Availability of Judicial Review for the Government Contractor, The

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NOTES

The Availability of Judicial Review for the Government Contractor

On May 14, 1956, the appellant entered into a contract with the government to manufacture felt canteen covers. Specimens of the covers tested by the government were found to be substandard, and the government agreed to accept the contract at a small price reduction.[1] Five years after the acceptance of the contract the appellant discovered that the government had tested the covers improperly. In accordance with the "disputes" clause[2] the appellant filed a claim with the contracting officer demanding (1) a refund of the price reduction and (2) an equitable adjustment for alleged increased costs of production. Both the contracting officer and the Armed Services Board of Contract Appeals (ASBCA) denied the claim. After exhausting the available administrative remedies the appellant filed suit in the Court of Claims six years and five months after the completion of the contract. The Court of Claims held that the appellant's claim was barred by the six year statute of limitations of the Tucker Act.[3]

The Court of Appeals, sitting *en banc*, affirmed, concluding that the cause of action first accrued no later than the date of final delivery of the disputed canteen covers, and that the statute of limitations was not tolled by the administrative hearings.[4] Because there was a conflict between the Second Circuit and the Third Circuit,[5] the Supreme Court granted certiorari. *Held, reversed and remanded*: If a claim filed by the contractor is a claim "arising under" the contract and therefore subject to administrative determination, his right to bring a civil action first accrues when the ASBCA finally rules on his claim. *Crown Coat Front, Inc. v. United States*, 386 U.S. 503 (1966).

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[1] The test the government used was set forth in the contract. The price modification agreed to was $.005 less per unit—a total of $270.01.

[2] The "disputes" clause common to all government contracts is as follows:

> Except as otherwise provided in this contract, any dispute concerning a question of fact arising under this contract which is not disposed of by agreement shall be decided by the Contracting Officer, who shall reduce his decision to writing and mail or otherwise furnish a copy to the Contractor. Within 30 days from the date of receipt of such copy, the Contractor may appeal by mailing or otherwise furnishing to the Contracting Officer a written appeal addressed to the Secretary or his duly authorized representative for the hearing of such appeals shall, unless determined by a court of competent jurisdiction to have been fraudulent, arbitrary, capricious, or so grossly erroneous as necessarily to imply bad faith, be final and conclusive; provided that if no such appeal is taken, the decision of the Contracting Officer shall be final and conclusive. In connection with any appeal proceeding under this clause, the Contractor shall be afforded an opportunity to be heard and to offer evidence in support of its appeal. Pending final decision of a dispute hereunder, the Contractor shall proceed diligently and in accordance with the Contracting Officer's decision.

32 C.F.R. § 7.103-12, § 597.103-12 (1966).

[3] Crown Coat Front, Inc. v. United States, 292 F.2d 290 (Ct. Cl. 1961), *aff'd*, 363 F.2d 407 (2d Cir. 1966), *rev'd and remanded*, 386 U.S. 503 (1967).

[4] Crown Coat Front, Inc. v. United States, 363 F.2d 407 (2d Cir. 1966), *rev'd and remanded*, 386 U.S. 503 (1967).

[5] Northern Metal Co. v. United States, 350 F.2d 833 (3d Cir. 1965) (the statute of limitations is tolled during the pending administrative proceedings).

Government Contract Procedure The bulk of the federal government's procurement of supplies and services is controlled by two regulations—The Armed Services Procurement Regulations (ASPR) and the Federal Procurement Regulations (FPR). The ASPR applies to all purchases and contracts made by the Department of Defense. A contracting officer, selected by the department head, is authorized to enter into contracts for supplies and services on behalf of the government. He is also authorized, pursuant to the changes clause found in all standard and customary government procurement contracts, to issue change orders concerning any modification in an existing contract which he feels is necessary.[6] The contractor is entitled to an equitable adjustment if the changes require an increased cost in production.

Through the standard "disputes" clause any dispute concerning a question of fact arising under the contract is to be resolved by a decision of the contracting officer.[7] A dispute may arise, for example, from the parties' inability to agree on the amount of an adjustment price. An actual breach of contract or failure of the government to perform any of its express obligations is outside the scope of the contract, and no remedy for such breach is provided in the contract itself.[8] The contractor may appeal the decision of the contracting officer after final determination by that officer[9] or upon failure of the officer to act.[10] The contractor has thirty days to appeal the contracting officer's decision to the ASBCA.[11] Judicial review will be granted only after the procedure of the particular

[6] The changes clause is as follows:

> The Contracting Officer may at any time, by a written order, and without notice to the sureties, make changes, within the general scope of this contract, in any one or more of the following: (i) drawings, designs or specifications, where the supplies to be furnished are to be specially manufactured for the Government in accordance therewith; (ii) method of shipment or packing; and (iii) place of delivery. If any such change causes an increase in the cost of, or the time required for, performance of this contract, an equitable adjustment shall be made in the contract price or delivery schedule, or both, and the contract shall be modified in writing accordingly. Any claim by the Contractor for adjustment under this clause must be asserted within 30 days from the date of receipt by the Contractor of the notification of change: *Provided, however,* That the Contracting Officer, if he decides that the facts justify such action, may receive and act upon this contract. Failure to agree to any adjustment shall be a dispute concerning a question of fact within the meaning of the clause of this contract entitled "Disputes". However, nothing in this clause shall excuse the Contractor from proceeding with the contract as changed.

