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CASE NOTES

Antitrust Law—Strict Standards of Clayton Act Held Not Applicable to Bank Mergers Under *1966* Bank Merger Act.—The Comptroller of the Currency approved the defendants'[1] proposed bank merger under the standards of the 1960 Bank Merger Act.[2] The Department of Justice attacked the proposed merger as being violative of the Sherman[3] and Clayton[4] Acts, but its application for a preliminary injunction was denied.[5] After a trial on the merits, judgment was postponed while the court awaited passage of legislation affecting the merger.[6] In the first decision under the 1966 Bank Merger Act,[7] the district court returned the case to the Comptroller for further consideration of the advisability of the merger under the guidelines contained in the 1966 act before a review de novo would be granted. *United States v. Crocker-Anglo Nat'l Bank*, Trade Reg. Rep. (1966 Trade Cas.) ¶ 71898 (N.D. Cal. Oct. 6, 1966).

Resolving the conflict between the needs of the financial community and necessary antitrust legislation is a difficult endeavor. Such legislation must mediate between the merits of preserving competition by prohibiting certain bank mergers and the need to prevent excessive competition which could lead to bank failures.[8] Congress attempted to balance these interests in the Bank Merger Act of 1960[9] by allowing the banking agencies[10] to determine the

1. The defendants were the Crocker-Anglo National Bank, the Citizens National Bank, and the Transamerica Corporation.
2. 74 Stat. 129 (1960), 12 U.S.C. § 1828(c) (1964).
3. 26 Stat. 209 (1890), as amended, 15 U.S.C. §§ 1-7 (1964).
4. 38 Stat. 730 (1914), as amended, 15 U.S.C. § 18 (1964).
5. United States v. Crocker-Anglo Nat'l Bank, 223 F. Supp. 849 (N.D. Cal. 1963).
6. The Comptroller approved the merger on September 30, 1963. Eight days later the Department of Justice filed its suit. While the trial was in progress, the Senate passed its version of a bill exempting the bank, and all banks, from similar government suits. S. 1698, 89th Cong., 1st Sess. (1966). Judgment was postponed until final legislation by both houses could be completed. The final bill, the 1966 Bank Merger Act, did not exclude the Crocker-Anglo merger because it was consummated after United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963), was decided, and, thus, the drafters felt that the defendants knew, at the time of the merger, that the courts would apply the Clayton Act to bank mergers. Only mergers consummated prior to June 17, 1963, were given exemption. Congress did feel, however, that the new substantive law should apply. See H.R. Rep. No. 1221, 89th Cong., 2d Sess. 4-5 (1966).
7. 80 Stat. 7, 12 U.S.C.A. § 1828(c) (Supp. 1966).
8. The problem is made more acute since, until 1959, large banking institutions were permitted to develop unhampered by the antitrust laws. See Seeley, Banks and Antitrust, 83 Banking L.J. 1035, 1036 (1966). Strict application of the antitrust laws now would inhibit the development of banks able to compete with the larger financial institutions. The merger disapproved in United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963), for example, would have resulted in greater competition on the national level. See id. at 370.
9. 74 Stat. 129 (1960), 12 U.S.C. § 1828(c) (1964).
10. The act intended to have the agency most familiar with the banks proposing merger

advisability of each proposed merger. The act, however, did not make clear what antitrust standards should be applied by the courts in reviewing the appropriate agency's decision. The United States Supreme Court, in a much criticized opinion, *United States v. Philadelphia Nat'l Bank*,[11] ruled that the Clayton Act applied to bank mergers, thus prescribing standards for determining the advisability of such mergers which differed from those employed by the banking agencies. The result was to nullify the 1960 act,[12] which was intended to enact criteria broader than those in the Clayton Act for examining a proposed bank merger.[13] The latter provides that a merger should be prohibited if "in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[14] The Supreme Court unexpectedly applied these standards to the merger in the *Philadelphia Bank* case by considering the line of commerce of commercial banking only,[15] excluding all other financial activities.[16] The appropriate section of the country was limited to the four-county metropolitan area, although the purpose of the merger was to enable the Philadelphia banks to compete with New York City financial institutions.[17] While the Bank Merger Act of 1960 intended the appropriate agency to approve a merger upon a determination that it was in the public interest after considering several factors, among them competition,[18] the *Philadelphia Bank* ruling would disallow such a merger if it

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consider the merger. National and district banks were considered by the Comptroller of the Currency; state banks, other than district banks, by the Federal Reserve Board; and nonmember state banks, other than district banks, by the Federal Deposit Insurance Corporation. Ibid.

