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## Award of Attorney's Fees Against a State Barred by Eleventh Amendment: *Jordan v. Gilligan*

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# NOTES

## Award of Attorneys' Fees Against a State Barred by Eleventh Amendment: *Jordon v. Gilligan*

Ohio plaintiffs brought a class action against the state apportionment board and various state officials challenging the constitutional validity of a board-adopted legislative reapportionment plan. The challenge was successful, and the district court ordered the submission of a revised plan that would meet constitutional demands. Subsequently, plaintiffs' counsel filed applications for attorneys' fees. In allowing the award, the court directed the state to make payment through its Governor, and later taxed the fees as costs when the state did not comply. On appeal, *Held, reversed*: The eleventh amendment bars an award of attorneys' fees against a nonconsenting state. *Jordon v. Gilligan*, 500 F.2d 701 (6th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3625 (U.S. May 27, 1975).

### I. THE ELEVENTH AMENDMENT AND STATES' SOVEREIGN IMMUNITY

The eleventh amendment to the United States Constitution,<sup>1</sup> though framed in terms of an absolute limitation on the judicial power of federal courts to entertain suits brought against states by noncitizens, means neither as much nor as little as its language suggests.<sup>2</sup> Although the amendment's terms clearly do not embrace these situations, the courts have held that the amendment bars suits brought by citizens against their own states<sup>3</sup> and those brought by foreign countries against a state.<sup>4</sup> Conversely, the amendment has not been applied to situations where a citizen sues to enjoin enforcement of an allegedly unconstitutional state statute,<sup>5</sup> or where a state agency or officer attempts to administer a valid law in a manner inconsistent with the Constitution.<sup>6</sup> The courts have interpreted the amendment primarily as

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1. "The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign States." U.S. CONST. amend. XI.

2. *See, e.g., Cullison, Interpretation of the Eleventh Amendment*, 5 HOUS. L. REV. 1, 5-6 (1967).

3. *See, e.g., Employees v. Department of Public Health & Welfare*, 411 U.S. 279 (1973); *Hans v. Louisiana*, 134 U.S. 1 (1890).

4. *See, e.g., Principality of Monaco v. Mississippi*, 292 U.S. 313 (1934).

5. *See, e.g., Georgia R.R. & Banking Co. v. Redwine*, 342 U.S. 299 (1952); *Ex parte Young*, 209 U.S. 123 (1908). In cases where the *Young* rationale has been employed, the courts have resorted to fiction to escape the confines of the amendment by denying that a suit is, when brought against a state officer in such instances, actually one against the state, even though the holding will ultimately force the state to comply with constitutional demands. In such cases, the courts speak in terms of the suit being against the "individual." *See, e.g., Georgia R.R. & Banking Co. v. Redwine*, 342 U.S. 299 (1952); *Citizens Comm. for the Hudson Valley v. Volpe*, 297 F. Supp. 809 (S.D.N.Y. 1969); C. JACOBS, *THE ELEVENTH AMENDMENT AND SOVEREIGN IMMUNITY* (1972).

6. *See, e.g., Peay v. Cox*, 190 F.2d 123 (5th Cir.), *cert. denied*, 342 U.S. 896 (1951); *Central R. Co. v. Martin*, 115 F.2d 968 (3d Cir. 1940), *cert. denied*, 313 U.S. 568 (1941).

if it were but "a restatement of the doctrine of sovereign immunity"<sup>7</sup> rather than a limitation on the power of the federal judiciary. At the same time, the courts have held that the amendment "partakes of the nature of a jurisdictional bar"<sup>8</sup> and may be raised for the first time on appeal.<sup>9</sup> This dichotomy has produced unwarranted results,<sup>10</sup> but instead of attempting to limit the amendment as either the embodiment of sovereign immunity, or as a limitation on judicial power, the courts have merely circumvented the amendment's harshness by the application of such doctrines as express and implied waiver by the state.<sup>11</sup> Typically, the amendment has been applied to bar suits involving an alleged breach of a state's legal duty where payment from the state treasury would be required.<sup>12</sup> However, the eleventh amendment has been held inapplicable where the plaintiff seeks to enjoin enforcement of an unconstitutional state statute, and the suit is not primarily one to recover monetary relief.<sup>13</sup> Apparently, the amendment does not bar the

7. Comment, *State Sovereign Immunity: No More King's X?*, 52 TEXAS L. REV. 100, 104 (1973). See, e.g., *Great N. Life Ins. Co. v. Read*, 322 U.S. 47, 59 (1944) (Frankfurter, J., dissenting); *Sostre v. McGinnis*, 442 F.2d 178 (2d Cir. 1971), cert. denied, 404 U.S. 1049 (1972); *Flores v. Norton & Ramsey Lines, Inc.*, 352 F. Supp. 150 (W.D. Tex. 1972), noted in 5 ST. MARY'S L.J. 152 (1973). Thus, when viewed as a restatement of the sovereign immunity doctrine the amendment would appear to be in the nature of a defense rather than a jurisdictional barrier. See *Taylor v. Perini*, 503 F.2d 899, 905 (6th Cir. 1974) (Weick, J., concurring), *judgmt vacated and cause remanded on other grounds*, 43 U.S.L.W. 3624 (U.S. May 27, 1975) (No. 74-506).

8. *Edelman v. Jordan*, 415 U.S. 651, 677-78 (1974).

9. See, e.g., *Ford Motor Co. v. Department of Treasury*, 323 U.S. 459, 467 (1945).

10. See Comment, *supra* note 7, at 100 (detrimental effect of the eleventh amendment on federal regulatory programs). The amendment's dual aspects stem from the reaction to *Chisholm v. Georgia*, 2 U.S. (2 Dall.) 419 (1793), which held that the states had given up their immunity through the judiciary article of the Constitution which extends the judicial power to suits "between a State and Citizens of another State . . ." U.S. CONST. art. III, § 2. Since the amendment was designed to overrule the *Chisholm* decision, it was framed in terms of judicial power. *Chisholm* was incorrectly decided in that the framers intended the states to retain their sovereign immunity despite the judiciary article. Cullison, *supra* note 2, at 7-15. But see C. JACOBS, *supra* note 5, at 40. For an excellent discussion of the history of the eleventh amendment see Mathis, *The Eleventh Amendment: Adoption and Interpretation*, 2 GA. L. REV. 207 (1968).

11. See, e.g., *Clark v. Barnard*, 108 U.S. 436, 447 (1883). For the leading cases on implied waiver, see *Parden v. Terminal Ry.*, 377 U.S. 184 (1964); *Petty v. Tennessee-Missouri Bridge Comm'n*, 359 U.S. 275 (1959). But see *Edelman v. Jordan*, 415 U.S. 651 (1974), and *Employees v. Department of Public Health & Welfare*, 411 U.S. 279 (1973), both indicating a more restrictive view of the concept of implied waiver. The concept of waiver or consent runs counter to an interpretation of the amendment as a jurisdictional bar. See, e.g., 1 A. FREEMAN, JUDGMENTS § 382, at 676 (5th ed. 1925); RESTATEMENT OF CONFLICT OF LAWS § 81, comment *g* (1934); C. WRIGHT, THE LAW OF FEDERAL COURTS § 7, at 15-16 (1970).

12. When applied, the amendment has produced a series of results, most of which are highly undesirable, for example, barring suit for the recovery of taxes paid to the state by the plaintiff under protest, *Ford Motor Co. v. Department of Treasury*, 323 U.S. 459 (1945); *Great Northern Life Ins. Co. v. Read*, 322 U.S. 47 (1944); disallowing claims for the recovery of welfare benefits wrongfully withheld by states, *Milburn v. Huecker*, 500 F.2d 1279 (6th Cir. 1974); *Rothstein v. Wyman*, 467 F.2d 226 (2d Cir. 1972), cert. denied, 411 U.S. 921 (1973); precluding the maintenance of an action to recover lost earnings by state employees caused by their wrongful discharge, *Janda v. State*, 348 F. Supp. 568 (N.D. Ill. 1972). Although these illustrations offer some direction to an understanding of the nature of the amendment, it should nevertheless be noted that "[t]he single most overwhelming fact about eleventh amendment cases is their complete confusion." Comment, *A Practical View of the Eleventh Amendment—Lower Court Interpretations and the Supreme Court's Reaction*, 61 GEO. L.J. 1473, 1498 (1973).