32 C.F.R. § 7.103.2 (1966).

[7] Ripley v. United States, 223 U.S. 695 (1911); Kihlberg v. United States, 97 U.S. 398 (1878); Edwards v. United States, 163 F.2d 268 (9th Cir. 1947).

[8] Nagler Elec. v. United States, 368 F.2d 847 (Ct.Cl. 1966). See also Morrison, Knudson Co. v. United States, 345 F.2d 833 (Ct.Cl. 1965); Tertleing v. United States, 334 F.2d 250 (Ct.Cl. 1964); Specialty Assembly & Packing Co. v. United States, 298 F.2d 794 (Ct.Cl. 1962); Cosmopolitan Mfg. Co. v. United States, 297 F.2d 546 (Ct.Cl. 1962); Holton, Seeyle & Co. v. United States, 65 F. Supp. 903 (Ct.Cl. 1946); Austine Eng'r Co. v. United States, 88 Ct.Cl. 43 (1939). Cases which have held that the cause of action accrues when the administrative hearings are final are: Electric Boat v. United States, 297 U.S. 710 (1935); Clifton Prods., Inc. v. United States, 169 F. Supp. 511 (Ct.Cl. 1959); Art Center School v. United States, 142 F. Supp. 916 (Ct.Cl. 1956); Griffin v. United States, 77 F. Supp. 197 (Ct.Cl. 1948).

[9] Before the decision of the contracting officer becomes final it must be clearly communicated to the contractor. See Brister & Loester Lumber Corp. v. United States, 188 F.2d 986 (D.C. Cir. 1951).

[10] Brister & Loester Corp. v. United States, 188 F.2d 986 (D.C. Cir. 1951).

[11] See note 2 *supra.*

administrative agency has been followed.[12] Pending a decision of the administrative hearing the contractor is required to do the work according to the contract until completion.

The authority of the contracting officer and the appeals board to render final decisions is limited to questions of fact.[13] The contracting officer can decide questions of law where the determination is necessary in deciding the questions of fact, but the determination is not final as to any judicial hearing.[14] If a claim is found by the officer to involve only a question of law, the contractor can go directly to a court of law. In such cases the officer has the responsibility to determine the government's position on the law and the evidence.

Restrictive Nature of Government Contract Suits The ancient common law maxim "the king can do no wrong" prevented suits being brought against the federal government until the creation of the United States Court of Claims in 1855. Prior to this date claims against the government had to be settled by Congress. The Tucker Act, which was enacted in 1885, sets forth the claims which may be litigated, and imposes a six-year time limit for filing such claims.[15] It is now the basis of all contract claims, including both express and implied contracts, against the government in the district court and the Court of Claims.[16]

[12] *E.g.*, United States v. Holpuch, 328 U.S. 234 (1946); United States v. Blair, 321 U.S. 730 (1944); United States v. Peter Kiewitt Son's Co., 345 F.2d 879 (8th Cir. 1965); Allied Paint & Color Works v. United States, 309 F.2d 133 (2d Cir. 1962); Morrison-Knudsen Co. v. United States, 345 F.2d 833 (Ct.Cl. 1965); Henry E. Wylie Co. v. United States, 169 F. Supp. 249 (Ct.Cl. 1959).

[13] Jurisdiction of the board of appeals is limited in part to matters such as application of contract terms to equitable adjustments pursuant to the changes clause, determination of the existence of a changed condition when relief is provided in the contract, and provision for proper terms under which a termination settlement should be allowed. Boards are empowered to take and hear evidence and make findings of fact concerning such breaches of contract even though they lack the authority to express an opinion. The boards will take evidence necessary for them to determine whether the matter before them falls under their jurisdiction and will not refuse to hear the matter if it is a breach. See note 8 *supra* and note 14 *infra*. See also Huntington Steel Corp. v. United States, 153 F. Supp. 920 (S.D.N.Y. 1957); Atlantic Carriers Inc. v. United States, 131 F. Supp. 1 (S.D.N.Y. 1955); United States v. Wessel Duval & Co., 115 F. Supp. 678 (S.D.N.Y. 1953).

[14] See T.D. & S. Constr. Co. (1964) I.B.C.A. No. 401, 1964 B.C.A. No. 4154; Peter Kiewitt Son's Co. (1964) I.B.C.A. No. 405, 1964 B.C.A. No. 4141; Thomas King Martin (1963) A.S.B.C.A. No. 8181, 1963 B.C.A. No. 3732.

