NO. 1455, 73d Cong., 2d Sess. 55 (1934).

8. The traditional rule was stated in *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). "[T]he only remedy which its framers deemed effective for this reform was the imposition of a liability based upon an objective measure of proof." *Id.* at 235. In a few recent cases a more subjective approach to § 16(b) liability has been adopted. *See, e.g., Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973). *See also* Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45 (1968).

sider to recover his section 16(b) profit⁹ or list the profit as a debt owed to the corporation by the insider.¹⁰

The Tax Court initially disallowed any deduction for insider repayments altogether. In *William F. Davis, Jr.*¹¹ the Tax Court characterized section 16(b) as a "penalty provision," and held that to allow a deduction would frustrate public policy by mitigating the deterrent effect of the section.¹² Five years later, in *Laurence M. Marks*,¹³ the Tax Court changed its position and allowed the deduction of the payment as an ordinary and necessary business expense, finding that Marks' motivation in making the payment was to protect his business reputation and to avoid publicity that would adversely affect his business. Following the *Marks* decision, the IRS revoked a 1951 ruling and issued Revenue Ruling 61-115, stating that a repayment under section 16(b) is not a penalty; rather, the purpose of the section is "to place the insider in the same position he would have occupied if he had never engaged in the stock dealings."¹⁴ The federal courts have since interpreted section 16(b) as remedial, rather than penal in nature.¹⁵

II. THE CONTROVERSY BETWEEN THE TAX COURT AND THE UNITED STATES COURTS OF APPEALS

Deductibility of the section 16(b) payment having been determined, the issue has become whether the deduction should be against ordinary¹⁶ or capital gain. In the 1961 case of *William L. Mitchell*¹⁷ the Tax Court allowed an ordinary business expense deduction under section 162(a), finding the purpose of the section 16(b) payment to be the protection of the taxpayer's business reputation, and avoidance of the embarrassment and expense of liti-

9. If the corporation does not institute suit within 60 days, or fails to prosecute diligently, a stockholder may institute suit on behalf of the corporation. 15 U.S.C. § 78p(b) (1971).

10. A corporation must list in its proxy statement any debt owed to the corporation by an officer or director. Section 16(b) liability has been included within this rule. SEC Reg. 14 A, Item 7(e), Instr. 4, 17 C.F.R. § 240.14a-101 (1973).

11. 17 T.C. 549 (1951).

12. *Id.* at 556. The Internal Revenue Service issued a ruling adopting the reasoning of *Davis*. I.T. 4069, 1952-1 CUM. BULL. 28.

13. 27 T.C. 464 (1956). Because liability under § 16(b) was questionable, the court saw the issue as "whether allowance of the deduction would frustrate 'sharply defined public policy,'" and determined that under the circumstances of the case, it would not. *Id.* at 468-69.

14. 1961-1 CUM. BULL. 46, 48. The language of Revenue Ruling 61-115 may have been an unfortunate choice of words. Section 16(b) was not a tax provision, and did not specify the tax effect of a repayment. The legislative history of § 16(b) and the stated purpose of the statute indicate that its purpose is to prevent the unfair use of information by insiders. There is no indication that § 16(b) was intended to have any effect on the insider other than requiring him to reimburse the corporation and deterring him from insider trading.

15. See, e.g., *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 740 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Booth v. Varian Associates*, 334 F.2d 1, 3 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Adler v. Klawans*, 267 F.2d 840, 846-47 (2d Cir. 1959); *Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569, 571 (E.D. Pa. 1962).

16. A deduction against ordinary income has been allowed under INT. REV. CODE OF 1954, § 162(a), which permits a deduction for ordinary and necessary business expense. Alternatively, § 165(a), which allows a deduction for business losses, has been used as authority for allowing § 16(b) payments to be set off against ordinary income.

17. 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971).

gation.¹⁸ The Commissioner argued that under the doctrine of *Arrowsmith v. Commissioner*¹⁹ the payment was so closely related to the earlier sale-purchase transactions as to require characterization of the payment as a long-term capital loss, since the profit from the sale was reported as a long-term capital gain.²⁰ The Tax Court in *Mitchell* rejected the Commissioner's argument. Observing that only the sale, not the later purchase, had income tax significance, the court found no relationship between the capital gain reported on the sale and the later section 16(b) payment. The Tax Court held that the section 16(b) payment had significance only under securities law,²¹ and thus it would be more appropriate to classify it as an ordinary business expense.²²

The Sixth Circuit reversed the Tax Court,²³ finding *Arrowsmith* controlling, particularly because of the interpretation given *Arrowsmith* by the United States Supreme Court in *United States v. Skelly Oil Co.*²⁴ In *Skelly Oil* the taxable income of the company was reduced by an oil depletion allowance.²⁵ When the taxpayer was required to refund part of the proceeds from the sale of oil in a subsequent tax year, it deducted the refund as an ordinary loss and the Commissioner disallowed the deduction. The Supreme Court held that the taxpayer should not be allowed the equivalent of a double deduction, and found the rationale for *Arrowsmith* "easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income."²⁶ The Sixth Circuit held

18. 52 T.C. at 176.

19. 344 U.S. 6 (1952). The Tax Court explained the *Arrowsmith* requirement as "the existence of an integral relationship between two taxable transactions in separate years, so that the characterization of the latter transaction by the earlier one is necessary in order to reflect the true taxable income of the taxpayer." 52 T.C. at 175. In *Arrowsmith* the taxpayers received distributions as transferees upon liquidation of a corporation, and classified the receipts as capital gains. In a subsequent tax year they were required to refund part of the proceeds when a judgment was rendered against the corporation. Each of the taxpayers took an ordinary business loss for the full amount of his payments. The Supreme Court found that the losses "fall squarely within the definition of capital losses," and that liability as transferees "was not based on any ordinary business transaction of theirs apart from the liquidation proceedings." 344 U.S. at 8. The Court found that the tax principle of the annual accounting year was not breached by looking to the transactions of prior years to classify the nature of the loss for tax purposes.