13. See note 5 *supra* and accompanying text. The amendment is also inapplicable in suits against geographically defined political subdivisions of the state, such as cities

assessment of court costs when the suit itself would be permitted.<sup>14</sup>

## II. THE COUNSEL FEE CASES

The problem of attorneys' fees and the eleventh amendment is one of recent origin. *Sims v. Amos*<sup>15</sup> was one of the first cases to confront the suggestion that an award of counsel fees assessed against a state or its officers might run counter to the eleventh amendment.<sup>16</sup> The plaintiffs in *Sims* successfully sued the Governor and Secretary of State of Alabama, challenging the validity of the state's legislative apportionment plan. On motion by plaintiffs the district court entered an award of attorneys' fees. In order to reach this result in a manner consistent with eleventh amendment prohibitions, the court invoked the fiction of *Ex parte Young*,<sup>17</sup> stating that in cases where the actions of "[i]ndividuals" contravene the Constitution, "the state has no power to impart to its officers any immunity from such injunction or from its consequences, including the court costs incident thereto."<sup>18</sup> Subsequently, *Sims* was summarily affirmed by the Supreme Court<sup>19</sup> over the defendants' objection that the court lacked jurisdiction to enter a monetary award against the state.<sup>20</sup>

A California federal district court was confronted with a similar situation in *La Raza Unida v. Volpe*,<sup>21</sup> a suit to enjoin construction of a state highway claimed to be in violation of federal regulations. After the injunction was granted, plaintiffs moved for an award of counsel fees. The court, considering sua sponte whether it had jurisdiction to make such an award, relegated the discussion to a footnote.<sup>22</sup> Relying on *Sims*, and declining to follow the earlier case of *Sinock v. Obara*,<sup>23</sup> which had held such an award impermissible, the court noted: "Other courts seem to hold that the power to tax costs against the state is necessarily incident to jurisdiction; that where jurisdiction over the action in the main is proper no specific statute is required to overcome the state's sovereign immunity in federal court."<sup>24</sup>

Against this meager background of authority, the Fifth Circuit met the attorneys' fee question in *Gates v. Collier*,<sup>25</sup> a suit arising out of the mistreatment of prisoners at the Mississippi State Penitentiary. After granting the

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and counties. See, e.g., *Lincoln County v. Luning*, 133 U.S. 529 (1890). Thus, an award of attorneys' fees against a county, for example, is not barred by the amendment. *Incarcerated Men of Allen County Jail v. Fair*, 507 F.2d 281, 287 (6th Cir. 1974).

14. *Fairmont Creamery Co. v. Minnesota*, 275 U.S. 70 (1927); cf. *Utah v. United States*, 304 F.2d 23 (10th Cir.), cert. denied, 371 U.S. 826 (1962). However, the eleventh amendment has been held inapplicable where the United States sues a state. See, e.g., *United States v. Texas*, 143 U.S. 621 (1892).

15. 340 F. Supp. 691 (M.D. Ala.), aff'd, 409 U.S. 942 (1972).

16. 340 F. Supp. at 694 n.8.

17. 209 U.S. 123 (1908); see note 5 supra.

18. 340 F. Supp. at 694 n.8.

19. 409 U.S. 942 (1972).

20. The jurisdictional statement of the *Sims* defendants is quoted in *Gates v. Collier*, 489 F.2d 298, 302 (5th Cir. 1973), rehearing granted, 500 F.2d 1382 (1974).

21. 57 F.R.D. 94 (N.D. Cal. 1972), aff'd, 488 F.2d 559 (9th Cir. 1973).

22. 57 F.R.D. at 101 n.11.

23. 320 F. Supp. 1098 (D. Del. 1970).

24. 57 F.R.D. at 101 n.11.

25. 489 F.2d 298 (5th Cir. 1973), rehearing granted, 500 F.2d 1382 (1974).

inmates declaratory and injunctive relief, the district court granted an award of attorneys' fees against the defendant state officials.<sup>26</sup> In holding that the award was not barred by the eleventh amendment, the court predicated its decision on three distinct grounds, the first being that the summary affirmance of *Sims* by the Supreme Court<sup>27</sup> carried enough precedential weight to control the counsel-fee issue.<sup>28</sup> Secondly, the court justified the award on the *La Raza* principle, that the fees were merely the incident of an injunction which the court in the first instance had jurisdiction to grant.<sup>29</sup> Finally, the court reasoned that since counsel fees were not damages they would not be barred by eleventh amendment immunity, even though paid from the state treasury.<sup>30</sup>

### III. JORDON V. GILLIGAN

In *Gilligan* the Sixth Circuit relied upon the broad language of the Supreme Court in *Edelman v. Jordan*,<sup>31</sup> a case arising after the initial decision in *Gates*, to reach the conclusion that a fee award against a state is barred by the eleventh amendment. Unlike the counsel fee cases, *Edelman* involved a claim for retroactive federal-state aid benefits wrongfully withheld by Illinois. The Court, speaking through Mr. Justice Rehnquist, held recovery was barred, and stated: "[T]he rule has evolved that a suit by private parties seeking to impose a liability which must be paid from public funds in the state treasury is barred by the Eleventh Amendment."<sup>32</sup> That this statement was overly broad became evident with the very holding of *Edelman* itself, which, although denying recovery of the withheld benefits, acknowledged that the injunction granted by the lower court would be permissible, even though it would require the state to expend funds in the future.<sup>33</sup> This was justified upon the ground that such relief is prospective in nature and hence not barred.<sup>34</sup> The Court reasoned that the amendment

26. 349 F. Supp. 881 (N.D. Miss. 1973).

27. 409 U.S. 942 (1972).

28. 489 F.2d at 302. However, the precedential value of a summary affirmance by the Court has recently come into question because of a statement by Mr. Justice Rehnquist in *Edelman v. Jordan*, 415 U.S. 651, 671 (1974):

[S]ummary affirmances obviously are of precedential [*sic*] value in support of the contention that the Eleventh Amendment does not bar the relief awarded by the District Court in this case. Equally obviously they are not of the same precedential [*sic*] value as would be an opinion of this Court treating the question on the merits.

The statement appears to have led some courts to pay less heed to summary affirmances, while others view the Justice's language as somewhat meaningless with regard to courts other than the Supreme Court. Compare *Taylor v. Perini*, 503 F.2d 899, 906-12 (6th Cir. 1974) (Edwards, J., dissenting), *judgment vacated and cause remanded on other grounds*, 43 U.S.L.W. 3624 (U.S. May 27, 1975) (No. 74-506), with *Doe v. Hodgson*, 500 F.2d 1206, 1207-08 (2d Cir. 1974).

29. *Id.*

30. *Id.* For awhile, the *Gates* decision went unnoticed, even in *Brandenburger v. Thompson*, 494 F.2d 885 (9th Cir. 1974), which relied on *Sims* to hold the counsel fee award permissible. However, *Gates* was applied in one case for that proposition. See *Kirkland v. New York State Dep't of Correctional Servs.*, 374 F. Supp. 1361 (S.D.N.Y. 1974).

31. 415 U.S. 651 (1974).

32. *Id.* at 663.

33. *Id.* at 658-59, 667-68.

34. *Id.* at 677. The Court here stated that the relief awarded in such instances is

forbids any award "measured in terms of a monetary loss resulting from a *past* breach of a legal duty on the part of the defendant state officials."<sup>35</sup> This expression, therefore, exhibited a further retreat from that language employed earlier in the opinion to indicate that *any* suit to claim *any* funds payable from the state treasury would be barred.<sup>36</sup> In disallowing the award of attorneys' fees the Sixth Circuit in *Gilligan* expressly declined to follow the lead of the Fifth Circuit in *Gates*, and stated that the imposition of counsel fees on the state fell not only within the ambit of *Edelman's* broad language but within the proscription of its limiting language as well.<sup>37</sup>

While it is true, as stated in *Gilligan*, that an assessment of counsel fees in such instances would result in a monetary loss to the state, it is unreasonable to characterize a claim for fees as resulting from or arising out of a *past* breach of a legal duty, or as an accrued monetary liability.<sup>38</sup> Indeed, a claim for attorneys' fees arises out of the attorney-client relationship<sup>39</sup> and only indirectly out of any breach on the part of the defendant. Conversely, claims for damages or retroactive benefits find their basis in the transactions between the actual parties which initially gave rise to the suit. Approached in this sense, a claim for fees in a suit which is properly before the court is outside the scope of the amendment, which speaks in terms of the relationship between the parties to the action.<sup>40</sup> Such a view would be consistent with the principle that an attorney is not a party to the suit for which he has been retained.<sup>41</sup> Herein lies the distinction between a claim for retroactive benefits and counsel fees which the *Gilligan* court did not recognize. Likewise, the distinction is analogous to that drawn by the Fifth Circuit in *Gates* between damages and counsel fees, although the distinction there was made upon different grounds.<sup>42</sup>

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limited to prospective injunctive relief, citing *Ex parte Young*, 209 U.S. 123 (1908), discussed at note 5 *supra*. But see the more recent case of *Scheuer v. Rhodes*, wherein it is stated: "In some situations a damage remedy can be as effective a redress for the infringement of a constitutional right as injunctive relief might be in another." 416 U.S. 232, 238 (1974).

35. 415 U.S. at 668 (emphasis added).

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

37. 500 F.2d at 709-10.

38. At least one circuit has realized that it is not persuasive to argue that court costs and attorneys' fees can be so characterized:

[W]e acknowledge that an award of court costs cannot be neatly categorized as either prospective or retroactive. An award of costs does operate as a direct levy on the state's general revenues . . . . On the other hand, costs are not awarded for accrued liability, but rather are assessed for certain litigation expenses in accordance with the generally mechanical provisions of Rule 39.

Boston Chapter of the N.A.A.C.P., Inc., v. Beecher, 504 F.2d 1017, 1029 (1st Cir. 1974). See also *Class v. Norton*, 505 F.2d 123 (2d Cir. 1974). While *Beecher* dealt with the allowance of an assessment of appeal costs against the state, and only indirectly touched upon the attorney fee problem, the First Circuit's reaction to the sole question of whether a fee award is barred by the amendment was nevertheless predictable by analogy. *Souza v. Trivisono*, 512 F.2d 1137 (1st Cir. 1975), *petition for cert. filed*, 43 U.S.L.W. 3639 (U.S. May 1, 1975) (No. 74-1372).

39. See, e.g., *Brandenburger v. Thompson*, 494 F.2d 885, 889 (9th Cir. 1974).

40. See note 1 *supra*.

41. See, e.g., *Bosley v. Dorsey*, 191 Md. 229, 60 A.2d 691 (1948); cf. *Texas Employers' Ins. Ass'n v. Davidson*, 290 S.W. 871 (Tex. Civ. App.—Fort Worth 1927, no writ).