11. 374 U.S. 321 (1963). See Celler, The Philadelphia National Bank Case: A Rejoinder, 1 National Banking Rev. 229 (1963); The Supreme Court, 1962 Term, 77 Harv. L. Rev. 79, 159 (1963); Comment, 62 Mich. L. Rev. 990 (1964).

12. "The result is, of course, that the Bank Merger Act is almost completely nullified; its enactment turns out to have been an exorbitant waste of congressional time and energy. As the present case illustrates, the Attorney General's report to the designated banking agency is no longer truly advisory, for if the agency's decision is not satisfactory a § 7 suit may be commenced immediately. . . . The only vestige of the Bank Merger Act which remains is that the banking agencies will have an initial veto." 374 U.S. at 384-85 (dissenting opinion). (Footnotes omitted.)

13. See S. Rep. No. 196, 86th Cong., 1st Sess. 1 (1959); Comment, 71 Yale L.J. 502 (1962). One of the reasons for passing the 1960 act was the thought that section 7 of the Clayton Act could not reach a bank merger. See, e.g., 106 Cong. Rec. 7257 (1960) (remarks of Representative Spence).

14. 38 Stat. 731 (1914), as amended, 15 U.S.C. § 18 (1964).

15. 374 U.S. at 356-57.

16. Competition to commercial banks in supplying credit comes from "mutual savings banks, savings and loan associations, credit unions, personal-finance companies, sales-finance companies, private businessmen . . . Small Business Investment Corporations, life insurance companies." Id. at 327 n.5.

17. Id. at 360 n.37.

18. 74 Stat. 129 (1960), 12 U.S.C. § 1828(c) (1964). The factors are: "the financial history and condition of each of the banks involved, the adequacy of its capital structure,

failed only the test of anticompetitive or monopolistic effect.[19] The 1966 act would allow some mergers with anticompetitive effects:

> The responsible agency shall not approve—
>
> (A) any proposed merger transaction which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States, or
>
> (B) any other proposed merger transaction whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served. In every case, the responsible agency shall take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions, and the convenience and needs of the community to be served.[20]

One of the biggest disagreements between the banking agencies and the Department of Justice prior to enactment of the new legislation revolved around the substantive law concerning the definition of the relevant market.[21] The Justice Department contended that the new bill should not and did not change the prior definition.[22] But the language of the new statute omitted the Clayton Act phrase, "in any line of commerce,"[23] thereby indicating a desire on the part of the drafters to broaden the test by requiring an appraisal of the overall effect of the merger upon competition rather than a search for anticompetitive effects in any one line of commerce.[24] The insertion in the statute of the require-

its future earnings prospects, the general character of its management, the convenience and needs of the community to be served, and whether or not its corporate powers are consistent with the purposes of [the Federal Deposit Insurance Corporation Act] . . . . [T]he appropriate agency shall also take into consideration the effect of the transaction on competition . . . ." Ibid.

19. 374 U.S. at 385 (dissenting opinion). See 112 Cong. Rec. 2343 (daily ed. Feb. 8, 1966).

20. 80 Stat. 7 (1966), 12 U.S.C.A. § 1828(c)(5) (Supp. 1966).

21. H.R. Rep. No. 1221, 89th Cong., 2d Sess. (1966). In defining such markets, "it is not so easy in the case of the larger banks, which serve a local market of individuals and small businesses, but which are also competing in the regional or national financial markets for the opportunity to place large loans with major corporations which are shopping the country for funds." Id. at 3.

22. Hearings on S. 1698 Before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 89th Cong., 1st Sess. 172 (1966) [hereinafter cited as House Hearings].

23. 38 Stat. 731 (1914), as amended, 15 U.S.C. § 18 (1964), provides in part: "No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation . . . where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

24. Note, The 1966 Amendment to the Bank Merger Act, 66 Colum. L. Rev. 764, 780 (1966). See also 112 Cong. Rec. 2541 (daily ed. Feb. 9, 1966) (remarks of Senator Robertson).

ment that, even if restraint of trade is established, the "public interest" and the "needs of the community to be served" must be weighed against that effect, seems to validate the latter interpretation.