20. 52 T.C. at 173.

21. *Id.* at 176.

22. The concurring judges suggested that the payment might be considered as additional basis of the purchased stock for tax purposes. *Id.*

23. 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971).

24. 394 U.S. 678 (1969). This decision was released nine days prior to the Tax Court's opinion.

25. The deduction was taken under INT. REV. CODE OF 1954, § 613.

26. 394 U.S. at 685. *Skelly Oil* may have misinterpreted *Arrowsmith*. *Arrowsmith* did not refer to a different rate of taxation, but to the close relationship between two transactions. Although *Skelly Oil* broadly characterizes *Arrowsmith* as requiring all income taxed at "special" reduced rates when received to have a corresponding reduction in the deduction if part is refunded, it is clear from the majority opinion that the Court did not intend the application of *Skelly Oil* to be far-reaching, since it indicated that the approach taken would affect "only a few cases." *Id.* at 686. Three dissenting judges warned that the broad statements in the majority opinion contravened the purpose of the annual accounting principle. *Id.* at 697. It is far from clear whether *Skelly Oil* requires in all situations where income is taxed at capital gains rates when received that repayments have capital loss treatment. For a discussion of situations to which *Skelly*

that *Arrowsmith* and *Skelly Oil* require that income taxed at reduced rates when reported should not be given the preferential treatment of an ordinary deduction in the full amount, and thus the payment must be deducted as a capital loss.²⁷

The Tax Court, however, refused to alter its position, maintaining in *James E. Anderson*²⁸ that the requisite "integral relation" was missing. Additionally, the court noted, the taxpayers in *Arrowsmith* and *Skelly Oil*, when required to make payments, occupied the same status as they held when reporting the income. Conversely, the insider in *Anderson* reported his taxes as a shareholder and incurred section 16(b) liability as an employee.²⁹ The Tax Court found that the payment was made to preserve the taxpayer's employment and to avoid injury to his business reputation, and should be characterized as an ordinary business expense.³⁰

The Seventh Circuit reversed the Tax Court in *Anderson*, characterizing the payment as a return of a portion of the sales proceeds.³¹ The court considered the purposes of section 16(b) relevant to the determination of the character of the deduction and refused to interpret the Internal Revenue Code "so as to allow this anomalous result which severely and directly frustrates the purpose of Section 16(b)."³² It found the Tax Court's argument that the payments were made in different capacities unpersuasive, and the taxpayer's motive in making the payments irrelevant.³³ The court said that where, as in *Anderson*, the repayment occurred in the year of the sale-purchase transaction, a capital loss deduction was most appropriate, and, therefore, the alternative suggested by some commentators of adding the repayment to the basis of the shares purchased would not be considered.³⁴ Thus, the Tax Court now maintains that the payment when meeting the requirements of section 162(a) may be an ordinary and necessary business expense, while the Sixth and Seventh Circuits have allowed only capital loss treatment.³⁵

Oil might be applicable, see Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85 (1972).

27. 428 F.2d at 263.

28. 56 T.C. 1370 (1971), *rev'd*, 480 F.2d 1304 (7th Cir. 1973).

29. 56 T.C. at 1374-75.

30. *Id.* at 1372.

31. 480 F.2d 1304, 1307.

32. *Id.* at 1308.

33. *Id.*

34. *Id.* at 1308 n.9. The *Anderson* decision was based on the position that *Arrowsmith* required characterization of the payment in the same manner as the proceeds of the sale. In *Arrowsmith*, however, the repayment was made in the year following the liquidating distribution; there would have been no need for the *Arrowsmith* decision if the refunds had been made in the same year as the distribution. Rather, refunds made in the same year would simply have reduced the amount of capital gain reported in that year.

Addition of the § 16(b) payment to the basis of the purchased shares as a solution has been discussed by several commentators. See generally Darrell, *supra* note 7, at 92; Lokken, *Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934*, 4 GA. L. REV. 298, 309-11 (1970); Rabinovitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85, 109 (1972).

35. Charles I. Brown, 32 CCH Tax Ct. Mem. 1300 (1973), involving the same issue, is now on appeal to the Tenth Circuit. The Fifth Circuit has not ruled on the characterization of § 16(b) payments for purposes of federal income tax deduction. The problem was mentioned in a 1974 Fifth Circuit case involving the deduction of payments made by sellers of oil wells in settlement of fraud claims by the buyers. *Kimbell v.*

III. NATHAN CUMMINGS

*Nathan Cummings*³⁶ involved a sale-purchase transaction with a possible violation of section 16(b), and a resultant repayment of section 16(b) profits to the corporation in a year subsequent to the year in which the gain from the sale was reported. The first *Cummings* decision³⁷ was rendered before the Seventh Circuit's reversal of *Anderson*. In the first decision the Tax Court held that *Arrowsmith* was not applicable "because the section 16(b) payment was not directly and integrally related to the earlier sales transaction which gave rise to the capital gain."³⁸ The court observed the absence of relationship between the amount of capital gain on the sale and the amount of the section 16(b) payment.³⁹ It found that the taxpayer's payment was made in the status of a director, while the capital gain tax was paid in the status of a shareholder.⁴⁰ The overriding business purposes in making the payment satisfying section 162(a) were found to be for the protection of his business reputation and avoidance of delay in the issuance of the MGM proxy statement.⁴¹

After *Anderson* was reversed, *Cummings* was reconsidered by the Tax Court on motion for rehearing, and the original decision was affirmed.⁴² The *Arrowsmith* "integral relationship" was found to be lacking, because the payment and the earlier sale in *Cummings* were not parts of a unified whole.⁴³ The court reasoned that the payments made in *Arrowsmith* and *Skelly Oil*, if made in the year of the first transaction, would have been offset against the amount of capital gain, and any excess would have reduced the percentage depletion allowance. In *Cummings*, had the payment been made in the same year as the sale and purchase, "there would have been no reason to require that the payment be offset against the gain realized on the sale."⁴⁴ The Tax Court found it significant that Cummings had not been adjudged guilty of the section 16(b) violation.⁴⁵ One dissenting judge in *Cummings*

United States, 490 F.2d 203 (5th Cir. 1974), *petition for cert. filed*, 42 U.S.L.W. 3699 (U.S. May 20, 1974) (No. 73-1733). The taxpayer cited as authority the Tax Court's decisions in *Charles I. Brown*, *James E. Anderson*, *William L. Mitchell*, *Laurence E. Marks*, and *Nathan Cummings*. The Fifth Circuit reasoned that even under a narrow reading of the *Arrowsmith* principle, such as the Tax Court's interpretation in *Anderson*, *Arrowsmith* applies to the settlement of fraud claims, where the payments were made in the capacity of seller. The court declined to comment on the dispute between the Tax Court and the courts of appeals.