42. The distinction in *Gates* was made on the ground that an award of counsel fees, unlike damages, was equitable in nature when granted incident to an injunction. 489

Urging a court to draw a distinction between an award of attorneys' fees and retroactive benefits based upon the relationships of the persons involved in the suit would be tantamount to urging the court to engage in judicial hair-splitting. This is particularly true if one views the amendment's primary purpose as protecting the fiscal integrity of the state. If this is true, this goal has not always been realized. Inherent in many of the permissible injunctive proceedings is the fact that compliance with the injunction will require expenditures by the state in the future.<sup>43</sup> However, this judicial hair-splitting is consistent with the fictions and doctrines attenuating the amendment over the years, most notably when viewed in light of the amendment's dual interpretation.<sup>44</sup>

Even assuming that a claim for attorneys' fees is within the very terms of the amendment, it is possible, as one court has suggested,<sup>45</sup> that a fee award is consistent with the *Edelman* language as having "[s]uch an ancillary effect on the state treasury [as] is . . . permissible and often an inevitable consequence of the principle announced in *Ex parte Young*."<sup>46</sup> However, the *Gilligan* court failed to address this possible solution; nor did the court satisfactorily distinguish the awarding of attorneys' fees from an assessment of court costs against a state.<sup>47</sup> Apparently the Sixth Circuit believed that costs, unlike counsel fees, do not result from a past breach of a legal duty.<sup>48</sup> This is one of the weaker points of the case when considered in light of both the relationship distinction and the ancillary effect doctrine. First, although traditionally not costs of litigation,<sup>49</sup> fees do involve relationships between persons not actually parties to the litigation. Costs and attorneys' fees, as a practical matter, ultimately inure to the benefit of someone other than the successful litigant. Upon this rationale, items such as costs, expenses, and counsel fees should be viewed as essential to the implementation of the judicial process itself, involving parties not actually the litigants of the controversy. Secondly, an award of attorneys' fees can be viewed as having the permissible ancillary effect on the state treasury allowed under *Edelman*, because unlike damages and retroactive benefits, claims for fees or costs are themselves not the essence of the lawsuit.<sup>50</sup> The *Gilligan* decision seems in-

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F.2d at 302. This distinction, based upon the equitable nature of the award, may no longer be tenable under *Edelman*, which refused to recognize the same distinction with regard to a grant of retroactive aid benefits wrongfully withheld by the state. 415 U.S. at 677.

43. See, e.g., *Edelman v. Jordan*, 415 U.S. 651, 678 (1974) (Douglas, J., dissenting); *Graham v. Richardson*, 403 U.S. 365 (1971); *Goldberg v. Kelly*, 397 U.S. 254 (1970).

44. See note 10 *supra*.

45. *Jordan v. Fusari*, 496 F.2d 646 (2d Cir. 1974).

46. *Edelman v. Jordan*, 415 U.S. 651, 668 (1974). *Fusari*, even though expressly indicating that an award of counsel fees would have but a permissible ancillary effect upon the state treasury, relied primarily on the waiver doctrine to reach its result. 496 F.2d at 651. See note 11 *supra* and accompanying text. See also *Class v. Norton*, 505 F.2d 123, 126-28 (2d Cir. 1974) (award not barred by eleventh amendment even in absence of waiver).

47. 500 F.2d at 709-10. See *Fairmont Creamery Co. v. Minnesota*, 275 U.S. 70 (1927).

48. 500 F.2d at 709-10.

49. See, e.g., Kuenzel, *The Attorney's Fee: Why Not a Cost of Litigation?*, 49 *Iowa L. Rev.* 75 (1963).

50. This again would be consistent with *Edelman*, which indicated that only those suits which in essence are for the recovery of money against a state are barred. 415

ternally inconsistent in that the court indicated that all monetary awards against the state would be barred by the amendment but nevertheless would have allowed an award of costs against the state which might just as well have constituted an attack on the state treasury.<sup>51</sup>

#### IV. CONCLUSION

By ignoring the basic distinctions between attorneys' fees and claims for damages or retroactive benefits, and the true holding of *Edelman* itself, the court in *Gilligan* erred. The issue was not one to be handled lightly, considering the holding's detrimental effect of discouraging litigation based on constitutional or federally created rights.<sup>52</sup> As the ancillary effect doctrine and the party-relationship distinction can be employed to support a holding that costs are not barred by the eleventh amendment, the rationale should have been adopted by the Sixth Circuit in analyzing an award of attorneys' fees rather than analogizing to the award of retroactive aid benefits in *Edelman*.

On reconsideration of the problem, if reconsidered at all,<sup>53</sup> the Fifth Circuit will gain by having the benefit of views on both sides of the issue. That the court, will, like *Gilligan*, fail its task by reaching the same result without consideration of the grounds on which fees may be awarded against a state consistently with the prohibitions of the eleventh amendment is unlikely. Although the court may reach the same unfortunate result, the case is certain to be grounded on better reasoning. The fact that the court need not reach that result is not only encouraging, it is evident. Nevertheless, the most definitive decision on this and related problems can come only from the Supreme Court based upon a long-needed reinterpretation of the eleventh amendment.<sup>54</sup>

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U.S. at 663, citing *Ford Motor Co. v. Department of Treasury*, 323 U.S. 459, 464 (1945).

51. The failure to recognize and respond to these various considerations was even more pronounced in the Fifth Circuit's *San Antonio Expressway* case, which, in overlooking *Gates* entirely and thus necessitating a rehearing on the issue in both cases, cited *Edelman* in one brief paragraph to hold an award of attorneys' fees against the Texas Highway Department barred by the eleventh amendment. *Named Individual Members of the San Antonio Conservation Soc'y v. The Texas Highway Dep't*, 496 F.2d 1017 (5th Cir. 1974), rehearing granted, 496 F.2d at 1026, cert. denied, 43 U.S.L.W. 3452 (U.S. Feb. 14, 1975).

52. Cf. Comment, *Allowance of Attorney Fees in Civil Rights Litigation Where the Action is Not Based on a Statute Providing for an Award of Attorney Fees*, 41 CINN. L. REV. 405 (1972).

53. The *San Antonio Expressway* case and *Gates* were consolidated for rehearing.

54. See note 10 *supra* and accompanying text. At the time this Note went to print at least five circuits had ruled on the counsel fee question, the First and Second Circuits holding an award permissible in the cases of *Souza v. Travisono*, 512 F.2d 1137 (1st Cir. 1975), petition for cert. filed, 43 U.S.L.W. 3639 (U.S. May 1, 1975) (No. 74-1372), and *Class v. Norton*, 505 F.2d 123 (2d Cir. 1974), and the Third and Sixth Circuits holding an award impermissible in *Skehan v. Board of Trustees*, 501 F.2d 31 (3d Cir. 1974), *judgmt vacated and cause remanded on other grounds*, 43 U.S.L.W. 3624 (U.S. May 27, 1975) (No. 74-558), and the *Gilligan* case. The Fifth Circuit appears to be in between, with the *Gates* case allowing an award and *Named Individual Members of the San Antonio Conservation Soc'y v. The Texas Highway Dep't*, 496 F.2d 1017 (5th



## Central Tablet Manufacturing Co. v. United States: Date of Casualty Is Date of Sale for Section 337 Claimants

The corporate assets of the Central Tablet Manufacturing Company were extensively damaged by a fire on September 10, 1965. Because of disputes as to the exact amounts payable under the insurance policies, final agreement on the building claim was not reached until May 20, 1966. On May 14, 1966, Central Tablet's shareholders adopted a plan of complete liquidation. The fire insurance proceeds, paid in June 1966, exceeded the corporation's adjusted tax basis in the insured property, but under the provisions of section 337 of the Internal Revenue Code of 1954<sup>1</sup> Central Tablet did not report this gain on its income tax returns. The Internal Revenue Service asserted a deficiency in the taxpayer's income tax for fiscal 1965. The taxpayer paid the deficiency and brought a refund suit. The district court held that the provisions of section 337 were applicable and entered judgment for the taxpayer.<sup>2</sup> The Sixth Circuit reversed in a strict construction of section 337, holding the date of the sale or exchange to be the same as the date of the destruction.<sup>3</sup> The taxpayer appealed to the United States Supreme Court. *Held, affirmed*: The date of an involuntary conversion of corporate assets by fire, treated as a completed sale or exchange for purposes of section 337(a) of the Internal Revenue Code of 1954, is the date of the destruction, rather than that of settlement with the insurer on any resulting claim. *Central Tablet Manufacturing Co. v. United States*, 417 U.S. 673 (1974).

### I. TAX RELIEF FOR LIQUIDATING CORPORATIONS

Prior to the adoption of section 337 of the Internal Revenue Code of 1954, a corporation that wished to liquidate could offer shareholders a substantial tax advantage by transferring the corporate assets to the shareholders for private sale.<sup>4</sup> The corporation realized no gain for income tax

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Cir. 1974), *cert. denied*, 43 U.S.L.W. 3452 (U.S. Feb. 14, 1975), disallowing an award. It should be noted that even though the Sixth Circuit is placed in the "against column," a three-member panel of that court has decided one case in favor of allowing such an award. *Milburn v. Huecker*, 500 F.2d 1279 (6th Cir. 1974). This case was apparently decided prior to *Gilligan* but got into print later. *Taylor v. Perini*, 503 F.2d 899, 911-12 (6th Cir. 1974) (Edwards, J., dissenting), *judgment vacated and cause remanded on other grounds*, 43 U.S.L.W. 3624 (U.S. May 27, 1975) (No. 74-506). However, the *Taylor* case reaffirmed the *Gilligan* holding.