In *United States v. Provident Nat'l Bank*,[25] an action was brought under section 7 of the Clayton Act to enjoin the defendants'[26] merger within thirty days[27] of the Comptroller of the Currency's approval of the merger. The court stated that it "does not sustain the position of Justice that it is entitled to sue under Section 7 of the Clayton Act. The only suit open to Justice to enjoin a bank merger lies solely within the ambit of BMA-66."[28] It held, however, that since the suit had only reached a preliminary stage, the Department of Justice would be able to amend its complaint to come under the act since it had alleged an antitrust violation.[29]

While the *Provident Bank* case did not discuss the manner in which the new rules would be applied, the instant court, being first to hear a case under the new act,[30] provided some guidelines for the administrative agencies to use in considering the advisability of proposed bank mergers. The court requested the Comptroller to make new specific findings as to the anticompetitive effects of the merger and to determine "whether, assuming that the merger has the effect upon potential competition which the Government claims, that effect would be outweighed in the public interest by the probable effect of the transaction in meeting the interest and convenience of the community to be served."[31] The principal issue underlying the *Provident Bank* and instant cases revolves around the role and status of banks in the economy. If they are to be considered similar to other industries, then it is advisable to have the narrow rules outlined in the Clayton Act apply to bank mergers as well as any other merger. This would result in a court review of the advisability of each proposed merger utilizing Clayton Act standards. However, Congress has decided that the competitive practices of other industries should not be tolerated if they would in any way lead to bank failures. Thus, the administrative agencies, whose members can utilize expert judgment and specialized knowledge of this unique and intricate industry, seem to be the proper forum for such decisions.

An examination of the criticism of the *Philadelphia Nat'l Bank* case, the 1960 Bank Merger Act, and the legislative history of the 1966 Bank Merger Act, whose purpose is "to reverse a decision of the Supreme Court,"[32] indicates that the advisability of bank mergers is not intended to be judged solely by the

25. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71931, at 83277 (E.D. Pa. Oct. 13, 1966), prob. juris. noted, 35 U.S.L. Week 3253 (Jan. 23, 1967) (No. 972).

26. Defendants were Provident National Bank and Central-Penn National Bank of Philadelphia.

27. 80 Stat. 7 (1966), 12 U.S.C.A. § 1828(c)(7)(A) (Supp. 1966). See note 45 infra.

28. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71931, at 83281.

29. Id. at 83280.

30. 112 Cong. Rec. 24867 (daily ed. Oct. 10, 1966).

31. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71898, at 83159. (Footnote omitted.)

32. 112 Cong. Rec. 2538 (daily ed. Feb. 9, 1966).

standard of anticompetitive effect.[33] Senator Robertson, chief Senate architect of the legislation, stated that "this bill, should convince the courts that the Congress does not intend that mergers in the banking field should be measured solely by the antitrust considerations which are applied in other industries."[34]

Although the intent of the drafters was to provide "a single set of standards for the consideration of future mergers by the banking supervisory agencies, the Department of Justice, and the courts under the antitrust laws,"[35] the legislation may not accomplish that purpose since no clear definitions of such terms as "public interest," "clearly outweighed," "convenience and needs" and "community" are provided. Under the 1960 act, which was equally vague, the agencies were inconsistent in determining what factors should be weighed in their consideration of the advisability of proposed mergers.[36] In determining the

33. The instant court made reference to an analogous line of cases heard by the Interstate Commerce Commission. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71898, at 83156-57. The Interstate Commerce Act, 54 Stat. 906 (1940), 49 U.S.C. § 5(2)(b) (1964), provides that the ICC may approve a merger violative of the Clayton Act or other antitrust laws so long as it finds, after weighing the effects of a lessening of competition against the advantages of improved service, that the merger is "consistent with the public interest." In Seaboard Air Line R.R. v. United States, 382 U.S. 154 (1965) (per curiam), the Supreme Court remanded a case in which the district court had set aside the ICC's approval of a railroad merger because the commission had not determined if the merger violated § 7 of the Clayton Act. The Court stated that the district court had failed to reach "the ultimate question whether the merger would be consistent with the public interest despite the foreseeable injury to competition." Id. at 156. (Footnote omitted.) The commission must not ignore the antitrust laws, McLean Trucking Co. v. United States, 321 U.S. 67, 79-80 (1944), but it may approve mergers otherwise violative of antitrust laws if they are in the public interest. Minneapolis & St. L. Ry. v. United States, 361 U.S. 173 (1959). The administrative agency and not the court should determine what is consistent with public interest. Cf. Purcell v. United States, 315 U.S. 381 (1942); Pennsylvania Co. v. United States, 236 U.S. 351 (1915); ICC v. Illinois Central R.R., 215 U.S. 452 (1910). Representative Moorhead felt that the public interest aspects of the 1966 Bank Merger Act should be given the same weight as has been given by the ICC and the courts to mergers heard under the Interstate Commerce Act. 112 Cong. Rec. 2340 (daily ed. Feb. 8, 1966). The instant court agreed. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71898, at 83156-60.