[15] The Tucker Act of March 3, 1887, 24 Stat. 505 (codified in scattered sections of 28 U.S.C.) was entitled "An Act to provide for the bringing of suits against the Government of the United States." Presently it reads:

> § 1346. United States as defendant.
> (a) The district courts shall have original jurisdiction, concurrent with the Court of Claims, of;
> (2) Any other civil action or claim against the United States, not exceeding $10,000 in amount, founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department or upon express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort.

28 U.S.C. § 1346(a)(2) (1966).

> § 2401. Time for commencing action against the United States.
> (a) Every civil action commenced against the United States shall be barred unless the complaint is filed within six years after the right of action first accrues. The action of any person under legal disability or beyond the seas at the time the claim accrues may be commenced within three years after the disability ceases.

28 U.S.C. § 2401(a) (1966).

[16] See note 15 *supra*. The act does not confer jurisdiction upon the court to hear tort claims, and special jurisdictional problems involving maritime contracts or disputes are governed by the Suits in Admiralty Act. 46 U.S.C. § 745 (1966). The act confers jurisdiction upon the Court of Claims to hear and dispose of claims without limitation as to amount, while it limits the jurisdiction of the district courts to under $19,000.

The "disputes" clause in government contracts declares that the parties to a contract agree that a decision of the ASBCA will be final and conclusive. Review of this decision will be granted only under certain circumstances. In 1951 in *United States v. Wunderlich,*[17] the Supreme Court limited the scope of judicial review to fraud. The Wunderlich Act,[18] resulting from that decision, expanded the scope to allow review when (1) the decision was fraudently determined or arbitrarily or capriciously made, (2) was so grossly erroneous as necessarily to imply bad faith in its rendition, or (3) unless it was not supported by substantial evidence. Apart from questions of fraud, determination of finality of questions of fact rests upon the consideration of the record before the department.[19]

The Statute of Limitations: A Seventy Year Old Problem In an action arising under the "disputes" clause of a contract[20] or where there is a breach,[21] a number of alternatives are present for determining when the cause of action accrues for limitation purposes.[22] In the past it was maintained that the cause of action accrued at the time of the actual breach. Support for this alternative was mainly the Supreme Court decision in *McMahon v. United States,*[23] a case, arising under the Suits in Admiralty Act and not under the Tucker Act, which held that the cause of action begins at the time of the seaman's injury. The second alternative was that the cause of action accrued, at the latest, at the completion or acceptance of the contract, the position maintained by the Second Circuit in *Crown*

[17] 342 U.S. 98 (1951).

[18] Wunderlich Act of May 11, 1954, 41 U.S.C. §§ 321-22 (1965).

[19] The Supreme Court has recently set some rigid standards for the courts to follow in consideration of the administrative record. In United States v. Carlo Bianchi & Co., 373 U.S. 709 (1963), the Court said that apart from questions of fraud, the scope of review of agency decisions is limited by a decision of whether the decision of the board was fraudulent, capricious or clearly erroneous as shown in the record of the board. In United States v. Anthony Grace & Sons, 384 U.S. 424 (1966), the Court said that the Court of Claims must return matters to the board for findings of fact, when the board had erroneously dismissed the matter on a procedural point without taking evidence on the questions of fact. In United States v. Utah Constr. & Mining Co., 384 U.S. 394 (1966), the Court held that the determination by the board of appeals of fact questions is binding on the courts in separate proceedings based upon breach even though the board had no jurisdiction over the breach. These rulings overturned the Court of Claims position that it had the right to try questions of fact at trial de novo.

[20] See note 2 *supra.*

[21] It is settled that when all events have occurred to fix the government's liability a cause of action accrues entitling the claimant to demand payment and to sue for the money. See Sauer v. United States, 354 F.2d 302 (Ct.Cl. 1965); Oceanic S.S. v. United States, 165 Ct.Cl. 217 (1964); Fattore v. United States, 312 F.2d 797 (Ct.Cl. 1963); Cosmopolitan Mfg. Co. v. United States, 297 F.2d 546 (Ct.Cl. 1962); Empire Inst. of Tailoring v. United States, 161 F. Supp. 409 (Ct.Cl. 1958); Ball v. United States, 137 F. Supp. 740, (Ct.Cl. 1956); Group v. United States, 125 Ct.Cl. 135 (1953); Reliance Motors, Inc. v. United States, 81 F. Supp. 228 (Ct.Cl. 1948); Withers v. United States, 69 Ct.Cl. 584 (1930).

[22] See UMW v. Gibbs, 383 U.S. 715 (1966); United States v. Dickinson, 331 U.S. 745 (1947); Holton, Seeyle & Co. v. United States, 65 F. Supp. 903 (Ct.Cl. 1946); Joplin v. United States, 89 Ct.Cl. 345 (1939); Myerle v. United States, 31 Ct.Cl. 105 (1896). Note that where a contract has no relevant "disputes" clause, the statute of limitations begins to run with the completion or the acceptance of the contract. See Mulholland v. United States, 361 F.2d 237 (Ct.Cl. 1966); Specialty Assembly & Packing Co. v. United States, 298 F.2d 794 (Ct.Cl. 1962); B-W Constr. Co. v. United States, 100 Ct.Cl. 227 (1943); Pink v. United States, 85 Ct.Cl. 121, *cert. denied,* 303 U.S. 642 (1938).