1. INT. REV. CODE OF 1954, § 337(a) provides, *inter alia*, that if "(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."

2. *Central Tablet Mfg. Co. v. United States*, 339 F. Supp. 1134 (S.D. Ohio 1972).

3. *Central Tablet Mfg. Co. v. United States*, 481 F.2d 954 (6th Cir. 1973).

4. This presupposes a capital gain. A corporation which would suffer a loss on the sale or exchange of particular property would thus choose to delay liquidation until after it had effected the sale or exchange. For an example of the computation of the tax under each alternative and the potential savings when the shareholder conducts the

purposes from the liquidation and distribution of assets to shareholders.<sup>5</sup> If, however, the corporation sold the assets before liquidation, the corporation realized a taxable gain. The net gain to the corporation also enhanced the value of the shareholder's investment which became taxable upon liquidation. In order to avoid this "double taxation," assets commonly were transferred to the shareholders for sale following liquidation.<sup>6</sup>

Problems arose, however, when the sale of assets closely followed the corporate liquidation, and was arguably arranged by the corporate officers rather than the shareholders. In *Commissioner v. Court Holding Co.*<sup>7</sup> a closely held corporation agreed to sell assets to a third party. After learning of the tax consequences of the sale, the corporation's two shareholders liquidated, surrendered their stock, transferred title in the assets from the corporation to themselves, and immediately conveyed to the third party. The United States Supreme Court held that the sale had in fact been made by the corporation even though not consummated until after distribution of the assets. Five years later the Court reached an opposite conclusion in a factually similar case, *United States v. Cumberland Public Service Co.*, distinguishing *Court Holding* on grounds that "[t]here the corporation had negotiated for sale of its assets and had reached an oral agreement of sale."<sup>8</sup> A unanimous court recognized that "the distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held."<sup>9</sup>

In response to the "shadowy" distinctions, Congress introduced section 337 of the Internal Revenue Code of 1954 to eliminate difficulties in determining whether the corporation or its shareholders had actually made a sale.<sup>10</sup> The Senate Finance Committee stated in support of section 337:

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sale see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 11.63, at 53 (3d ed. 1971).

5. See *General Util. Co. v. Helvering*, 296 U.S. 200 (1935), which held a corporation realized no gain from the distribution of assets to shareholders as a dividend. This principle was first enacted in the present Code in §§ 311, 336. INT. REV. CODE OF 1954, § 336 provides: "Except as provided in section 453 . . . no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

6. See generally B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 11.65, at 65; Kovey, *When Will Section 337 Shield Fire Loss Proceeds? A Current Look at a Burning Issue*, 39 J. TAX. 258 (1973); Comment, *Extending Section 337 to Liquidations Triggered by the Involuntary Conversion of Corporate Assets*, 62 GEO. L.J. 1203, 1206 n.21 (1974); Recent Decision, 42 GEO. WASH. L. REV. 663, 665 (1974). For an analysis of pre-§ 337 procedure see Cary, *The Effect of Taxation on Selling Out a Corporate Business for Cash*, 45 ILL. L. REV. 423 (1950).

7. 324 U.S. 331 (1945).

8. 338 U.S. 451, 453 (1950). In *Cumberland* a closely held corporation distributed its assets in kind to its shareholders, who then transferred to a purchaser. The trial court found that the corporation had never intended to sell the assets.

9. *Id.* at 454-55.

10. See S. REP. NO. 1622, 83d Cong., 2d Sess. 48-49, 258-59 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 38-39, A106-09 (1954).

Section 337 allows nonrecognition of capital gain from a sale or exchange of assets (not inventory) if the corporation has adopted a complete plan of liquidation before, or on the day of the sale or exchange. For a detailed analysis of § 337 requirements see Mahon, *Section 337 (12 Month) Liquidations: What Constitutes a Plan*, N.Y.U. 28TH INST. ON FED. TAX. 691-724 (1970). See also B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 11.64; Bittker & Eustice, *Complete Liquidations and Related Problems*, 26 TAX. L. REV. 191 (1971); Bonovitz, *Current Liquidation Problems Under § 334(b)(2)*

"The result of these last two decisions [*Court Holding* and *Cumberland*] is that undue weight is accorded the formalities of the transaction and they, therefore, represent merely a trap for the unwary."<sup>11</sup>

Section 337, on its face, relates only to "the sale or exchange" of property, and initially the Internal Revenue Service refused to consider involuntary conversions that occurred after adoption of a plan of complete liquidation as within section 337,<sup>12</sup> but after the Court of Claims<sup>13</sup> and the Fourth Circuit<sup>14</sup> allowed involuntary conversions to be treated as sales or exchanges under section 337, the Service reversed its position, treating an involuntary conversion occurring after adoption of a plan of complete liquidation as a "sale or exchange" with resulting nonrecognition.<sup>15</sup>

## II. THE DATE OF SALE UNDER INVOLUNTARY CONVERSIONS

The technical requirements of section 337 necessitate a determination of the date of the sale or exchange<sup>16</sup> because the statute requires that the sale or exchange of property occur after the adoption of a plan of liquidation.<sup>17</sup> In this regard courts which have dealt with involuntary conversions have applied differing criteria to determine the date upon which the sale or exchange took place.<sup>18</sup> For example, the date of the sale or exchange for section 337 purposes in a condemnation case is the date of the passage of title under the applicable law to the condemning authority.<sup>19</sup> Thus, the sale

*and § 337: Distribution and Reserves*, N.Y.U. 30TH INST. ON FED. TAX. 1095 (1972). For an extended treatment of "property" for § 337 purposes see Note, *Use of Tax Benefit Principles to Override Section 337: D.B. Anders v. Commissioner*, 45 IND. L.J. 413 (1970).

11. S. REP. NO. 1622, 83d Cong., 2d Sess. 48-49 (1954).

12. Rev. Rul. 56-372, 1956-2 CUM. BULL. 187. This revenue ruling followed the Court's decision in *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941), in which the Court held that fire insurance proceeds did not result in gain from a sale or exchange of capital assets within the meaning of § 117(d) of the Revenue Act of 1934. This result was overcome statutorily by the enactment of § 151(b) of the Revenue Act of 1942, 56 Stat. 846, now carried over into INT. REV. CODE OF 1954, § 1231(a).

13. *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373 (Ct. Cl. 1960). The Court of Claims concluded that Congress must have intended involuntary conversions to be treated as sales or exchanges under § 337. "It is not conceivable that Congress would have drawn a distinction between a gain from a voluntary conversion and an involuntary one, had the possibility of an involuntary conversion *during liquidation* come to its attention." *Id.* at 376 (emphasis added).

In *Towanda* nonrecognition followed the extension of the sale or exchange definition since the fire loss occurred during the 12-month period following adoption of a plan of complete liquidation.

14. *Kent Mfg. Corp. v. Commissioner*, 288 F.2d 812 (4th Cir. 1961) (disallowing § 337(a) treatment where both the fire and the settlement took place prior to the adoption of a plan of liquidation).

15. Rev. Rul. 64-100, *revoking* Rev. Rul. 56-372, 1964-1 CUM. BULL. 130.

16. Nonrecognition is available only if the sale or exchange takes place following the adoption of a plan of liquidation or on the same day. See note 10 *supra* and note 31 *infra*.

17. *Id.* Not only must the sale or exchange take place after adoption of a plan of liquidation or on the same day, but it must follow within 12 months of the adoption of such a plan for the corporation to utilize § 337's nonrecognition provisions.

18. Compare (fire cases) *Central Tablet Mfg. Co. v. United States*, 481 F.2d 954 (6th Cir. 1973), *rev'g* 339 F. Supp. 1134 (S.D. Ohio 1972); *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968); *Towanda Textiles, Inc. v. United States*, 180 F. Supp. 373 (Ct. Cl. 1960), *with* (explosion case) *Kent Mfg. Corp. v. Commissioner*, 288 F.2d 812 (4th Cir. 1961), *and with, e.g.,* (condemnation cases) *Covered Wagon, Inc. v. Com-*

or exchange may occur without advance warning to the owner or determination of the amount of compensation.<sup>20</sup> However, in the case of an involuntary conversion by destruction, no actual passage of title occurs. Moreover, even if an insurance claim is considered a form of property to which title can be deemed to have passed, the basic questions essential to a completed sale—liability and coverage—are generally unanswered immediately following the destruction.<sup>21</sup>

In trying to determine when the sale or exchange resulting from an involuntary conversion by destruction occurred, both the Internal Revenue Service and the courts treated the conversion as a true sale.<sup>22</sup> The Internal Revenue Service, in a revision of a revenue ruling which allowed involuntary conversions to be considered as "sales or exchanges," made it clear that the date on which involuntarily converted property is treated as sold or exchanged for purposes of section 337(a) should be the date of the involuntary conversion.<sup>23</sup> In *United States v. Morton* the Eighth Circuit disregarded this contention and held that the sale was not completed until the policy proceeds were "determined and made available."<sup>24</sup> In reaching this decision, the court stated that any sale or exchange entails the receipt of valuable consideration for the article sold or exchanged.<sup>25</sup> Applying this rule to the salient facts, the court reasoned that mere conversion of a tangible asset into a chose in action against an insurance company did not constitute a completed sale or exchange because the receipt of consideration, the policy proceeds, remained contingent upon the insurer's investigation of the claim.<sup>26</sup> Since the corporation was allowed to negotiate the sale of its assets before adopting a plan of liquidation, the *Morton* court reasoned the same leeway should be extended

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missioner, 369 F.2d 629 (8th Cir. 1966); *Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285 (10th Cir. 1969), *cert. denied*, 397 U.S. 987 (1970).