34. 112 Cong. Rec. 2541 (daily ed. Feb. 9, 1966). "The bill would require the courts to use the new standards of the bill in all . . . 'post-Philadelphia' cases now pending in court . . . . It is a primary purpose of the bill to assure that the courts will never again dismiss as irrelevant the question of the need of a community." 112 Cong. Rec. 2339 (daily ed. Feb. 8, 1966) (remarks of Representative Ashley). "These provisions . . . provide a banking standard that may allow economic assistance to a community even though a merger tends to lessen competition in that community." 112 Cong. Rec. 2343 (daily ed. Feb. 8, 1966) (remarks of Representative Stanton).

35. H.R. Rep. No. 1221, 89th Cong., 2d Sess. 1 (1966).

36. See House Hearings 185-87. The Justice Department frequently finds anticompetitive effects. The banking agencies tend not to do so. Since 1960 the agencies approved over 700 mergers. During that period, the Justice Department found adverse competitive effects in 470 cases. Id. at 175.

competitive effects, credit unions, personal loan companies, and federal lending institutions,[37] as well as mutual savings banks,[38] were included upon occasion, yet in other cases, the agencies failed to make any mention of competition from non-banking institutions at all.[39] The public interest factors also posed problems as the agencies seemed undecided as to whether the banks must show benefit to the public[40] or whether the New York State approach,[41] that of showing harm to the public before denying the application,[42] was the proper method for basing its rulings.[43]

There is also the problem, raised by the instant case, of de novo review of an administrative agency decision. The requirement of the new act that the courts review the agency's judgment of the anticompetitive effects of a merger presents little problem as the courts have traditionally made such decisions.[44] The de novo provisions,[45] however, also require review of the second feature of the agency's determination, whether the anticompetitive results of the merger will be outweighed by the advantage to the community to be served. Traditionally, this type of determination has been considered a legislative or executive one and thus not reviewable by the courts[46] under article III of the Constitution. The instant court concluded that the findings of the Comptroller concerning the "convenience and needs" test could be reviewed under the more limited substantial evidence rule.[47] This rule requires examination of the agency's ruling

37. 49 Fed. Reserve Bull. 1514, 1516 (1963).

38. 51 Fed. Reserve Bull. 819 (1965).

39. 50 Fed. Reserve Bull. 711 (1964).

40. Commercial & Sav. Bank, 51 Fed. Reserve Bull. 821, 822 (1965).

41. New York Banking Law § 601; see Comment, 115 U. Pa. L. Rev. 218 (1966).

42. "New York State's approach to [the public interest problem is] . . . that it is necessary to determine whether the effect on competition is such as to be injurious to the public interest. In other words, under New York's approach, if all other factors are equal, approval would be granted unless it can be shown that the public will be harmed." Letter from G. Russell Clark to Senator Javits, in 106 Cong. Rec. 9713-14 (1960).

43. 48 Fed. Reserve Bull. 14, 16 (1962).

44. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71898, at 83154.

45. 80 Stat. 7 (1966), 12 U.S.C.A. § 1828(c)(7)(A) (Supp. 1966). "Any action brought under the antitrust laws arising out of a merger transaction shall be commenced [within 30 days, or 10 days in special circumstances, from agency approval] . . . . The commencement of such an action shall stay the effectiveness of the agency's approval . . . . In any such action, the court shall review de novo the issues presented." Ibid.

46. The instant court determined this a "legislative or administrative determination." Ibid. (Footnote omitted.) See United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 371 (1963); FPC v. Idaho Power Co., 344 U.S. 17 (1952); Federal Radio Comm'n v. General Elec. Co., 281 U.S. 464, 469 (1930); Keller v. Potomac Elec. Power Co., 261 U.S. 428, 444 (1923).