36. 61 T.C. 1 (1973), *aff'g* 60 T.C. 91, *appeal docketed*, No. 74-1406 (2d Cir., Jan. 8, 1974).

37. 60 T.C. 91 (1973).

38. *Id.* at 94.

39. *Id.*

40. *Id.*

41. *Id.* at 95.

42. 61 T.C. 1 (1973); *see note 4 supra*.

43. 61 T.C. at 2.

44. *Id.* at 2-3; *cf.* discussion of *Anderson* in note 34 *supra*.

45. 61 T.C. at 3. He repaid the § 16(b) profit the day after receiving his notification of a possible violation, without legal advice, in order that the proxy statement could go out. Without a definite violation of § 16(b), the court implied, there is no frustration of public policy. *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958), was held not to be applicable because it involved an admitted violation of state law. In *Tank Truck Rentals* the taxpayer motor carrier had paid large fines to the State of Pennsylvania for intentional violations of state maximum weight laws. The deduction of money paid as fines was disallowed altogether because "allowance of the deduction

found *Skelly Oil* controlling, but offered no reasons for his position, and suggested that the appropriate solution would be an addition of the payment to the basis of the shares purchased.⁴⁶ Thus, the payment would be treated as an additional cost of acquiring the purchased shares, and the taxpayer would not recoup any of his capital gains tax until he sold the purchased stock.

The Tax Court's analysis of *Arrowsmith* as it applies to the sale-purchase transaction appears correct because the section 16(b) liability does not arise from the sale transaction standing alone, and the purchase has no income tax significance.⁴⁷ Section 16(b) liability is independent of the capital gain, if any, resulting from the sale. For the *Arrowsmith* principle to apply, the section 16(b) payment must have a direct connection with the sale, so that the payment is a continuation of the sale transaction.⁴⁸ The section 16(b) payment arises because of the sale combined with the subsequent purchase, but the payment is not a refund of the profit of the sale, so as to qualify it under the *Arrowsmith* principle.⁴⁹ Although the Sixth and Seventh Circuits found the *Skelly Oil* interpretation of *Arrowsmith* controlling, the Tax Court mentioned *Skelly Oil* only to distinguish it by the integral relationship reasoning.⁵⁰ The Tax Court seems to imply that *Skelly Oil* does not expand the *Arrowsmith* principle for purposes of determining whether a section 16(b)

would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof." *Id.* at 33-34. Other cases have limited the scope of *Tank Truck Rentals*. See, e.g., *Commissioner v. Sullivan*, 356 U.S. 27 (1958), where a bookmaker was allowed a deduction for amounts paid as wages and rent in carrying on illegal gambling operations, and *Commissioner v. Teller*, 383 U.S. 687 (1966), where the taxpayer was allowed to deduct legal expenses incurred in the unsuccessful defense of charges for violation of the mail fraud statute and the Securities Act of 1933. Generally, the "frustration of public policy" rationale invoked in *Skelly Oil* and *Tank Truck Rentals* has been applied only where the payments were in satisfaction of a fine. Nelson, *Tax Deductibility of Insider Profit Repayment: Resolving An Apparent Conflict*, 24 CASE W. RES. L. REV. 330, 347 (1973). The Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, codified certain deductions which would not be permitted, including bribes, fines and penalties, and antitrust damages payments.

46. 61 T.C. at 5. Five other dissenting judges referred to the reasons given in their dissent in *James E. Anderson*, 56 T.C. 1370, 1377-79 (1971).

47. The purchase-sale transaction should receive different tax treatment. In such cases, the repayment immediately follows the sale, and the § 16(b) profit will usually equal the capital gain on the sale where the shares sold were the shares purchased. The *Arrowsmith* integral relationship is present, so the *Arrowsmith* principle should be applied to require a capital loss deduction. It has been argued that if the repayment in a purchase-sale transaction is made in a subsequent tax year, reductions or increases in the deduction should be made, to correspond with changes in the taxpayer's income tax bracket or other factors, so as to achieve a perfectly neutral tax result. Nelson, *supra* note 45, at 349-51. However, since in other situations where a change in tax brackets is permitted to produce a "windfall" for either the government or the taxpayer (see *United States v. Skelly Oil Co.*, 394 U.S. 678, 681 (1968)), the insider payment should be no different.

48. See *Arrowsmith v. Commissioner*, 344 U.S. 6, 8 (1952).

49. A crucial disagreement between the Tax Court and the Sixth and Seventh Circuits was whether the § 16(b) payment can be tied to the sale in a sale-purchase transaction. Compare *Anderson v. Commissioner*, 480 F.2d 1304, 1307 (7th Cir. 1973), with *James E. Anderson*, 56 T.C. 1370, 1376 (1971).