For excellent analyses of the differing criteria employed in determining the date of the sale or exchange by destruction see Kovey, *supra* note 6, at 261; COMMENT, *supra* note 6; Recent Decision, *supra* note 6.

19. Rev. Rul. 59-108, 1959-1 CUM. BULL. 72. See also Kovey, *supra* note 6, at 260-61.

20. State laws allowing appeals from condemnation decisions may delay the date of the sale or exchange. Thus in *Mountain Water Co.*, 35 T.C. 418 (1960), *appeal dismissed* (9th Cir.), *acquiesced in*, 1961-1 CUM. BULL. 4, the date when the sale or exchange occurred was the date when the corporation decided not to appeal the condemnation action.

21. The Government persistently argued in the *Central Tablet* case that the sale was complete, that questions of liability and coverage were unimportant, and that the destruction of insured property triggered the obligation of the insurer, even if the insured was required by the insurance contract to meet other responsibilities before receipt of the insurance proceeds. Brief for Government at 16, *Central Tablet Mfg. Co. v. United States*, 481 F.2d 954 (6th Cir. 1973); Brief for Government at 17-20, *Central Tablet Mfg. Co. v. United States*, 417 U.S. 673 (1974), reprinted in 6 LAW REPRINTS TAX SERIES No. 6, at 59-62 (1974). See also Kovey, *supra* note 6, at 261.

22. *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968); *Central Tablet Mfg. Co. v. United States*, 339 F. Supp. 1134 (S.D. Ohio 1972); *Kinney v. United States*, 74-1 U.S. Tax Cas. ¶ 9140 (N.D. Cal. 1972); Rev. Rul. 64-100, 1964-1 CUM. BULL. 130.

23. Misc. Announcement 525, *revising* Rev. Rul. 64-100, and Misc. Announcement 248, reprinted in J. MERTENS, 1961-65 RULINGS 248.

24. 387 F.2d 441, 448 (8th Cir. 1968), holding that where a corporation using the cash basis of accounting suffered fire loss, within two months adopted plan of liquidation, and the next month settled with insurer, § 337 allowed nonrecognition of any resulting gain.

25. *Id.* at 447-48.

26. *Id.*

to a corporation which had suffered destruction of corporate assets.<sup>27</sup> Morton, a cash basis accounting corporation, was held not to have completed the sale until the insurance proceeds were received. The result might have been different however, if the corporation had utilized the accrual method of accounting. The district court in *Central Tablet* established a two-pronged test for such taxpayers, holding that the sale was complete for an accrual basis taxpayer when (1) the right to receive the income became fixed, and (2) the amount of the proceeds to be received could be determined with reasonable accuracy.<sup>28</sup>

The Sixth Circuit in *Central Tablet* was concerned with the possible unfair advantages which could attach to a corporation suffering involuntary conversion of its assets.<sup>29</sup> Moreover, the court stated that Congress had afforded relief in such instances with the enactment of section 1033,<sup>30</sup> providing for nonrecognition of gains from insurance proceeds employed to replace destroyed property within a stipulated time. Thus, the court reasoned that Congress intended the benefits of section 337 to extend only to corporations which had already adopted a plan of liquidation.<sup>31</sup> The court concluded with a reaffirmation of the principle that statutes granting tax privileges, exemp-

27. The Regulations provide that an executory contract to sell is unlike a contract of sale, Treas. Reg. § 1.337-2(a) (1974), "thus implying that the former may precede the adoption of the [liquidation] plan so long as the sale itself occurs within the prescribed period." Bittker & Eustice, *supra* note 10, at 252. See also Kovey, *supra* note 6, at 260.

28. 339 F. Supp. at 1138. The Government attempted to distinguish *Morton* in the district court since *Central Tablet* was an accrual basis taxpayer. The Government contended that since the right to the income was fixed, the gain had accrued before the plan of liquidation was adopted. The court, utilizing the two-pronged test, held that no accrual had taken place before the adoption of the plan since (1) no right to receive income was fixed: "And even if it were possible to conclude that liability was at some point impliedly admitted, there is insufficient evidence in the record to determine at what point in time such admission occurred." *Id.* at 1139, and (2) the amount of proceeds could not be determined with reasonable accuracy: "[S]ubstantial discrepancies existed between the initial offers made by the insurance companies, the maximum permissible insurance coverage, and the amounts ultimately negotiated." *Id.*

This two-pronged test has been formalized by Treas. Reg. § 1.451-1(a) (1971) which provides in pertinent part: "Under an accrual method of accounting, income is includable in gross income when [1] all the events have occurred which fix the right to receive such income and [2] the amount thereof can be determined with reasonable accuracy."

For a detailed analysis of accrual accounting procedures, their relation to the issue in *Central Tablet*, and a reaffirmation of the district court's decision see the dissenting opinion in *Central Tablet*, 417 U.S. 673 (1974). See generally 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 12.65 and p. 236 (1974 rev.).

29. 481 F.2d at 960.

30. INT. REV. CODE OF 1954, § 1033.

31. 481 F.2d at 960. This statement is subject to qualification. If on the day of the condemnation action the corporation adopts a plan of complete liquidation, it may avail itself of the benefits of § 337 even though the plan is adopted following the passage of title which constitutes the sale or exchange. This result is possible because of the wording of § 337(a): "If . . . a corporation adopts a plan . . . and . . . within the 12-month period beginning on the date of the adoption of such plan, all of the assets are distributed . . . then no gain . . . shall be recognized . . . from the sale . . . by it of property within such 12-month period." The involuntary conversion would fall "within such 12-month period." This result would equally follow the adoption of a plan on the same day as a destruction by fire.

This result could also be achieved by adoption of a contingent plan of liquidation conditioned on involuntary conversion of a percentage of the corporate assets, or adoption of a conditional liquidation authority vested with the directors. See Recent Decision, *supra* note 6, at 674.

tions, deferments, or deductions must be strictly construed.<sup>32</sup>

The Eighth Circuit in *Morton* addressed the Government's contention that the holding period cases supported the conclusion that the date of the destruction was the date of the sale or exchange.<sup>33</sup> It is well settled that in determining the holding period of destroyed property in the ascertainment of long- or short-term capital gain or loss consequences that the date of destruction is the date of termination of the holding period.<sup>34</sup> Responding to this argument, the Eighth Circuit recognized that the cases were sound, but dismissed any analogy by stating: "[The cases] appear to be of limited relevance in determining when a sale or exchange has taken place in the event of an involuntary conversion . . . ."<sup>35</sup>

### III. CENTRAL TABLET MANUFACTURING CO. V. UNITED STATES

The United States Supreme Court, resolving the conflict between the Sixth and the Eighth Circuits, held that the date of the sale or exchange of the assets, for section 337 purposes, is the date of the involuntary conversion by destruction. This determination, affecting both cash and accrual basis taxpayers, eliminates bothersome technical considerations which could have led to a situation similar to the *Court Holding-Cumberland* confusion.<sup>36</sup>

The Court carefully considered the legislative history of section 337 and concluded that the statute was not enacted to eliminate "double taxation" but to "eliminate the formalistic distinctions [between corporate and shareholder ownership] recognized and perhaps encouraged by the decisions in *Court Holding* and *Cumberland*."<sup>37</sup> The Court's construction of the legislative history found support in a 1959 House Advisory Group report which indicated that section 337 was not to extend to involuntary conversions preceding the adoption of a plan of liquidation.<sup>38</sup> The Advisory Group, however, suggested that section 337(a) treatment be extended to all involuntary conversions and that a corporation have sixty days in which to adopt a plan of liquidation following the involuntary conversion.<sup>39</sup> The Court said

32. 481 F.2d at 960; *see, e.g.*, *Elam v. Commissioner*, 477 F.2d 1333 (6th Cir. 1973).

The provisions of § 337 definitely make it prey for the operation of this principle of strict construction. "Although most nonrecognition provisions merely postpone the tax by providing for a carryover of the taxpayer's original basis, section 337(a) eliminates completely the tax on any gain from a liquidation sale or exchange. Therefore, the provision gives what is in effect an exemption from any tax at the corporate level for all sales made within twelve months pursuant to a plan of complete liquidation." Recent Decision, *supra* note 6, at 667.

33. 387 F.2d at 446.

34. *Rose v. United States*, 229 F. Supp. 298 (S.D. Cal. 1964); *Steele v. United States*, 52-2 T.C. ¶ 9451 (S.D. Fla. 1952).

35. 387 F.2d at 446.

36. *See* notes 7-9 *supra* and accompanying text.

37. 417 U.S. at 682.

38. *Hearings before the House Committee on Ways and Means on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code*, 86th Cong., 1st Sess. 532 (1959).