47. In a true trial de novo, the court substitutes its judgment for that of the agency. Southern Canal Co. v. State Bd. of Water Eng'rs, 159 Tex. 227, 318 S.W.2d 619 (1958). However, the instant court ruled that the convenience of the community determination

to determine as a question of law "whether findings of fact by the agency are supported by substantial evidence."[48] The instant court will be able to do this since there were some 1605 pages of testimony and exhibits.[49] This problem was also raised by *United States v. First City Nat'l Bank*.[50] There the court placed the burden on the government to "prove an anticompetitive result of the merger, and further that that is not outweighed by the convenience and needs aspect of the matter."[51] The Department of Justice is taking

outlined in the statute was nonjudicial in character. "Decisions that require the inquisitorial type of procedure . . . which must . . . be based upon a mosaic of expert opinion, judgment, and decisions are and should be regarded as nonjudicial and left primarily to the administrators." Finfrock, Trial De Novo—Panacea?, 14 Baylor L. Rev. 135, 160 (1962). The substantial evidence rule has been instituted by the courts to review such decisions. The courts may review the administrative ruling to determine if the action was supported by substantial evidence at the hearing, Trapp v. Shell Oil Co., 145 Tex. 323, 198 S.W.2d 424 (1946), but may not substitute its discretion for that of the agency in such nonjudicial decisions.

48. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71898, at 83155.

49. Id. at 83150.

50. Trade Reg. Rep. (1966 Trade Cas.) ¶ 71970 (S.D. Tex. Dec. 2, 1966), prob. juris. noted, 87 Sup. Ct. 754 (1967).

51. Id. at 83434. Under the criteria of the 1966 act, it seems clear that the Comptroller of the Currency would give approval of the Philadelphia National Bank merger were it heard today. While the merged bank would have become the largest in the Philadelphia area, controlling "36% of the area banks' total assets, 36% of deposits, and 34% of net loans," 374 U.S. at 331, the intent of the merger was to establish a bank which was capable of offering Philadelphia corporations a scope of services commensurate with those offered by the large New York banks, with which they were otherwise forced to deal. Id. at 333-34. This need of the business community in the Philadelphia area would probably have been held sufficient to overcome any anticompetitive effects. This merger was attacked in the courts for violation of § 7 of the Clayton Act and § 1 of the Sherman Act. The United States Supreme Court determined that the Clayton Act violation was enough to stop the merger without reaching the Sherman Act question. 374 U.S. at 323-24. Under the new act it would seem that the Clayton Act could not be used for this purpose. Further, a suit could not be brought under § 1 of the Sherman Act, which states that "every . . . combination . . . in restraint of trade . . . is declared to be illegal." 26 Stat. 209 (1890), as amended, 15 U.S.C. § 1 (1964). Although this test has been included in the new statute, which clearly states that "(B) In any judicial proceeding attacking a merger transaction approved under paragraph (5) on the ground that the merger transaction alone and of itself constituted a violation of any antitrust laws other than section 2 of the Act of July 2, 1890 [section 2 of the Sherman Antitrust Act, 15 U.S.C. 2], the standards applied by the court shall be identical with those that the banking agencies are directed to apply under paragraph (5)." 80 Stat. 7 (1966), 12 U.S.C.A. § 1828(c)(7)(B) (Supp. 1966), it is a factor which can be outweighed by the public interest. Thus, if the courts heard the Philadelphia Nat'l Bank case today the issue would be whether the Department of Justice could prove that there were anticompetitive effects or a restraint of trade which was not outweighed by the needs of the community. If the substantial evidence rule were invoked, the agency ruling would carry great weight. See note 49 infra.

This contention is further supported by a recent case in which the Department of Justice this case to the Supreme Court, contending that once adverse effects on competition can be shown, the burden should be on the banks to demonstrate that the public interest outweighs the competitive effects. To do otherwise, according to Donald F. Turner, the Assistant Attorney General of the Antitrust Division of the Department of Justice, would make the government's task "significantly more difficult than Congress intended."[52] These contentions may be valid as there would seem to be some degree of public interest in favor of every proposed merger and since the public interest factor of the agency's determination will be heard in light of the substantial evidence rule. Placing the burden upon the banks to prove that there was substantial evidence for agency approval would preserve the autonomy of the agency ruling yet provide a fairer means of accomplishing court review. This system would have further merit in that the agency with antitrust expertise would have the burden on the antitrust issue, while a banking agency would have the burden on technical banking matters.