50. 61 T.C. at 2-3. Nor did the Tax Court deal at length with *Skelly Oil* in *Anderson*. There, *Skelly Oil* was distinguished because the repayments in *Skelly Oil* were made in the same status as the income was reported, and because of the integral relationship between the repayment and the income reported in *Skelly*.

payment must receive capital loss treatment.⁵¹ Thus, the Tax Court has read *Arrowsmith* narrowly in allowing an ordinary business expense deduction for a payment in satisfaction of an alleged insider violation, because the business purpose requirement of section 162(a) was met.⁵² In contrast, the emphasis in the Sixth and Seventh Circuits has been on achieving an overall equitable result, rather than applying the case law literally.⁵³

Section 16(b) and its legislative history express a policy which should not be overlooked when considering the tax consequences of deductions for insider payments. The language of section 16(b),⁵⁴ its legislative history,⁵⁵ and its judicial interpretation⁵⁶ indicate that the purposes of the section are deterrent and remedial. Even if an insider's section 16(b) liability is questionable, allowing a tax advantage to a short-swing trader who can show a business purpose in repaying, without an inquiry into actual liability, undercuts the deterrent policy of section 16(b) and discriminates against one electing to contest his liability.⁵⁷ Since the Tax Court cannot determine section 16(b) liability, an attempt to distinguish between those insiders likely to prevail if contested and those unlikely to prevail would be incomplete and improper at the Tax Court level.⁵⁸

Ideally, the alleged insider would be neither penalized nor benefited tax-wise as a consequence of having taken a short-swing profit. Either a capital loss deduction or an addition of the payment to the basis of the purchased shares more closely achieves a neutral tax effect than does an ordinary loss deduction. The deduction has been treated as a capital loss in the Sixth and Seventh Circuits because *Arrowsmith* was held to require treatment of the repayment in a manner consistent with the way in which income from the sale had been reported. Because *Arrowsmith*, properly construed, is not controlling,⁵⁹ addition to basis is preferable in a sale-purchase situation where the repayment occurs in a subsequent tax year. Because a capital loss deduction in a subsequent tax year may have a penalizing effect on the taxpayer if he has no corresponding capital gain in the year of repayment, addition of the section 16(b) payment to the basis of the purchased shares provides a more neutral tax effect than capital loss treatment.⁶⁰ Likewise,

51. The Seventh Circuit in *Anderson* correctly observed that if the payments are considered a return of the sale proceeds, *Arrowsmith* is applicable with or without the benefit of its interpretation in *Skelly Oil*. 480 F.2d at 1307.

52. INT. REV. CODE OF 1954, § 162(a) provides that a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business . . ."

53. "Since there is hardly anything inevitable about whether the § 16(b) payments inherit the capital character of the sale transaction, we think the purpose and operation of Section 16(b) relevant to the determination." *Anderson v. Commissioner*, 480 F.2d 1304, 1307 (7th Cir. 1973).

54. See note 1 *supra*.

55. See note 7 *supra*.

56. See text accompanying note 15 *supra*.

57. The business purpose required by § 162(a) usually will not be difficult to show in the situation of § 16(b) payments; a desire to avoid damage to one's reputation in the financial community would apply to most insider repayments.

58. The Seventh Circuit in *Anderson* suggested that the taxpayer should have proposed a defense theory to raise doubt as to his § 16(b) liability. 480 F.2d at 1308.

59. See text accompanying notes 47-49 *supra*.

60. Addition to basis seems preferable to capital loss treatment even when the payment is made in the same year as the gain from the sale is reported, because the payment

Skelly Oil is not controlling, since if the section 16(b) payments are not identified as a return of the sale proceeds, it is inaccurate to treat the repayments as taxed at special reduced rates when received.⁶¹ The Tax Court in *Cummings* correctly found *Skelly Oil* inapplicable, but should have provided more support for its position than the relatively weak argument which was presented, that the section 16(b) payments were made by Cummings in his capacity as an employee in contrast to the sale which was consummated by him in his capacity as a shareholder.

By describing a return of the insider to the position he occupied before engaging in the offending transactions,⁶² Revenue Ruling 61-115 confuses the federal income tax consequences of section 16(b) with its purposes under securities law. If the revenue ruling can be interpreted as advocating a return of the insider to the position he would have been in if the sale and the purchase had been made at the same price, and no section 16(b) liability had been incurred, then an addition to the basis of the purchased shares in the amount of the section 16(b) payment approximates this position. Since the transaction that triggers liability is the subsequent purchase, this interpretation may be accurate. The recoupment of tax will be deferred until the purchased shares are sold, but that result does not seem inconsistent with the purposes of section 16(b). Treating the payment as an added cost of acquiring the purchased shares would more clearly reflect acquisition cost of the purchased shares, would achieve the purposes of section 16(b), and is consistent with Revenue Ruling 61-115.

IV. CONCLUSION

Although section 16(b) is not a penalty provision, the deterrent policy underlying the section should not be undercut by allowing a taxpayer to profit taxwise as a result of a short-swing trade. *Arrowsmith* and *Skelly Oil*, properly construed, are not applicable to the deduction of insider repayments if liability results from a sale followed by a purchase. Ideally, the net tax effect of a deduction for an insider repayment would be neither a gain nor a loss for the taxpayer, and an addition of the section 16(b) payment to the basis of the purchased shares most nearly accomplishes a neutral after-tax result. The circuit courts should adopt the addition to basis solution or follow the Tax Court's lead in letting Congress rectify inconsistencies in the interaction of the tax law and securities law.⁶³

Margaret E. Barrett

is not a refund of the actual profit on the sale, and usually will not equal the capital gains tax paid. See note 2 *supra*.

61. See text accompanying note 26 *supra*.

62. See note 14 *supra*, and accompanying text.

63. The dissenting judge in *Cummings* who recommended addition of the payment to basis observed, "[T]he proposal I am making is not before the Court in this case, and may never be urged by either a taxpayer or the Commissioner, because a tax benefit in the hand is worth two possible ones in the future . . ." 61 T.C. at 5. For the proposition that general equitable considerations have no place in the administration of tax laws, see *United States v. Skelly Oil Co.*, 394 U.S. 678, 692-93 (1969) (dissenting opinion); *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955); *International Trading Co. v. Commissioner*, 484 F.2d 707 (7th Cir. 1973); *Anderson v. Commissioner*, 480 F.2d 1304, 1309 (7th Cir. 1973) (dissenting opinion); *Busse v. Commissioner*, 479 F.2d 1147 (7th Cir. 1973); *United States v. Shirah*, 253 F.2d 798 (4th Cir. 1958).