39. *Id.* The Court stated: "It is true that this recommendation was made before the Internal Revenue Service had recognized a casualty as a 'sale or exchange,' within the language of § 337(a), . . . . Nonetheless, the Advisory Group clearly recognized that even if the involuntary conversion were a 'sale or exchange,' § 337(a) did not reach

that since Congress had not disclosed an intent to permit a corporation to liquidate after a casualty and obtain nonrecognition benefits, the policy, if desirable, "is for the Congress, not the courts, to effectuate."<sup>40</sup>

The Court dismissed the taxpayer's efforts to draw an analogy between the involuntary conversion by destruction and a true sale.<sup>41</sup> Relying on their determination that nothing in the purpose of section 337 dictated the extension of its benefits to preplan situations, the Court stated: "With a fire loss, the obligation to pay arises upon the fire. Unlike an executory contract to sell, the casualty cannot be rescinded. . . . [T]he fundamental contractual obligation that precipitates the transformation from tangible property into a chose in action consisting of a claim for insurance proceeds is fixed by the fire."<sup>42</sup> This analysis concluded with a reaffirmation of the principle that the extent of gain need not be known for the completion of a sale.<sup>43</sup>

The Court accepted the Government's analogy between destruction cases and condemnation cases, recognizing that a distinction made between the two for section 337 purposes would favor the casualty taxpayer over the condemnation taxpayer by granting the casualty taxpayer an option on section 337 benefits.<sup>44</sup> The Court also upheld the Government's contention that the holding period cases were analogous to the section 337 sale or exchange date. The Court thought it "anomalous" that the sale for section 337 purposes could take place after the termination of the holding period for capital gain or loss purposes since the basis for the termination of the holding period was that the destruction was equivalent to a sale.<sup>45</sup> The Court may also have desired to limit any further growth of differing judicial definitions attaching to the term "sale."

The dissent adopted the taxpayer's analogy between a true sale and a section 337 "sale" by conversion and gave only lip service to the majority's

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the conversion that occurred prior to the adoption of the plan of liquidation . . . ." 417 U.S. at 689 n.9.

40. *Id.* at 690. See, e.g., *Boehm v. Commissioner*, 326 U.S. 287 (1945).

41. 417 U.S. at 684-86; see Comment, *supra* note 6; Comment, *Involuntary Conversions and Section 337 of the Internal Revenue Code*, 31 WASH. & LEE L. REV. 417 (1974). In an attempt to analogize the involuntary conversion by fire to a true sale of property, the corporation had contended that the fire was only one event of many—the filing of proofs of claim, negotiations, acceptance and payment—before completion of the sale. Brief for Petitioner at 5, LAW REPRINTS, *supra* note 21, at 29. See also note 21 *supra* (Government's position).

42. 417 U.S. at 685.

43. *Id.* at 685-86. In *Burnet v. Logan*, 283 U.S. 404 (1931); the Court held that the taxpayer had completed a sale when part of the consideration was an annual payment based on production under a mineral lease. The lease did not require production of maximum or minimum tonnage, thereby making the amount of the annual payments uncertain.

44. 417 U.S. at 687. See text accompanying notes 19-21 *supra*. The dissenters agree in principle with the date of the passing of title in condemnation cases as the date of the sale or exchange for § 337 purposes, but distinguish the majority analogy to an involuntary conversion by destruction with: "The taking vests title in Government, the condemnee is deprived of his property and he is *certain to recover* at least the *fair market value* estimated by the Government." 417 U.S. at 701 (emphasis added). Thus the dissent reconciles the settled law in condemnation cases with their test for determining the date of sale. Both the right to receive income and the amount of proceeds are essential to the determination and both are known in condemnation cases. See note 28 *supra* and accompanying text.

45. 417 U.S. at 689. *But see* Comment, *supra* note 6, at 1213 n.55. See text accompanying notes 33-35 *supra*.

other arguments. The dissent looked to "settled law" for its contention that no sale or exchange could occur with an accrual basis taxpayer until the taxpayer had a "clear right to the income, and the [amount of the proceeds was] . . . ascertainable within reasonable limits."<sup>46</sup> In so distinguishing between accrual and cash basis taxpayers, the dissent's reasoning would open a Pandora's box of mischief. The dissent's position that accrual accounting procedures should be utilized to determine the date of the sale or exchange would allow cash basis taxpayers a longer period in which to adopt a plan of liquidation for a section 337 shield.<sup>47</sup> In addition, the adoption of any date other than the date of destruction would consume valuable court time in determining the exact date when the sale occurred, as demonstrated by cases preceding *Central Tablet*.<sup>48</sup>

If the date were not conclusively set, the potential for confusion would be great. The Internal Revenue Service can require a taxpayer to use the accounting method most likely to reflect income,<sup>49</sup> and a cash basis taxpayer required to use the accrual method might be subject to either the *Morton* test for cash basis taxpayers<sup>50</sup> or the settled test for accrual basis taxpayers.<sup>51</sup> The distinction between the two types of taxpayers would inject a new trap for the unwary "into a statute passed to remove unequal tax treatment resulting from formalities."<sup>52</sup> Adoption of the dissent's two-fold test of accrual of income<sup>53</sup> would have led to problems reminiscent of the *Court*

46. 417 U.S. at 694.

47. Since the Eighth Circuit in *Morton* held that gain would not be recognized for a cash basis taxpayer until the proceeds were available, 387 F.2d at 448, the cash basis taxpayer could adopt a liquidation plan after settlement and still avail himself of § 337 benefits. Under accrual principles according to the dissent the gain would be recognized upon settlement. See note 28 *supra* and accompanying text.

Neither the Sixth Circuit nor the Supreme Court majority gave serious consideration to these accounting procedures. In fact, the Court recognized that the corporation might ultimately be taxed on gain in the tax year following that in which the fire occurred because of its accounting procedures, even though that was the year in which gain from all other "sales and exchanges" would escape recognition under the provisions of § 337. 417 U.S. at 677 n.4.

The Court dissent implies that liability itself was in issue, rather than the amount of liability, so that there was no right to receive income, *id.* at 696; however, this point is of no consequence in the analysis utilized by the majority.

48. See, e.g., *Central Tablet Mfg. Co. v. United States*, 481 F.2d 954 (6th Cir. 1973), *rev'g* 339 F. Supp. 1134 (S.D. Ohio 1972); *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968).

One writer has made the equitable suggestion that a court could conclude for the purpose of allowing § 337 nonrecognition that "where the major part of a corporation's assets are taken involuntarily, either by destruction or by condemnation, liquidation is inevitable and that the destruction or condemnation constitutes, for all practical purposes, the informal adoption of a plan of liquidation." Comment, *supra* note 6, at 1224.

49. INT. REV. CODE OF 1954, § 446(b); cf. *Family Record Plan, Inc. v. Commissioner*, 309 F.2d 208 (9th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963) (unaccrued gain should not continue to appear as corporate asset); *Commissioner v. Kuckenber*, 309 F.2d 202, 204-06 (9th Cir. 1962), *cert. denied*, 373 U.S. 909 (1963); *Bittker & Eustice*, *supra* note 10, at 259-61.

50. Tax is due when proceeds are "determined and made available," 387 F.2d at 448. See text accompanying note 24 *supra*.

51. Tax is due when right to receive income is fixed and amount of proceeds can be determined, *Central Tablet Mfg. Co. v. United States*, 339 F. Supp. 1134, 1138 (S.D. Ohio 1972). See note 28 *supra* and accompanying text. See, e.g., *United States v. Anderson*, 269 U.S. 422, 441 (1926); *Dixie Pine Prods. Co. v. Commissioner*, 320 U.S. 516, 519 (1944).

52. Comment, *supra* note 6, at 1213 n.54.

53. 417 U.S. at 696-97; see note 28 *supra* and accompanying text.



*Holding-Cumberland* confusion of two decades ago.<sup>54</sup> That such results should flow from a statute which was enacted to end such substantive technicalities is inconceivable.

The Court dealt thoroughly with all major contentions which have been presented by taxpayers seeking section 337 benefits who have suffered preplan involuntary conversions by destruction.<sup>55</sup> Nevertheless, the Court did not expressly overrule *United States v. Morton*,<sup>56</sup> which is regrettable since distinguishing circumstances may give it an occasional resurrection.

#### IV. CONCLUSION

The five-Justice majority holding that the date of the destruction is the date of the sale or exchange for section 337 purposes effectively avoided troublesome technical distinctions between accrual and cash basis corporate taxpayers. The decision is firmly grounded on a close analysis of the legislative history of the statute coupled with policy considerations against unequal tax treatment and wasted court time. Moreover, the Court's refusal to distinguish between accrual and cash basis taxpayers prevents possible future situations in which cash basis corporations might have argued that their method of accounting allowed them a longer time than accrual taxpayers in which to elect to adopt a plan of liquidation.<sup>57</sup>

In sum, after considering all technical and policy considerations, the Court followed traditional tax-benefit principles and refused to extend the benevolent arm of the statute to corporations standing within the shadow of the already judicially extended provisions of section 337.

*Billy F. Hicks*

### Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.— Tipper and Tippee Liability Under Rule 10b-5

Merrill Lynch, Pierce, Fenner & Smith, Inc. was engaged as the underwriter for a proposed Douglas Aircraft Corporation offering. Douglas had issued a statement indicating earnings of 85¢ per share for the first five months of its fiscal year. Subsequently, Merrill Lynch was advised by Douglas that substantially lower earnings than had been estimated were expected. Shortly thereafter, Merrill Lynch, knowing the information was not yet public, disclosed this fact to certain customers who promptly sold from

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54. See text accompanying notes 7-9 *supra*.

55. See notes 19-35 *supra* and accompanying text. These contentions are analyzed in four recent articles, written in the wake of the Sixth Circuit Central Tablet decision: KOVEY, *supra* note 6; Comment, *Involuntary Conversions and Section 337 of the Internal Revenue Code*, 31 WASH. & LEE L. REV. 417 (1974); Comment, *supra* note 6; Recent Decision, *supra* note 6; three of which are cited in the course of the Court's opinion. 417 U.S. at 682, 686, 689.