Bankruptcy—Penalties for Trustee's Failure To File Returns for Taxes Incurred by the Debtor in Possession Held Allowable Against the Bankrupt Estate.—Beachcomber Motel, Inc., filed an original petition for an arrangement with its unsecured creditors under Chapter XI of the Bankruptcy Act.[1] Operating the motel as a debtor in possession, the corporation withheld income and social security taxes from its employees' wages and collected excise taxes on the receipts from its cabaret. The arrangement subsequently failed and an adjudication of bankruptcy was entered.[2] A trustee in bankruptcy was appointed, and, when the withheld and collected taxes later became due,[3] he neither paid the taxes nor filed returns for them. The United States filed claims for the taxes, for interest thereon, and for penalties for failure to file. The referee in bankruptcy allowed the claim for taxes, but disallowed the claims for penalties and interest.[4] The district court affirmed.[5] The Fifth Circuit reversed in

sought to enjoin the merger of the second and fourth largest banks in the Nashville area. Although commercial banking in the area was extremely concentrated (the three largest banks accounted for 93% of all deposits and loans), the court held that under the new act a mere quantitative analysis is not sufficient to establish a violation of either the Sherman or Clayton Acts. United States v. Third Nat'l Bank, 35 U.S.L. Week 2307 (M. Tenn. Nov. 22, 1966).

52. Business Week, Jan. 28, 1967, p. 101, at 102.

1. Bankruptcy Act § 322, 52 Stat. 907 (1938), as amended, 11 U.S.C. § 722 (1964).

2. Nicholas v. United States, 384 U.S. 678, 680 (1966). See Brief for Petitioner on the Merits, p. 23, Nicholas v. United States, 384 U.S. 678 (1966).

3. The income taxes, social security taxes and cabaret taxes were due to be paid on October 31, 1958. On January 31, 1959, a payroll tax was due. 384 U.S. at 680.

4. Id. at 681.

5. Ibid.

part, allowing the claims for both penalties and interest in addition to the claim for the principal of the taxes.[6] The Supreme Court[7] disallowed the claim for interest,[8] but affirmed the allowance of penalties. *Nicholas v. United States*, 384 U.S. 678 (1966).

Boteler v. Ingels,[9] held controlling in the instant case,[10] allowed penalties against a trustee in bankruptcy for failure to pay license and registration fees on vehicles which he operated in the process of liquidating a bankrupt business.[11] There the Court held inapplicable section 57(j) of the Bankruptcy Act,[12] which provides that "debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed . . . ."[13] It was reasoned that the wording of section 57(a) of the act[14] indicates that the entirety of section 57 applies only to claims owing from the bankrupt to a creditor.[15] Since the penalties in issue were incurred by the trustee, they were not owed by the bankrupt. Therefore, the Court found that the penalties in question should be allowed[16] pursuant to the Act of June 18, 1934, which provides that "any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation."[17] The principle was thereby established that penalties against a trustee for failure to pay taxes incurred while operating a bankrupt business were allowable against the bankrupt estate.[18]

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6. United States v. Nicholas, 346 F.2d 32 (5th Cir. 1965).

7. Because of a contrary result reached in the Eighth Circuit in United States v. Kalishman, 346 F.2d 514 (8th Cir. 1965), the Supreme Court granted certiorari. 382 U.S. 971 (1966).

8. The Court discerned three periods in the life of this bankrupt estate—the time prior to the filing of the petition for an arrangement, the abortive arrangement proceeding, and the straight bankruptcy. The Court held that interest on a claim may only accumulate during the period in which the claim arose. 384 U.S. at 685-86. Mr. Justice Harlan disagreed, arguing that the arrangement period should not be treated separately from the subsequent bankruptcy period, and that, therefore, the interest should continue to accumulate after the termination of the arrangement. Id. at 696 (separate opinion).

9. 308 U.S. 57 (1939).

10. 384 U.S. at 693-95.

11. 308 U.S. at 60-61.

12. Id. at 60.

13. 30 Stat. 561 (1898), as amended, 11 U.S.C. § 93(j) (1964).

14. 30 Stat. 560 (1898), as amended, 11 U.S.C. § 93(a) (1964). "A proof of claim shall consist of a statement, in writing and signed by a creditor, setting forth the claim . . . and that the claim is justly owing from the bankrupt to the creditor." Ibid.

15. 308 U.S. at 60.

16. Id. at 61.

17. 28 U.S.C. § 960 (1964).