[23] McMahon v. United States, 342 U.S. 25 (1951), overruling Thurston v. United States, 179 F.2d 514 (9th Cir. 1950). See also United States v. Sherwood, 312 U.S. 584 (1941); United States v. Shaw, 309 U.S. 495 (1940); United States v. Michel, 282 U.S. 656 (1931).

Coat.[24] In addition it was maintained that the cause of action accrued at the completion of the contract but that the statute of limitations was tolled during the pending administrative hearings, the position followed by the Third Circuit.[25] Finally the Court of Claims has held that the statute begins to run at the end of the administrative hearings since this is the only time when the contractor is aware of his injury to the fullest extent.[26]

Conflicting purposes pervade any selection among the alternatives. At some time a defendant ought to be secure that old claims cannot be raised, and he ought not to be called to resist a claim when evidence has been lost, memories have faded, or witnesses have disappeared. On the other hand this policy seems outweighed by the concern for justice when a plaintiff would suffer injury through no fault of his own.[27]

Most statutes of limitations are only procedural, *i.e.*, the claim is unenforceable but is not extinguished after the statutory period has run. In such situations equitable considerations may decide the outcome. Courts have engrafted numerous exceptions; *e.g.*, where there has been fraud,[28] or where an injury is discovered after the statute has run,[29] or where the injury is caused by a slow and continuing process,[30] or where principles of estoppel prevent the defendant from raising the defense of the time bar.[31] On the other hand, the statute of limitations of the Tucker Act is jurisdictional. Thus the claim is extinguished.[32] The Second Circuit in discussing the jurisdictional aspect stated,

> ". . . where a statute creates a cause of action which was unknown at common law the period of limitation set up in the same statute is regarded as a matter of substance, limiting the right as well as the remedy. Filing a complaint within the prescribed period is a condition precedent to recovery, and the cause of action is extinguished after the running of the period."[33]

The Supreme Court Opinion in Crown Coat The opinion of the Court, delivered by Mr. Justice White, settled many of the problems which resulted from the conflict among the circuits. The Court stated that if the

[24] Crown Coat Front, Inc. v. United States, 363 F.2d 407 (2d Cir. 1966). See also Unexcelled Chem. Corp. v. United States, 345 U.S. 59 (1953); Engel v. Davenport, 271 U.S. 33 (1926); Isthmian S.S. Co. v. United States, 302 F.2d 69 (2d Cir. 1962); States Marine Corp. v. United States, 283 F.2d 776 (2d Cir. 1960); Leonick v. Jones & Laughlin Steel Corp., 258 F.2d 48 (2d Cir. 1958); MacInnes v. United States, 189 F.2d 733 (1st Cir. 1951); Gregory v. United States, 187 F.2d 101 (2d Cir. 1951); Sgambati v. United States, 172 F.2d 297 (2d Cir. 1949); Burch v. United States, 163 F. Supp. 476 (E.D. Va. 1958); Finley v. United States, 147 F. Supp. 184 (D.N.J. 1956); Atlantic Carriers v. United States, 131 F. Supp. 1 (S.D.N.Y. 1955); Pacific-Atlantic S.S. Co. v. United States, 127 F. Supp. 931 (D.Del. 1955); Wessel, Duval & Co. v. United States; 126 F. Supp. 79 (S.D.N.Y. 1954).

[25] Northern Metal Co. v. United States, 350 F.2d 833 (3d Cir. 1965).

[26] Nagler Elec. v. United States, 368 F.2d 847 (Ct.Cl. 1966).

[27] Order of R.R. Telegraphers v. Railway Express Agency, Inc., 321 U.S. 342 (1944).

[28] Glus v. Brooklyn E. Dist. Terminal, 359 U.S. 231 (1959); Bailey v. Glover, 88 U.S. 342 (1874).

[29] Urie v. Thompson, 337 U.S. 163 (1949).

[30] Daniels v. Beryllium Corp., 227 F. Supp. 591 (E.D. Penn. 1964).

[31] See *Developments in the Law—Statute of Limitations*, 63 HARV. L. REV. 1177, 1233 (1950).

[32] Soriano v. United States, 352 U.S. 270 (1957); United States v. Wardwell, 172 U.S. 48 (1898); United States v. Greathouse, 166 U.S. 601 (1897); Finn v. United States, 123 U.S. 227 (1887). See also Fattore v. United States, 312 F.2d 797 (Ct.Cl. 1963).