56. 387 F.2d 441 (8th Cir. 1968).

57. See notes 28, 50 *supra*.

existing positions or made short sales. When the information was subsequently made public, the price of the stock made a sudden and severe drop.<sup>1</sup> Plaintiffs brought an action under section 10(b) of the Securities Exchange Act of 1934<sup>2</sup> and SEC rule 10b-5<sup>3</sup> on behalf of themselves and all others who had purchased Douglas stock during the period that defendants traded without disclosing. Defendants moved for judgment on the pleadings, claiming that plaintiffs had failed to state a claim upon which relief could be granted. The motion was denied and defendant appealed. *Held, affirmed*: The conduct of Merrill Lynch and its customers violated antifraud provisions of the securities laws, and both were liable in damages to all persons who, during the same period, purchased the company's stock on the open market without knowledge of the material inside information. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

### I. CIVIL LIABILITY UNDER RULE 10b-5

The private right of action under section 10(b) and rule 10b-5 was developed in *Kardon v. National Gypsum Co.*,<sup>4</sup> and has been continuously upheld.<sup>5</sup> The elements of the private cause of action as originally developed were materiality, *scienter*, causation, reliance, and privity.<sup>6</sup> These com-

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1. In proceedings before the SEC, Merrill Lynch was found to have violated the antifraud provisions of the federal securities laws. A settlement was made whereby Merrill Lynch suspended activities at its New York Institutional Sales Office for a period of twenty-one days and West Coast Underwriting Office for fifteen days. Additionally, employees, directors, and officers involved were suspended and censured. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 (1968). Tippees were also found guilty of a rule 10b-5 violation. *Investors Management Co.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,163 (1971).

2. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970):

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

3. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973):

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

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

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

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

4. 69 F. Supp. 512 (E.D. Pa. 1946).

5. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). Neither the statute nor the rule specifically mention private right of action, and there is little information regarding congressional intent. Arguably, the intent expressed by one of the draftsmen of section 10(b) was to provide authority for the Commission to deal with new manipulative devices, not private plaintiffs. *See Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720*, 73d Cong., 2d Sess. 115 (1934). The private right is inferred from the statute because the courts must be able to adjust their remedies to grant the necessary relief whenever a federally protected right has been invaded. *Fratt v. Robinson*, 203 F.2d 627, 632-33 (9th Cir. 1953); *cf. Bell v. Hood*, 327 U.S. 678, 684 (1946).

6. 3 L. LOSS, *SECURITIES REGULATION* 1763 (2d ed. 1961).

ponents were adopted from the common law action for deceit<sup>7</sup> where their purpose was to define the nature of the acts which would give rise to the action, limit the class of plaintiffs, and limit the suability of defendants.<sup>8</sup> While some of these particular elements have weakened as to rule 10b-5 actions, the three reasons given for their existence have continued as important factors in defining and limiting civil liability under rule 10b-5.

The specific nature of the acts involved in a rule 10b-5 violation is not significant, if defendant's misrepresentation or omission is material and contains some element of *scienter*.<sup>9</sup> The test of materiality is whether a reasonable man would attach importance to the fact misrepresented in determining his course of action in the transaction in question.<sup>10</sup> However, this definition should not imply that the test of materiality is a conservative one. A material misrepresentation or omission involves any fact which affects the desire of investors to buy, sell, or hold a corporation's securities, and is not merely that which concerns a corporation's earnings.<sup>11</sup> In addition to materiality, some type of *scienter*, or state of mind of a defendant at the time of the material omission or misstatement, in terms of intent, purpose, knowledge, or belief, has generally been required to frame a cause of action. Common law *scienter*, that is, intent to deceive, to mislead, or to convey a false impression, is clearly not required, although the present state of the law is in flux regarding what degree of *scienter* is necessary for rule 10b-5 liability.<sup>12</sup>

To obtain relief in a private action the plaintiff was required under a strict reading of the elements of the cause of action to prove that his injury resulted from reliance upon defendant's material misrepresentation or omission, that the defendant's acts caused the alleged injury, and that there was privity of contract between plaintiff and defendant.<sup>13</sup> These limitations upon recovery proved unduly restrictive, especially in light of the structure and operation of modern-day securities markets where the vast majority of securities transactions occur, and the nature and purpose of rule 10b-5 to secure fair dealing in the securities markets by promoting full disclosure of and equal access to material information. As a result, these requirements have been weakened. First, although non-disclosure of material inside information before trading is a violation of rule 10b-5, a requirement of actual reliance by plain-

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7. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 9.2 (1973).

8. 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5, § 8.1 (1973) [hereinafter cited as BROMBERG, FRAUD].

9. Rule 10b-5 prohibits *all* fraudulent schemes in connection with the purchase or sale of securities, whether they are of the "garden type variety of fraud" or are a unique form of deception. Novel or atypical methods do not provide immunity from the securities laws. *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967). Non-disclosure is merely one variety of fraud. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 198 (1963).

10. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965).

11. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

12. Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482 (1970). The Second Circuit apparently requires "a knowledge of falsity or reckless disregard for the truth standard." *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 356 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). Other circuits may allow an action where the defendant's misrepresentation or omission was negligent. *See, e.g., City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 229-30 (8th Cir. 1970); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 102 (N.D. Ill. 1967).

13. *See* note 8 *supra* and accompanying text.

tiff in such a case would make private recovery virtually impossible. There would simply be no way for a plaintiff to know that he was relying upon a misrepresentation that he was unaware had been made.<sup>14</sup> The courts have responded to this situation by allowing reliance to be presumed from the materiality of the non-disclosure.<sup>15</sup> The causation requirement has also been weakened, especially when the transactions involved in the rule 10b-5 violation occur on anonymous exchanges.<sup>16</sup> In the absence of privity, where it is impossible to distinguish those who purchased or sold in reliance upon the defendant's act, the causal link between defendant and plaintiff could not be established.<sup>17</sup> The courts have continued to treat causation as necessary,<sup>18</sup> but in recognition of the anomaly that would be created by its strict application, the causation required for rule 10b-5 civil liability has been lessened to what is called "causation-in-fact," that is, causation implied from the materiality of the misrepresentation or non-disclosure.<sup>19</sup> The early requirement of privity, carried over from the common law and applied to rule 10b-5 by *Joseph v. Farnsworth Radio & Television Co.*,<sup>20</sup> has proved to be an unmanageable relic of a less developed economy, and thus has not survived the growth of rule 10b-5. As a result of the weakening of privity, third parties to the sale or purchase involved in a rule 10b-5 violation have been found liable in damages. Such liability has been found for participating in or aiding and abetting a scheme to defraud,<sup>21</sup> giving knowing assistance to the purchaser or seller involved in the fraudulent scheme,<sup>22</sup> and being in control of a purchaser or seller who actively perpetrated the violation.<sup>23</sup> The courts had not found civil liability for damages as to those who merely tipped material inside information to others who subsequently bought or sold,<sup>24</sup> and

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14. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 356 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). Reliance is defined in terms of whether the misrepresentation or non-disclosure is a substantial factor in determining the course of conduct which results in plaintiff's loss. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965). No conscious reliance is necessary if the materiality of the violation is such that it would influence the plaintiff to act differently than if there had been no misrepresentation or non-disclosure. *Id.* at 463.

15. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 356 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965).

16. BROMBERG, FRAUD § 8.7.

17. Comment, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 677 (1965).

18. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965).

19. *See Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

20. 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952). At common law privity limited the defendant's liability because the courts presumed that there could be no remote causation or reliance. Such a requirement today, when the vast majority of securities transactions occur on anonymous markets, would serve to eliminate personal liability almost entirely. *See Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967); *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967); *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962).

21. *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967).

22. *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963).

23. *Lorenz v. Watson*, 258 F. Supp. 724 (E.D. Pa. 1966).

24. Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications*, 22 Sw. L.J. 731 (1968); Comment, *Liability of 'Tippees' under Rule 10b-5 of the Securities Exchange Act of 1934*, 30 WASH. & LEE L. REV. 527 (1973).

in only one case had the courts found civil liability as to those who traded on the material inside information that had been tipped to them.<sup>25</sup>

## II. TIPPERS, TIPPEES, AND RULE 10b-5

"Tipping" is the selective disclosure of material inside information for trading or other personal purposes.<sup>26</sup> Transmitting such information for purely corporate reasons, such as to an underwriter who is preparing a securities offering for the corporation, is generally not considered tipping, if the transmitter is reasonably certain that the information will not be used for other than business purposes.<sup>27</sup> Transmitting material inside information as a means of touting the corporation's stock,<sup>28</sup> protecting preferred clients,<sup>29</sup> including friends in a rising market,<sup>30</sup> or other similar purposes, has been labeled tipping, and has been held to violate rule 10b-5.

The tipper violates rule 10b-5 because tipping material inside information frustrates the policy of equal access to all investors to such facts.<sup>31</sup> Liability has been imposed on the theory that persons possessed with material inside information have a fiduciary duty toward purchasers on the open market.<sup>32</sup> In *Cady, Roberts & Co.*<sup>33</sup> the SEC stated that such a duty was breached by trading with undisclosed inside information. In *SEC v. Texas Gulf Sulphur Co.*,<sup>34</sup> the first case to hold that tipping, by itself, was a violation of rule 10b-5, the court ruled that giving outsiders confidential information not available to shareholders and the public at large was a violation of the tipper's corporate trust.<sup>35</sup> Another rationale for finding a rule 10b-5 violation by the tipper rests upon concepts of participation, aiding-abetting, and conspiracy.<sup>36</sup> Under this theory the tip is not illegal per se; rather, the action is illegal because it is part of a fraudulent scheme of trading with undisclosed inside information.<sup>37</sup> If this concept were strictly applied, the tipping violation would be limited to those instances where the tippee's actions also violated the rule;

25. *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967).