When Are Patent Applications Property of a Depreciable Character Under Section 1239?—*Chu v. Commissioner*

Taxpayer Lan Jen Chu, an authority on electromagnetic theory and antenna systems, filed a patent application with the United States Government on June 26, 1956, seeking to patent a new antenna system. After receiving notice on three occasions that the primary claims had been disallowed,¹ Dr. Chu assigned his interest in the invention to his controlled corporation, Chu Associates.² Subsequently, the application was approved. Pursuant to the assignment, Dr. Chu received considerable sums of money which he reported as long-term capital gain. The Commissioner assessed a deficiency under section 1239 of the Internal Revenue Code³ on the grounds that the sums received were ordinary income. The Tax Court ruled in favor of the taxpayer, declaring that section 1239 was inapplicable.⁴ An appeal was taken by the Commissioner. *Held, affirmed*: A patent application is ordinarily neither a depreciable asset, nor property of a character subject to depreciation; the Chu application had not so fully matured⁵ by the time of transfer as to be considered depreciable for the purpose of section 1239. *Chu v. Commissioner*, 486 F.2d 696 (1st Cir. 1973).

I. TAXATION OF PATENT TRANSFERS BETWEEN AN INDIVIDUAL AND HIS CONTROLLED CORPORATION

Capital Gains Treatment of Patent Transfers and the Treatment of Gain as Ordinary Income Under Section 1239. The Internal Revenue Code pro-

1. The application contained 18 separate claims. The primary claims, 1-13, embodied the basic antenna structure. Claims 14-18 involved an alternate system which was never produced.

2. INT. REV. CODE of 1954, § 1239 defines a controlled corporation as one in which the taxpayer, his spouse, and his minor children and minor grandchildren own more than 80% in value of the outstanding stock. The control question was not at issue in *Chu*, as both the Tax Court and the First Circuit held that the depreciation question disposed of the case and that questions regarding control need not be decided. It is possible, however, for taxpayers to avoid § 1239 by owning less than 80% in value of the outstanding stock. See *United States v. Parker*, 376 F.2d 402 (5th Cir. 1967); *Trotz v. Commissioner*, 361 F.2d 927 (10th Cir. 1966); *Mitchell v. Commissioner*, 300 F.2d 533 (4th Cir. 1962). See also Note, *Meaning of More Than 80% in Value of the Outstanding Stock Under § 1239*, 66 MICH. L. REV. 533, 536-40 (1968).

3. INT. REV. CODE of 1954, § 1239 provides in part:

(a) In the case of a sale or exchange, directly or indirectly, of property described in subsection (b)—

. . .

(2) between an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren;

any such gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) This section shall apply only in the case of a sale or exchange by a transferor of property which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 167.

4. *Lan Jen Chu*, 58 T.C. 598 (1972).

5. See *Estate of Stahl v. Commissioner*, 442 F.2d 324 (7th Cir. 1971), discussed at text accompanying notes 18-25 *infra*.

vides in section 1235 that "[a] transfer . . . of all substantial rights to a patent . . . shall be considered the sale or exchange of a capital asset held for more than 6 months"⁶ This applies regardless of whether payments for the patent rights are to be periodic, or contingent on productivity.⁷ Thus, the proceeds from a transfer of patent rights are entitled to the preferential capital gains treatment provided by section 1201.⁸ By affording such treatment to patent transfers, the Government provides a greater incentive to inventors.⁹

Section 1239, however, places certain constraints on the availability of this favorable capital gains treatment.¹⁰ Gains realized on the transfer of property of a character subject to depreciation between an individual and his controlled corporation will be taxed as ordinary income.¹¹ Section 1239 was intended to discourage the practice of selling depreciable assets to controlled corporations in order to obtain certain tax advantages.¹² Previously, income from such transfers was taxed at capital gains rates, while the taxpayer's controlled corporation was provided with an asset the depreciation of which could be offset against ordinary income.¹³

The Depreciability of Patent Applications and the Maturity Question. The key to the applicability of section 1239 lies in the definition of "depreciable property." While a patent is a form of property which is subject to the allowance for depreciation,¹⁴ a patent application is not ordinarily considered depreciable property.¹⁵ The uncertain duration of a patent application

6. INT. REV. CODE OF 1954, § 1235; see *Storm v. United States*, 243 F.2d 708 (5th Cir. 1957); *Lawrence v. United States*, 242 F.2d 542 (5th Cir. 1957). See generally J. MCFADDEN & C. TUSKA, ACCOUNTING AND TAX ASPECTS OF PATENTS AND RESEARCH 109-17, 180-214 (1960); Meyer & Hickey, *Taxation of Contingent Payments on the Sale of a Patent*, 14 IDEA 497 (1970-71).

7. INT. REV. CODE OF 1954, §§ 1235(a)(1), (2).

8. *Id.* § 1201. This section provides for an alternate tax which affords preferential treatment to income realized on the sale of capital assets held for more than six months as defined in § 1221. See generally R. HOLZMAN, FEDERAL TAXATION OF CAPITAL ASSETS (1969); L. SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES (1951).

9. Lower capital gains rates make patent transfers more profitable, thus providing added incentive for inventors in their quest for discovery of patentable inventions, and at the same time encouraging greater transferability of patent rights. See S. REP. NO. 1622, 83d Cong., 2d Sess. 113-14 (1954). See also *Fawick v. Commissioner*, 436 F.2d 655 (6th Cir. 1971).

10. Because of its limited scope, § 1239 has been regarded as an ineffective tool in the hands of the Commissioner. See Ellis, *Tax Problems in Sales to Controlled Corporations*, 21 VAND. L. REV. 196, 200-01 (1965). See also notes 41, 42 *infra* and accompanying text.