18. A similar holding followed in In re Los Angeles Lumber Prod. Co., 45 F. Supp. 77 (S.D. Cal. 1942). In a case involving liability for penalties for failure to pay sales taxes, the court ruled that penalties on taxes that had accrued prior to bankruptcy were not

The present case is, however, one of first impression. As the majority opinion noted, the *Boteler* case is distinguishable from the instant case.[19] In *Boteler*, the Court found an obligation on the trustee to pay the license taxes on vehicles employed in his own liquidating operations. Here the penalties were imposed solely because of the trustee's failure to file returns for taxes incurred by the debtor in possession during the Chapter XI arrangement period. The Court felt, however, that this distinction, rather than dictating a different result than in *Boteler*, gave an additional reason for allowing the penalty. Allowance in the instant case did not involve the risk inherent in *Boteler* that a trustee would be forced to choose between incurring a penalty or paying a tax and later finding that there is not enough money in the estate to pay claims with higher priorities.[20]

Before reaching the question of whether the penalty was allowable, the Court had to consider whether the penalty was validly assessed against the trustee. The Court first reasoned that the trustee was liable for the taxes to the extent of the priority granted under section 64(a)(1).[21] This liability "results from his succession in interest to the title of the debtor in possession, who, as an officer of the bankruptcy court, was clearly subject to such taxes under the provisions of 28 U.S.C. § 960 . . . ."[22] Since the trustee was liable for the taxes, he was required to file a return under section 6011(a) of the Internal Revenue Code,[23] and his failure to do so justified the imposition of penalties.

Mr. Justice White, with whom Justices Douglas and Fortas concurred, dissented on the penalty issue.[24] He found fault with the majority's reliance on *Boteler*, arguing that there the trustee had incurred the obligation in his own operation of the bankrupt business and not as a result of a debtor's prior operations.[25] Here, he felt, the penalty should not have been assessed, since the trustee's obligation to pay the taxes could become effective "only when and if [the taxes] . . . are allowed and distribution is ordered."[26] Thus, he argued,

allowable under section 57(j), but that penalties on taxes that had accrued after bankruptcy were allowable under the Boteler rule. Another case in which the Boteler decision was followed was In re Chicago & N.W. Ry., 39 F. Supp. 147 (N.D. Ill.), aff'd, 119 F.2d 971 (7th Cir. 1941), where state taxes were levied in 1935 and became a lien forthwith, but did not become due until the following year. In the interim, the debtor was adjudicated bankrupt. After the taxes had become delinquent, during a trustee's term, the state sought allowance of its claim for penalties for failure to pay the taxes. The court held that since the taxes did not become due nor did the penalties begin to accumulate until after the adjudication in bankruptcy, the trustee was liable for payment of the taxes and was, therefore, liable for penalties for nonpayment thereof.

19. 384 U.S. at 694.

20. Id. at 694-95.

21. 52 Stat. 874 (1938), as amended, 11 U.S.C. § 104(a)(1) (1964).

22. 384 U.S. at 693 n.27.

23. Int. Rev. Code of 1954, § 6011(a). This section provides that "any person made liable for any tax . . . shall make a return . . . ."

24. 384 U.S. at 696 (separate opinion).

25. Id. at 701 (separate opinion).

26. Id. at 698 (separate opinion).

there was no liability to pay the taxes as envisioned by section 6011(a) and the trustee was neither bound to file the return, nor subject to a penalty for failure to do so.[27] Mr. Justice White concluded that the majority's treatment of the trustee as the same legal person as the debtor in possession had no legal basis, because

> the successor liability of the trustee who succeeds a debtor in possession is no different from that of the trustee who succeeds the ordinary bankrupt, except that taxes accruing during the arrangement are distinguished from prearrangement taxes in that they are classified as administrative expenses and thus are escalated from a Class 4 to a Class 1 priority, although relegated to an inferior position within Class 1 and hence payable only if there are sufficient assets to pay prior expenses.[28]

The majority's rationale for treating the debtor in possession and the trustee as the same legal person was essentially the same as the reasoning which makes the trustee liable to pay claims which arise from debts incurred by the ordinary bankrupt before bankruptcy.[29] It is, however, well-established that the trustee following an ordinary bankrupt "is not obligated to, indeed is not authorized to, file the individual's return . . . ."[30] If the mere liability to pay claims were the type of liability envisioned by section 6011(a), as the majority held, "the bankruptcy trustee in the ordinary proceeding not following an abortive Chapter XI arrangement could not escape the rule [advanced by the majority] . . . ."[31] As the dissent noted, holding one person responsible for certain acts of another is quite different from terming the two in all respects the same legal person.[32]

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27. Id. at 698-99 (separate opinion).