[33] Osbourne v. United States, 164 F.2d 767, 769 (2d Cir. 1947).

action arose under the contract (thus through the "disputes" clause) the action did not accrue until final determination by the ASBCA. Only then does the claim become subject to adjudication by the courts, and protracted administrative proceedings may last six years beyond the completion of the contract. The Court noted that in enacting the Wunderlich Act Congress proposed to insure adequate judicial review of administrative decisions on claims arising under government contracts.[34] The Court discounted the use of the protective suit, since the contractor cannot ask a court to review a decision before it has been made; nor can he make the proper allegations before the hearings are final. Only when it is alleged and proved that the administrative determination was arbitrary, capricious or not supported by the evidence may a court refuse to honor the administrative decision. Until the decision is made the contractor cannot know what claim he has or on what grounds the administrative action may be vulnerable.

The Court distinguished cases brought under the Suits in Admiralty Act and previously used as authority in Tucker Act cases.[35] The Suits in Admiralty Act requires the claim to be brought within two years after the cause of action accrues. The Clarification Act[36] brought such claims as the seaman's injury in *McMahon* and those claims in the cases decided by the Second and Third Circuits under the Suits in Admiralty Act and permits no court action unless the suit is administratively disallowed. The limitation period on such claims runs from the time of the injury since there is no reasonable time period limitation for the claimant to bring his action. If the period was postponed as it is under the Tucker Act the claimant would be able to postpone indefinitely the commencement of the limitation period. Another distinguishing factor between the Admiralty Act and the Tucker Act is that under the Admiralty Act the claimant may proceed directly to court if his claim has not been rejected within 60 days. Thus there is no chance for administrative action to consume the entire limitation period and therefore bar all resort to the courts. The cases relied upon by the Second Circuit in *Crown Coat* were based upon the Suits in Admiralty Act and in actuality have no valid effect upon contract claims brought under the Tucker Act.

Conclusion The Supreme Court in *Crown Coat* has cleared up a seventy year old problem. The Court interpreted the Tucker Act limitation period to run from the end of the administrative hearings. The contractor now knows that when he has a cause of action "arising under" the contract, he must follow the administrative procedure before he files his suit. For limitation purposes the cause of action accrues after the administrative hearings are final. Thus a contractor will have six years to file suit. The length of time in such a situation is not important since the record of the administrative body will be preserved and used by the court. But

[34] See note 19 *supra.*
[35] 46 U.S.C. § 745 (1966); See also note 15 *supra.*
[36] 50 U.S.C. § 1291(a) (1965).

the Court left open an important question. Where there is a breach of contract and questions of fact which must be decided by the administrative body, when does the cause of action accrue? The lower courts have held that the contractor should bring his claim in one suit; thus *Crown Coat* would also control in this instance. It remains to be seen whether this position will be upheld by the Court in future decisions.

Lawrence J. Brannian

Binding Effect of State Court Judgment in Federal Tax Cases

I.

The decedent Herman Bosch set up a revocable trust to pay income to his wife during her lifetime. In 1951, on the advice of her attorney and to avoid future adverse tax consequences, Mrs. Bosch executed an instrument which attempted to release her general testamentary power of appointment for the trust, converting it to a special power which would not be taxable to her estate upon her death.[1] When Herman Bosch died, his executor claimed the value of the trust as a marital deduction,[2] thus reducing the estate tax paid.[3] The Commissioner of Internal Revenue determined that the trust did not qualify for the marital deduction due to the release of the power of appointment[4] and asserted a federal tax deficiency. The executor filed a petition in the Tax Court for a redetermination of the deficiency.

While this action was pending in the Tax Court, the trustee, who was also the executor of the estate, brought an action in the New York Supreme Court for a settlement of his account as trustee. As a part of this accounting, a determination of the validity of Mrs. Bosch's attempted release was requested and the state court held it to be a nullity. Three briefs were filed in the state action, all arguing that the release was a nullity.[5] The trustee conceded that the New York proceeding was instituted "at least in part for the purpose of affecting the outcome of the case before the Tax Court." The Commissioner conceded that the state court decree might be final as

[1] INT. REV. CODE OF 1954, § 2041(a)(1). It should be noted that this was a power created before October 21, 1942.

[2] INT. REV. CODE OF 1954, § 2056(b)(5).

[3] INT. REV. CODE OF 1954, § 2056(a).

> The value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

[4] In order for the trust to qualify for the marital deduction it would have to vest in the wife sufficient control of the trust property. If the release of the power of appointment was valid there would be no control over the trust property and the marital deduction would fail. To avoid this result the suit in the state court was instituted.

[5] The three briefs were filed by the trustee, Mrs. Bosch, and a guardian *ad litem* for a relative of Mr. Bosch, the only remainderman to take a position. The Second Circuit opinion in *Bosch* conceded that "no argument for the validity of the release was presented to the court;" in fact, as the dissent in that case pointed out, all three briefs "treated the invalidity of the release as almost beyond doubt."

to the parties, but he contended that it was not binding on the Tax Court and that the Tax Court should independently construe the New York statute. The Tax Court, however, chose to accept this state court decision as to the validity of the release and did not attempt to interpret the New York law applicable to the release of powers of appointment. The Commissioner appealed. The Second Circuit affirmed since the New York judgment, rendered by a court which had jurisdiction over parties and subject matter, authoritatively settled the rights of the parties not only for New York but also for the application to those rights of the relevant provisions of federal tax laws. *Held, reversed:* Where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are bound only by a determination of such property interest by the highest state court. *Commissioner v. Estate of Bosch,* 35 U.S.L.W. 4542 (U.S. June 6, 1967).