11. INT. REV. CODE OF 1954, § 1239.

12. H.R. REP. NO. 586, 82d Cong., 1st Sess. 26 (1951); S. REP. NO. 781, 82d Cong., 1st Sess. 69 (1951); CONF. REP. ON H.R. 4473, 82d Cong., 1st Sess. (1951).

13. *Chu v. Commissioner*, 486 F.2d 696, 704 (1st Cir. 1973) (Campbell, J., concurring). This would be especially advantageous in an inflationary economy because the royalties based on a percentage of gross sales would increase with inflation, but would receive preferential tax treatment normally afforded capital gains. In addition to this, during an inflationary period the value of the invention is virtually sure to increase during the time between application for and issuance of a patent, thus establishing a higher basis for the allowance for depreciation. See generally W. PETERSON, INCOME, EMPLOYMENT, AND ECONOMIC GROWTH 363-98 (1967).

14. See, e.g., *American Chem. Paint Co. v. Commissioner*, 66 F.2d 381 (3d Cir. 1933); *Kershaw v. United States*, 180 F. Supp. 415 (Ct. Cl. 1960).

15. *Hershey Mfg. Co.*, 14 B.T.A. 867, 876-77, *aff'd*, 43 F.2d 298 (10th Cir. 1930), wherein the Board of Tax Appeals stated:

It is elementary that an asset which has no definite period of useful life is

makes it difficult to determine the amount of depreciation in any given year.¹⁶ A patent application is generally considered an inchoate right which matures into a depreciable asset when letters of patent are issued.¹⁷

However, in *Estate of Stahl v. Commissioner*¹⁸ the Seventh Circuit recognized that patent applications possess many characteristics normally associated with depreciable property¹⁹ and set forth guidelines for determining when a patent application might be considered property of a character subject to depreciation for the purpose of section 1239.²⁰ The court stated that there is often some point in the application process when a patent application has so fully matured that it should be considered depreciable.²¹ When only the ministerial acts of processing the application remain, so that issuance is virtually certain, the application will be regarded as the substantial equivalent of a depreciable patent.²² Notices of allowability were held to be the proper indicia of maturity.

In *Stahl* the taxpayer transferred to his controlled corporation (1) patents, (2) patent applications, which, prior to transfer, the Patent Office had al-

not the proper subject of exhaustion, as one of the essentials to measuring the deduction is unknown. . . . Furthermore, the date the patent issues marks the beginning of the asset in use as an enforceable right, as well as fixes its life. It follows that the inchoate right represented by a patent application matures into a depreciable asset beginning with the date the patent is issued

See also *Estate of Stahl v. Commissioner*, 442 F.2d 324 (7th Cir. 1971), *aff'g in part, rev'g in part*, 52 T.C. 591 (1969); *Sarkes Tarzarian, Inc. v. United States*, 159 F. Supp. 253 (S.D. Ind. 1958); *United States Mineral Prod. Co.*, 52 T.C. 177 (1969); *Max A. Burde*, 43 T.C. 252 (1964), *aff'd*, 352 F.2d 995 (2d Cir. 1965); *Twin Disc Clutch Co.*, 2 B.T.A. 1327 (1925). See generally 4 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 23.74 (1973).

16. 14 B.T.A. 867, *aff'd*, 43 F.2d 298 (10th Cir. 1930). See also *United States v. American Bell Tel. Co.*, 167 U.S. 224 (1897), where the Court noted that the final decision of the Patent Office as to whether a patent will issue cannot be foretold.

17. See cases cited note 15 *supra*. An inventor has no exclusive right and cannot exclude others from the use of his invention until he obtains letters of patent. See *Coakwell v. United States*, 372 F.2d 508 (Ct. Cl. 1967). However, an applicant can take advantage of Patent Office interference procedures under 35 U.S.C. § 135 (1970) to protect his rights as the first inventor. Cf. 35 U.S.C. § 102(g) (1970); *Marconi Wireless Tel. Co. v. United States*, 320 U.S. 1 (1942).

18. 442 F.2d 324 (7th Cir. 1971).

19. The language of § 1239(b) qualifies the word "depreciable" with the words "of a character." Patent applications do possess many of the characteristics normally associated with depreciable property. They are used "in trade or business" and are held for the "production of income." See INT. REV. CODE OF 1954, § 167. In some instances patent applications are actually considered to be depreciable. Rev. Rul. 67-136, 1967-1 CUM. BULL. 58, provides that where a patent will issue in the normal course of events, and the purchase price is fixed by contract as a percentage of the annual return derived from the use of the patent over its life, an amount equal to the price paid for patents or patent applications during the taxable year may be deducted under § 167. It was felt that the use of amounts which the taxpayer had contractually obligated himself to pay as the measure of the allowance for depreciation would assure the minimum distortion of income. See *Best Lock Corp.*, 31 T.C. 1217 (1959); *Associated Patentees, Inc.*, 4 T.C. 979 (1945), *acquiesced in* 1959-2 CUM. BULL. 3. Neither the ruling nor the cases define what is meant by the words "normal course." Presumably the reference is to an application which has been fully processed by the applicant and which appears to be allowable so that the application is the substantial equivalent of a patent itself.

20. 442 F.2d 324 (7th Cir. 1971).

21. *Id.*

22. *Id.* at 328. Although the *Stahl* court did not take note of Rev. Rul. 67-136, it could be argued that when an application is such that a patent is sure to issue in the normal course and therefore depreciable under the ruling, the application must, by its very nature, be mature under the *Stahl* test.

lowed or indicated appeared allowable, and (3) patent applications which had been rejected.²³ As to those applications which had been allowed or which appeared allowable, the court ruled that they would mature into patents "with the merest of diligence by the transferee in processing the application after sale,"²⁴ and, therefore, should be considered property of a depreciable character under section 1239. The court did not apply section 1239 to those applications which had been rejected prior to their transfer, despite the fact that one of the applications was later approved.²⁵ Thus, *Stahl* endorsed the view that while patent applications are generally not depreciable assets, when mature they may be treated as depreciable for the purpose of section 1239.