26. BROMBERG, FRAUD § 7.5(2).

27. *Id.*

28. *See, e.g., SEC v. Glen Alden Corp.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,280 (S.D.N.Y. 1968).

29. *See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 (1968).

30. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

31. *Id.* at 850.

32. *See Whitney, Section [sic] 10b-5: From Cady Roberts to Texas Gulf: Matters of Disclosure*, 21 BUS. LAW. 193, 195-97 (1965); *cf. Mosser v. Darrow*, 341 U.S. 267 (1951).

33. 40 S.E.C. 907 (1961).

34. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

35. *Id.* at 850 n.10.

36. BROMBERG, FRAUD § 7.5. The lines which separate participation, aiding-abetting, and conspiracy are indistinct and the ideas often overlap. Participation implies the most direct involvement. *See Sprayregen v. Livingston Oil Co.*, 295 F. Supp. 1376 (S.D.N.Y. 1968). Aiding-abetting suggests that the principals are doing the significant things while the aider-abettors are assisting or encouraging them in subordinate ways. *See, e.g., Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). Conspiracy in rule 10b-5 actions requires overt acts in furtherance of a common plan into which defendants entered with intent to deceive and defraud the plaintiff. *Robinson v. Difford*, 92 F. Supp. 145, 149 (E.D. Pa. 1950).

37. BROMBERG, FRAUD § 7.5.

however, one case has stated that merely making the information available with the intent that it be used for the tippee's personal benefit is sufficient to constitute a violation, even though the tippee does not act.<sup>38</sup>

Civil liability for tipping had not previously been found. However, in the *Texas Gulf* remedy action<sup>39</sup> the Second Circuit upheld an order for the tipper to make restitution to the corporation for the profits derived by his tippees. The court stated that restitution to the corporation would be subject to a "higher equity" in those personally injured by the tipper and tippees,<sup>40</sup> thus indicating judicial recognition of a private right against tippers. Otherwise, the closest decision in a private action was *Ross v. Licht*,<sup>41</sup> where the court held insider defendants liable in damages for their actions in a complex scheme to defraud certain shareholders of the corporation, part of which involved disclosure to tippees of planned public and private offerings.

Trading by tippees was found to be a violation of rule 10b-5 in *Cady, Roberts & Co.*<sup>42</sup> The SEC determined that the violation rested upon the existence of a relationship giving access, directly or indirectly, to information intended to be available only for corporate purposes, and the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing.<sup>43</sup> The access portion of the test created by *Cady* makes tippees equivalent to corporate insiders insofar as their use of inside information, even though the tippee may not strictly be termed an insider under the definition in section 16(b) of the Securities Exchange Act.<sup>44</sup> Furthermore, the access requirement does not mean that the tipper must occupy a special relationship with a corporate source. Rather, the test is met if the tippee receives information which he has reason to know emanates from a corporate source.<sup>45</sup> Liability for tippee trading was found in *Ross v. Licht*,<sup>46</sup> where the court held that even if the tippees were not insiders, they were subject to the same duty as insiders not to trade without disclosing the material inside information.<sup>47</sup>

Thus, tipper and tippee liability existed, if not strongly within prior case law, then certainly within the developing pattern of rule 10b-5 liability culminating in *Texas Gulf*. The authoritative establishment of liability and a determination of the extent of that liability remained to be decided.

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38. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 (1968). See also *SEC v. Glen Alden Corp.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,280 (S.D.N.Y. 1968). There is apparently no requirement that the tipper obtain any benefit from his tip to be considered an aider-abettor; however, as a practical matter, benefit to the tipper will strengthen the likelihood of finding participation, aiding-abetting, or conspiracy. See *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).

39. *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 1005 (1971).

40. *Id.* at 1308.

41. 263 F. Supp. 395 (S.D.N.Y. 1967).

42. 40 S.E.C. 907 (1961).

43. *Id.* at 912; see note 31 *supra* and accompanying text.

44. 15 U.S.C. § 78p(b) (1970). "Insider" is defined to include officers, directors, and beneficial owners of more than 10% of any class of equity security registered pursuant to the Securities Exchange Act.

45. *Investors Management Co.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,163 (1971).

46. 263 F. Supp. 395 (S.D.N.Y. 1967). See note 41 *supra* and accompanying text.

47. 263 F. Supp. at 410.

## III. SHAPIRO V. MERRILL LYNCH, PIERCE, FENNER &amp; SMITH, INC.

The decision in *Shapiro* was, as the court said, a "logical sequel to our prior decisions . . . ." <sup>48</sup> The court merely applied the underlying rationale of equal access to material information developed by prior rule 10b-5 decisions to impose civil liability as to tippers and tippees. If the scope of the rule was broadened in spite of attempts to remain within the bounds of prior decisions, then the court was forced to do so by the purpose behind the rule, which is to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information.

The court began its decision by rejecting the defendants' argument that *Texas Gulf* was inapplicable to a private action for damages. The court did not accept the contention that *Texas Gulf* was distinguishable because it was an action for injunctive relief brought by the SEC. Since the policy of equal access to material information should apply regardless of the remedy sought, the court ruled that a distinction on such grounds would frustrate the basic goals of the antifraud provisions of the securities acts. Secondly, the defendants argued that they owed no duty to disclose material inside information to those with whom they were not in privity. In eliminating this argument, the court stated that on anonymous exchanges a privity requirement would make a mockery of the disclosure rules and would frustrate the major purpose of the antifraud provisions, which is to insure the integrity and efficiency of the securities markets. Having disposed of these arguments, the court ruled that defendants owed a duty to all persons who purchased Douglas shares on the open market without knowledge of the material inside information which defendants possessed, and, furthermore, that defendants were liable in damages for breach of that duty. <sup>49</sup>

For tippers, civil liability arose merely by "recommending" securities while in possession of material inside information. Tippees were civilly liable under the *Cady, Roberts* theory <sup>50</sup> which made them subject to the same standard as insiders, even though as non-insider tippees they would have been unable to effect a full disclosure of the material information before trading. The court said that the mere inability to disclose would not excuse liability because the duty was to disclose or abstain from trading, and the tippees were perfectly capable of abstaining. Liability to all persons who purchased at the same time as tippees sold was rested upon the loosened causation requirements in *Affiliated Ute Citizens v. United States*, <sup>51</sup> where the Supreme Court required causation to be established upon a showing that material inside information was withheld in the presence of a duty to disclose that information. Here, the defendants were under a duty either to abstain from trading or to disclose the information to the investing public; therefore, breach of that duty established "causation-in-fact" as to those who purchased during the applicable time period.

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48. 495 F.2d at 235.

49. *Id.* at 237.

50. See note 43 *supra* and accompanying text.

51. 406 U.S. 128 (1972).

After finding defendants liable, the court remanded to the district court for the determination of facts bearing on the form of relief to be granted, including whether the action was to be maintained as a class action, the exact date of effective disclosure by Douglas, the extent to which the integrity of the market was undermined, and other similar questions related to the background of the rule violation. The court did not deal further with the aspect of damages, except to say that its decision favoring liability would not foreclose the possibility of limiting the extent of liability imposed on either class of defendant.

#### IV. CONCLUSION

While *Shapiro* recognized that the underlying rationale of section 10(b) and rule 10b-5 requiring equal access to material information for all persons trading on impersonal exchanges was not served by the common law notions of limiting liability, the case failed to recognize the danger of eliminating restraints upon access to the court. The two purposes of the private action, redressing private wrongs<sup>52</sup> and providing a means of enforcement,<sup>53</sup> are not served by allowing recoveries which are merely windfalls to plaintiffs whose injuries have resulted only from the fortuity of trading on the open market at the same time as a tippee. The significant factor in limiting the class of plaintiffs is no longer whether the plaintiff's injury has resulted from any particular relationship between defendant's malfeasance and plaintiff's trade, but, rather, the amount of market activity within the significant time frame.<sup>54</sup> Thus, in attempting to assure more equal investment opportunity and more equal access to information, the court in *Shapiro* has granted a small degree of assurance of equal investment results by insuring investors against their own bad deals.<sup>55</sup> Although the court indicated a willingness to limit the amount of damages, the nexus between violation and compensation will not be strengthened. Of course, if damages are not limited in some way, these defendants will be subject to an enormous judgment,<sup>56</sup> but if damages are limited significantly, each plaintiff's recovery may be so small as to make it unworthwhile to have brought suit. The private damage action is a well-settled principle in securities fraud; however, in cases similar to *Shapiro* the appropriate question is whether this well-settled principle serves the originally intended purpose.

*David Allen Weatherbie*

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52. *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

53. *Herpich v. Wallace*, 430 F.2d 792, 804 (5th Cir. 1970); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 547 (2d Cir. 1967).

54. Note, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.: The Tippee of the Rule 10b-5 Iceberg*, 5 RUTGERS-CAMDEN L.J. 256, 279 (1974). "[C]ourts have given inadequate attention to damages when making sweeping statements regarding the elements which must be proven in order to sustain a private action under Rule 10b-5." Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423 (1968).

55. BROMBERG, *FRAUD* § 12.2; Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1069 (1969).

56. 495 F.2d at 242.