II. Status of the Binding-Effect Theory Before Bosch

The weight to be given to any state court adjudication of property rights rests on the premise that under the federal system the state law determines property rights.[6] However, the effect of a state court interpretation of state law regarding the property in question is often uncertain. To be given any effect at all the state court must be one of proper jurisdiction[7] and the decision must be binding on all the parties to the action.[8] If these conditions are not met, the Tax Court has a duty to ascertain independently the applicable state law and to apply it to the rights involved.[9] Moreover, and the most important consideration in *Bosch,* a state court adjudication is not binding on the federal court if the state court proceeding was collusive.[10]

Three Supreme Court decisions potentially on point,[11] all in the 1930's,

[6] Merten, Federal Income Taxation, § 61.03, at 4 (1964 and 1967 Supp.). This is not to be confused with the rule that for purposes of the interpretation of federal statutes, local law is not controlling unless the federal statute "by express language or necessary implication, makes its own operation dependent upon state law." Helvering v. Stuart, 317 U.S. 154 (1942); Lyeth v. Hoey, 305 U.S. 188, 194 (1938); Heiner v. Mellon, 304 U.S. 271, 279 (1938); and Burnet v. Harmel, 287 U.S. 103, 110 (1932). In a fact situation as was present in *Bosch,* the state court decision has no res judicata effect upon the federal courts, Freuler v. Helvering, 291 U.S. 35, 43 (1934); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955). Clearly a decision in the state court could not be binding on the Commissioner, as he was not a party to the action, Restatement, Judgments § 93 (1942).

[7] Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955); Goodwin's Estate v. Commissioner, 201 F.2d 576 (6th Cir. 1953). Merten, Federal Gift & Estate Taxation § 10.11 (1959 and 1965 Supp.).

[8] Blair v. Commissioner, 300 U.S. 5 (1937); Babcock's Estate v. Commissioner, 234 F.2d 837 (3d Cir. 1956); Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955). Merten, Federal Gift & Estate Taxation § 10.12 (1959 and 1965 Supp.).

[9] Merten, Federal Gift & Estate Taxation § 10.13 (1959 and 1965 Supp.).

[10] Blair v. Commissioner, 300 U.S. 5 (1937); Freuler v. Helvering, 291 U.S. 35 (1934); Old Kent Bank & Trust Co. v. United States, 362 F.2d 444 (6th Cir. 1966); United States v. Farish, 360 F.2d 595 (5th Cir. 1966); Pierpont v. Commissioner, 336 F.2d 277 (4th Cir.), *cert. denied,* 380 U.S. 908 (1964); Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964); Peyton's Estate v. Commissioner, 323 F.2d 438 (8th Cir. 1963); Darlington's Estate v. Commissioner, 302 F.2d 693 (3d Cir. 1962); Faulkerson's Estate v. United States, 301 F.2d 231 (7th Cir.), *cert. denied,* 371 U.S. 887 (1962); *In re* Sweet's Estate, 234 F.2d 401 (10th Cir.), *cert. denied,* 352 U.S. 878 (1956); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955). 5 P-H 1967 Fed. Tax Serv. ¶ 41,110.

[11] Sharp v. Commissioner, 303 U.S. 624 (1938); Blair v. Commissioner, 300 U.S. 5 (1937); Freuler v. Helvering, 291 U.S. 35 (1934).

considered only whether or not the state court decision determined the property rights involved and never set a standard for determining collusion. For a period of time following the Supreme Court decisions there was little litigation in this area; however, since the middle 1950's an increasing number of federal courts have faced the problem of collusive state suits in tax controversies. These recent cases have varied greatly in result, thus leaving a discrepancy in the various circuits.

Several circuits have found the state court adjudication to be collusive merely because the contest was non-adversary.[12] On the other hand, both the Third and Eighth Circuits have held that the non-adversary character of the state proceeding is not in itself sufficient to defeat use of its result in the federal courts but is merely relevant evidence to be considered in the question of collusion.[13] The Third Circuit has frequently refused to find collusion in the absence of actual fraud or improper conduct.[14] A few courts considered the correctness of the state court decision in determining collusiveness.[15] However, there was authority that the correctness of the state court adjudication should not be a factor since such adjudication, for state court purposes, is conclusive of the property rights of the parties involved.[16] Another factor considered was whether the federal tax authorities were notified of the action.[17]

A subjective element often considered by the circuit courts was the taxpayer's motive in instituting the state court proceeding.[18] The Sixth Cir-