II. CHU V. COMMISSIONER

Underlying the entire *Chu* opinion is the view that section 1239 applies only to depreciable property, and not to property which might ultimately become depreciable.²⁶ The court rejected the Government's contention that the broad language of section 1239(b)²⁷ endorses the treatment of patent applications as depreciable property for the purpose of section 1239.²⁸ Although the First Circuit recognized that the Government's position might be sound tax policy, the court saw its role not as one of formulating tax policy, "but rather to ensure that the enactments of Congress are implemented in accordance with their intended legislative design."²⁹ An examination of the legislative history of section 1239 convinced the court that the statute was intended to apply only to depreciable property.³⁰

Justification for this approach was found by noting the situation which might confront an inventor whose patent application is rejected.³¹ Under the Government's proposal there would be no added incentive to an inventor because his controlled corporation would not receive a depreciable asset, and he would still be taxed at ordinary rates on the income realized from the

23. *Id.* at 326.

24. *Id.* at 328. After notice of allowability the applicant need only make a timely payment of the issue fee as required by Patent Office Rule 314, 37 C.F.R. § 1.314 (1973). An applicant is also required to record any assignment and pay a fee for the recording. See 37 C.F.R. §§ 1.331, 1.332 (1973).

25. 442 F.2d at 327-28.

26. 486 F.2d at 704.

27. The Government argued that the qualifying words "of a character" in § 1239(b) gave the court the ability to treat patent applications as depreciable property for the purpose of § 1239. *Id.* at 700.

28. *Id.*

29. *Id.* See *McClain v. Commissioner*, 311 U.S. 527, 530 (1941), where the Court stated: "We must apply the statute as we find it, leaving to Congress the correction of asserted inconsistencies and inequities in its operation." See also *Graham v. Commissioner*, 304 F.2d 707 (2d Cir. 1962); *Miller v. Commissioner*, 299 F.2d 706 (2d Cir. 1962).

30. 486 F.2d at 700. See also note 12 *supra* and accompanying text. Further support for this view was found in Treas. Reg. § 1.1239-1 (1960), which indicates that § 1239 is applicable only to transfers of depreciable property. The court also noted that the caption to § 1239(b) indicates that it applies only to depreciable property. Judge Campbell, concurring, noted, however, that "[i]t is virtually inescapable that Congress, when it passed section 1239, meant to penalize transactions of the sort involved in this case." 486 F.2d at 705 (Campbell, J., concurring).

31. *Id.* at 701.

transfer. The court also noted that it would be anomalous to "say that a patent application is 'property of a character' subject to depreciation if it is eventually approved, while [it] is not 'property of a character' subject to depreciation if it is not eventually approved."³² Thus, the First Circuit found that in the case of a transfer to a controlled corporation it was "entirely rational . . . for Congress to conclude that 1239 should apply only [to depreciable property]."³³

Chu reaffirmed the view that patent applications are ordinarily not depreciable property. The court relied on substantial Tax Court precedent beginning with *Hershey Manufacturing Co.*,³⁴ and also noted that approval of an application is an event of uncertain outcome and that a patent application "has no definitive life over which to be depreciated."³⁵ Judge Campbell, concurring, stated that "Tax Court precedent, supported by [*Stahl*], holds that patent applications are ordinarily not property 'of a character which is subject to the allowance for depreciation,'"³⁶ and that the taxpayer is entitled to rely on these previous cases "when making decisions that will irrevocably fix his liability for taxes."³⁷

Without endorsing the *Stahl* doctrine,³⁸ the *Chu* court concluded that Dr. Chu's application had not so fully matured under the *Stahl* test as to be considered property of a depreciable character for the purpose of section 1239.³⁹ The court found authority in *Stahl* for its conclusion that the *Chu* application should not be subject to the constraints of section 1239, since ultimate approval was not sufficiently certain.⁴⁰

The First Circuit acknowledged that the *Chu* decision left a loophole which substantially impaired the effectiveness of section 1239 in dealing with patent transfers.⁴¹ Decisions following *Stahl* and *Chu* point out the inef-

32. *Id.* at 701 n.6.

33. *Id.* at 701.

34. 14 B.T.A. 867, *aff'd*, 43 F.2d 298 (10th Cir. 1930). For Tax Court precedent supporting *Chu* see cases cited note 15 *supra*.

35. 486 F.2d at 702.

36. *Id.* at 704 (Campbell, J., concurring). He also noted that the court ignored Rev. Rul. 67-136 and a line of cases holding that patent applications are, in some instances, depreciable. See note 19 *supra*. However, consideration of Rev. Rul. 67-136 and the related cases would not have made any difference in *Chu*, as the basic claims of Dr. Chu's application were rejected three times by the Patent Office and, therefore, a patent would probably not have issued in the normal course. See note 22 *supra*.

37. 486 F.2d at 704 (Campbell, J., concurring).

38. *Id.* at 703 n.8. The First Circuit in *Chu* never approved the *Stahl* decision, and, in fact, criticized it on the basis that Patent Office notices of allowability are not necessarily final. In support of this view the *Chu* court cited Patent Office Rule 313 which indicates that even after notice of allowability patents will not always issue upon the exercise of the "merest of diligence." Prior to issuance of letters of patent the allowance may be withdrawn at any time on the grounds of fraud, illegality in the application, any alleged interference, or mistake on the part of the Patent Office. See 37 C.F.R. § 1.131 (1973).

39. 486 F.2d at 704.

40. *Id.* at 703. In *Stahl* the rejected applications were not found to be depreciable and thus escaped § 1239 in spite of the fact that one of the applications was later approved. In *Chu* the claims which represented the "heart" of the invention were "thrice rejected" by the Patent Office prior to the transfer, and the Tax Court regarded this as an effective rejection of the whole application, 58 T.C. at 610 n.2. On this basis the First Circuit found that Dr. Chu's application was not certain to mature into a depreciable patent "with the merest of diligence," and that more than the "ministerial act of 'processing' the application" remained. 486 F.2d at 703.