[12] Pierpont v. Commissioner, 336 F.2d 277 (4th Cir.), *cert. denied*, 380 U.S. 908 (1964); Stallworth's Estate v. Commissioner, 260 F.2d 760 (5th Cir. 1958); Merchant's Nat'l Bank & Trust Co. v. United States, 246 F.2d 410 (7th Cir. 1957); *In re* Sweet's Estate, 234 F.2d 401 (10th Cir.), *cert. denied*, 352 U.S. 878 (1956); Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Wolfsen v. Smyth, 223 F.2d 111 (9th Cir. 1955); Saulsbury v. United States, 199 F.2d 578 (5th Cir.), *cert. denied*, 345 U.S. 906 (1953). There has been no clear definition of a non-adversary proceeding, but it would seem that unless both sides of an issue were presented and the issue intelligently decided, there could be no adversary character. Merchant's Nat'l Bank & Trust Co. v. United States, 246 F.2d 410 (7th Cir. 1957), stated that whether or not a proceeding was adversary was a fact question to be ascertained from all the circumstances surrounding the proceeding. A non-adversary proceeding should be distinguished from the consent decree which is a decree entered upon what is admittedly the agreement of the parties. A consent decree may be accepted if not collusive. See, *e.g.*, 26 C.F.R. §§ 20.2053-1(b)(2), 20.2056(e)-2(d)(2) (1954). See also Braverman & Gerson, *The Conclusiveness of State Court Decrees in Federal Tax Litigation*, 17 TAX L. REV. 545, 566 (1962).

[13] Peyton's Estate v. Commissioner, 323 F.2d 438 (8th Cir. 1963); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955); 5 P-H 1967 FED. TAX SERV. ¶ 41,110; MERTEN, FEDERAL GIFT & ESTATE TAXATION § 10.17 (1959 and 1965 Supp.).

[14] Darlington's Estate v. Commissioner, 302 F.2d 693 (3d Cir. 1962); Babcock's Estate v. Commissioner, 234 F.2d 837 (3d Cir. 1956); Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955); Sharpe v. Commissioner, 107 F.2d 13 (3d Cir.), *cert. denied*, 309 U.S. 665 (1939).

[15] Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964); Peyton's Estate v. Commissioner, 323 F.2d 438 (8th Cir. 1963). See also 26 C.F.R. § 20.2053-1(b)(2) (1954).

[16] Pitts v. Hamrick, 228 F.2d 486 (4th Cir. 1955); Hardenbergh v. Commissioner, 198 F.2d 63 (8th Cir. 1952); Weyenberg v. United States, 135 F. Supp. 299 (E.D. Wisc. 1955).

[17] Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964); Peyton's Estate v. Commissioner, 323 F.2d 438 (8th Cir. 1963). However, this is probably of little significance since the Internal Revenue Service has a policy not to intervene in such suits and to move to dismiss if made a party. Mim. 6134 (1947), 6 CCH 1966 STAND. FED. TAX REP. ¶ 5781.4192; MERTEN, FEDERAL GIFT & ESTATE TAXATION § 10.20 (1959 and 1965 Supp.). See also Harrar, *The 'Collusive' State Decree; A Nullity in Determining Federal Tax Consequences?*, 21 J. TAXATION 372 (1964).

[18] Sacks, *The Binding Effect of Nontax Litigation in State Courts*, N.Y.U. 21ST INST. ON FED. TAX 277, 295 (1963) (collusion—for the sole and single purpose of defeating the federal tax imposed); Braverman & Gerson, *The Conclusiveness of State Court Decrees in Federal Tax Litigation*, 17 TAX L. REV. 545, 576 (1962) (when the decree appears to serve no purpose other than to avoid federal taxation, the decree should not be regarded as determinative of state law property rights); MERTEN, FEDERAL GIFT & ESTATE TAXATION § 10.15 (1959 and 1965 Supp.).

cuit has recently held the proceeding collusive if "the motive of avoiding tax liability to the federal government so dominates over the usual interest of the parties in protecting their own interests in property as to overturn what would otherwise be the result of such litigation under applicable state law."[19] This view was echoed by the Seventh Circuit.[20] The United States Supreme Court in dicta in *Freuler v. Helvering* defined collusion as a situation where "all the parties joined in a submission of the issues and sought a decision which would adversely affect the Government's right to additional . . . tax."[21] This definition has not been followed, thus allowing the confusion among the circuits.

The Second Circuit Opinion As Judge Friendly pointed out in his dissent, the Second Circuit in *Bosch* has chosen to follow the lead of the Third Circuit[22] by applying the state court result if no fraud or improper conduct was involved. In refusing to find collusion because of non-adversity, the court stated that it was not deciding "whether the federal court is 'bound by' the decision of the state tribunal but whether or not a state tribunal has authoritatively determined the rights under state law of a party to the federal action."[23] The distinction seems illusory since such rights under state law, if honored, are conclusive of the outcome in the tax case. Surely the court was not suggesting that a federal court *may*, in its discretion, choose to adopt the state court decree at any time. With no standards at all to be applied, a party could never be sure of the outcome in a federal case.