41. *Id.* at 700; see note 45 *infra*.

fectiveness of section 1239 in preventing a taxpayer from providing his controlled corporation with a depreciation deduction and at the same time paying capital gains rates on the income received from the transfer.⁴² In *Benjamin I. Davis*⁴³ the taxpayer had transferred a patent application to his controlled corporation ten months prior to notification of allowability, and despite the invention's obvious patentability, the Tax Court refused to consider it property of a depreciable character.⁴⁴ Thus, if the taxpayer can effect the assignment to his controlled corporation prior to the maturity of the application, he can reap substantial tax advantages.⁴⁵ The court, noting that legislative tax reform might be needed in this area,⁴⁶ suggested that capital gains treatment of income received from the initial transfer be retained, but that section 1239 be amended to provide for ordinary income treatment for all royalty payments received after the application is approved.⁴⁷ This proposal, while avoiding the unfavorable tax situation which might confront an inventor whose application is rejected,⁴⁸ would not effectively fill the loophole since methods of initial payment could be devised which would circumvent such a provision.⁴⁹

Judge Campbell, concurring, suggested that regulations be promulgated to set out a more specific definition of depreciable property, or to "create a rebuttable presumption that all patent applications are depreciable."⁵⁰ The specific definition suggested by Judge Campbell would be ideal from the court's point of view in that judicial construction would be minimized. However, it is doubtful that such a definition could be fashioned to cover all possible circumstances while allowing for the necessary flexibility.⁵¹ The rebuttable presumption of depreciability offers a way of avoiding the unfavorable tax consequences to the inventor which were perceived by the court under the Government's proposal,⁵² while providing for the enforcement of the spirit of section 1239.⁵³ When a patent application is transferred to a

42. Benjamin I. Davis, P-H Tax Ct. Mem. 1972-235, *aff'd*, 491 F.2d 709 (6th Cir. 1974); Vincent W. Eckel, P-H Tax Ct. Mem. 1974-33.

43. P-H Tax Ct. Mem. 1972-235, *aff'd*, 491 F.2d 709 (6th Cir. 1974).

44. The *Davis* court relied on *Stahl* and *Chu*, as well as *Hershey* and the earlier precedent, for the proposition that patent applications are not depreciable property for the purpose of § 1239 at least until notification of allowability from the Patent Office.

45. When the patent is issued, the taxpayer's controlled corporation will have a depreciation deduction from ordinary income at the stepped-up basis of the patent. The inventor-taxpayer will be taxed at capital gains rates on his personal income realized from the transfer. This is precisely the kind of transaction which § 1239 was intended to discourage. See note 12 *supra* and accompanying text. See also *United States v. Parker*, 376 F.2d 402 (5th Cir. 1967); R. HOLZMAN, *supra* note 8, at 107.

46. 486 F.2d at 704.

47. *Id.* at 704 n.9.

48. *Id.* at 701; see note 31 *supra* and accompanying text.

49. For example, the taxpayer could discount to its present value the expected future return from the patent and have his controlled corporation pay him this sum initially. Under the *Chu* court's proposal such a transaction would receive capital gains treatment.

50. 486 F.2d at 706 (Campbell, J., concurring). He noted that the proposed regulation might allow the taxpayer to apply to the Commissioner for a ruling prior to any transfer.

51. The limitations of language would likely prevent any successful effort at writing a definition of property of a depreciable character which would take in all situations which might arise under § 1239.

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

53. In a proper case such a presumption could be rebutted, thus affording the taxpayer the opportunity to transfer a non-depreciable patent application to his controlled

controlled corporation it seems fair to hold the taxpayer to this presumption, especially in light of his exhibited belief in the patentability of his own invention.⁵⁴

III. CONCLUSION

The First Circuit could have relied on the broad language of section 1239(b), "of a character," and its legislative history, to expand on the existing precedent, thereby holding that Dr. Chu's patent application was of a depreciable character for the purpose of section 1239. This construction would not have been unfair in light of the fact that Dr. Chu was fully acquainted with the prior art of antenna systems and expected that letters of patent would eventually issue on his new system.⁵⁵ Nevertheless, section 1239 and the relevant Tax Court precedent leads one to the conclusion that a patent application is ordinarily not property of a depreciable character.

Clearly, legislative or administrative reform is needed. A patent application realistically represents the same invention as does a patent. Inventors whose controlled corporations pay large amounts for patent rights are not fearful of unfavorable tax consequences, but are rather seeking the substantial tax advantages of a depreciation deduction for their controlled corporations, and the lower capital gains treatment for personal income realized on the transfer. Capital gains treatment is normally regarded as "the exception, not the rule,"⁵⁶ and it is clear that section 1239 was intended to penalize the transactions within its scope.⁵⁷ If the courts are unable to find language in the statute susceptible to judicial construction, Congress or the Treasury Department should act to supply it. The First Circuit's reform proposals may provide a starting point.

Barton R. Bentley

corporation. Such a case would be very unusual, however, because the taxpayer would be placed in the anomalous position of asserting the patentability of his invention before the Patent Office, while arguing non-patentability before the Commissioner.

54. Some commentators have questioned the general efficacy of preferential capital gains taxation on grounds of basic equity and the belief that the preferential treatment encourages the conversion of ordinary income into capital gains, thereby distorting otherwise normal investment patterns. See M. DAVID, *ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION* (1968); L. SELTZER, *supra* note 8, at 285-89. *Contra, id.* at 282-85; TAX INSTITUTE, *CAPITAL GAINS TAXATION* 14-16 (1946). See generally J. PECHMAN, *FEDERAL TAX POLICY* 66-67, 96-97 (1971).

55. 58 T.C. at 605. Dr. Chu's expectation is further evidenced by the fact that his controlled corporation, Chu Associates, agreed to pay \$2000 upon the execution of the assignment and a minimum of \$317,000 over the life of the patent. *Id.*

56. 486 F.2d at 704 (Campbell, J., concurring); see *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960); *Corn Prod. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955).

57. See note 12 *supra* and accompanying text.