Although pointed out in the dissent, the taxpayer's motive was not discussed by the majority. Under facts similar to those in *Bosch* where the taxpayer admitted that the proceeding was instituted "at least in part for the purpose of affecting the outcome of the case before the Tax Court," the Sixth and Seventh Circuits would have disregarded the state court decree as collusive.[24] The *Bosch* court's finding of no collusion illustrates the conflicting criteria among the circuits and the uncertain result when state decrees are to be considered.

III. The Supreme Court Opinion in Bosch

The Supreme Court in *Bosch* has finally settled the long standing problem of the effect to be given a state court adjudication in federal tax matters. In holding that the decree of any court lower than the highest court of the state can never be binding in federal tax matters, the Supreme Court has applied the doctrine of *Erie Railroad Co. v. Tompkins*[25] since "the underlying substantive rule involved is based on state law and the state's highest court is the best authority on its own law."[26] Previously

[19] Old Kent Bank & Trust Co. v. United States, 362 F.2d 444 (6th Cir. 1966).

[20] Faulkerson's Estate v. United States, 301 F.2d 231 (7th Cir.), *cert. denied*, 371 U.S. 887 (1962). See also Freuler v. Helvering, 291 U.S. 35, 45 (1934).

[21] 291 U.S. 35, 45 (1934).

[22] Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955).

[23] 363 F.2d 1009, 1013 (2d Cir.), *rev'd* 35 U.S.L.W. 4542 (U.S. June 6, 1967).

[24] See text accompanying notes 19, 20 *supra*.

[25] 304 U.S. 64 (1938).

[26] 35 U.S.L.W. at 4545.

the *Erie* doctrine was not thought applicable to the "binding-effect" problem since *Erie* involves a determination of whether federal as opposed to state law should apply and not whether a state court decision fixing property rights was binding on the federal court.[27] Under the *Bosch* doctrine if there is no decision by the highest court, federal authority must apply what it finds to be the state law after giving proper regard to relevant rulings of other courts of the state. In this respect it can be said to be sitting as a state court. Thus it appears that a determination of property rights by less than the highest state court can never be binding on the federal court but is considered only another lower state court opinion to which "proper regard" is to be given.[28]

The *Bosch* opinion, based on an analysis of legislative history and the Rules of Decision Act,[29] did not discuss the factors previously thought to be controlling,[30] but rather extended the *Erie* doctrine from diversity cases to federal tax questions. This extension to non-diversity cases is not unique, since writers have stated that the *Erie* doctrine applies, whatever the ground for federal jurisdiction, to any issue or claim which has its source in state law.[31] In fact, one Second Circuit case, *Maternally Yours, Inc. v. Your Maternity Shop, Inc.*,[32] applied *Erie* in a non-diversity case involving common law trademarks.

However, as Justice Harlan points out in his dissent, "it is difficult to see why *Erie* is necessarily applicable without modification in all situations in which federal courts must ascertain state law."[33] Indeed in tax controversies where precisely the legal and factual circumstances have already been litigated in the state court it seems wasteful to rule that the state court proceeding can never be controlling under any circumstances. Such a result seems to be contrary to the theory that unnecessary litigation should be avoided.

Although the effect this decision will have on state-federal law relationships remain to be seen, it is obvious that, as Justice Harlan states in his dissent, the "result might be widely destructive of both the proper relationship between state and federal law and the uniformity of the administration of law within a state."[34] A situation could surely be imagined

[27] See the Second Circuit opinion in *Bosch*, 363 F.2d 1009, 1013 (2d Cir. 1966) on this point. See also Helvering v. Leonard, 310 U.S. 80 (1940) (If the case were here on application of local law under the rule of *Erie* we would not be inclined to disturb that finding. But it is not. Here respondent is seeking to escape one of the normal incidents of the federal income tax.). *Cf.* Dayton & Mich. v. Comm., 112 F.2d 627, 630 (4th Cir. 1940).

[28] However, there is a line of cases that have held that a federal court is obligated to follow the decision of a lower state court in the absence of decisions of the state supreme court showing that the state law is other than announced by the lower court. Stoner v. New York Life Ins. Co., 311 U.S. 464 (1940); West v. American Tel. & Tel. Co., 311 U.S. 223 (1940); Six Companies of California v. Joint Highway District, 311 U.S. 180 (1940); Fidelity Union Trust Co. v. Field, 311 U.S. 169 (1940). See 1A MOORE FEDERAL PRACTICE ¶ 0.307 [27] at 3302 (2d ed. 1965, Supp. 1966).

[29] 28 U.S.C. § 1652 (1964).

[30] See discussion in Section II *supra*.

[31] 1A MOORE FEDERAL PRACTICE ¶ 0.305 [3] at 3055 (2d ed. 1965, Supp. 1966); Maternally Yours v. Your Maternity Shop, 234 F.2d 538, 540 n.1 (2d Cir. 1956).

[32] 234 F.2d 538 (2d Cir. 1956).

[33] 35 U.S.L.W. at 4547.

[34] 35 U.S.L.W. at 4548.