28. Id. at 699 (separate opinion).

29. See 384 U.S. at 693 n.27. The majority relied on In re Wil-low Cafeterias, Inc., 111 F.2d 429 (2d Cir. 1940), where the debtor, in a reorganization proceeding, had been permitted by the court to continue the operation of the business and to hire new employees as a debtor in possession. The debtor then made a contract with a union providing that each union member employed by the debtor was to receive a week's vacation with pay per year of service. In an employee's suit against the subsequently appointed trustee for one week's pay under the contract, the court held that the contract was an authorized act of the debtor in possession and that the trustee was therefore liable under it for the employee's claim. See also In re Wil-low Cafeterias, Inc., 111 F.2d 83 (2d Cir. 1940), in which the question arose as to whether subleases adopted under court authorization by the debtor in possession bound the subsequently appointed trustee. In holding that the trustee succeeded to both the rights and obligations of the debtor in possession under the sublease, the court said, "with the court's approval an officer of the court had affirmed the subleases; it is incredible that another officer subsequently appointed need reaffirm them or has any power to disaffirm them, at least in the absence of some extraordinary circumstance." Id. at 86. "[T]he receiver or trustee is bound in the absence of unusual circumstances, by the authorized acts of the debtor in possession." 8 Collier, Bankruptcy ¶ 6.32, at 965 (14th ed. 1966).

30. 384 U.S. at 698 (separate opinion).

31. Ibid.

32. Ibid.

Mr. Justice White, assuming the validity of the penalties, also disagreed with their allowance. The majority's holding was an apparent violation of the spirit of the Court's prior holding in *Simonson v. Granquist.*[33] There it was said that section 57(j) "is in keeping with the broad aim of the Act to provide for the conservation of the estates of insolvents to the end that there may be as equitable a distribution of assets as is consistent with the type of claims involved."[34] The *Simonson* decision also noted that it would be inequitable to punish the bankrupt's creditors rather than the wrongdoer himself by the allowance of penalties.[35] Although the issue in the *Simonson* case was whether a liened tax penalty incurred prior to bankruptcy was exempt from the prohibition of section 57(j), the Court's reasoning as to the purpose of that section would be applicable here.

Most commentators agree with the interpretation of 57(j) which would disallow penalties against bankrupt estates. "[T]he manifest purpose of the prohibitive section [57(j)] is to protect the general creditors from diminution of their shares . . . ."[36] Hardship to creditors, such as attorneys and employees, in no-asset cases has been cited as another evil resulting from an overly generous allotment to the government[37] inasmuch as "the creditor has contributed to the bankrupt's estate prior to bankruptcy, which is the basis for his claim, while the government is seeking to recover a mere fine or type of punishment assessed against the bankrupt."[38]

The present holding, failing to follow the "general policy against allowing penalties against bankrupt estates"[39] could be justified "if the filing of the return by the trustee performed some critical function . . . ."[40] The government, however, will collect its taxes regardless of the filing of the return since notice must be given to the Internal Revenue Service of the first creditors'

33. 369 U.S. 38 (1962).

34. Id. at 40.

35. "Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors." Id. at 41. "It is this consideration for the bankrupt's creditors that pervades § 57j." 3 Collier, Bankruptcy ¶ 57.22, at 346 (14th ed. 1966).

36. 40 B.U.L. Rev. 131, 136 (1960). The author discussed "the resultant inequities to the sharing creditors if the contested penalty claims were allowed." Ibid.; see H.R. Rep. No. 745, 86th Cong., 1st Sess. 12 (1959), where it is said that, "since the purpose of a penalty is to punish the wrongdoer, that purpose is in no way furthered by permitting a penalty assessed against the bankrupt to be allowed against the bankrupt's estate." Id. at 20. See also Comment, Post-Petition Interest on Tax Claims, 34 Fordham L. Rev. 504 (1966).

37. See Note, 35 Ind. L.J. 351, 359 (1960).

38. 38 Texas L. Rev. 800, 803 (1960). The author concluded that "the allowance of a penalty seems grossly inequitable and against the underlying theory of the Bankruptcy Act, which is equal distribution of the bankrupt's assets . . . ." Id. at 801.

39. 384 U.S. at 699 (separate opinion).

40. Ibid.

meeting, and the government would, therefore, have ample opportunity to file a claim.[41] Moreover, it will be difficult for a trustee to determine whether tax returns must be filed, and, if the date for filing is soon after the trustee's appointment, it might be difficult for him to gather the proper information and file.[42]

The majority itself, in that part of the opinion disallowing the government's claim for interest, sanctioned equitable principles which it ignored in its allowance of penalties. These principles are based on "historical considerations of equity and administrative convenience . . . ."[43] "Equity" protects the general creditors from constantly diminishing shares in the bankrupt estate due to the accumulation of interest on the government's claim and the delay in the settlement of the estate caused by operation of law. "Administrative convenience" refers to the burden spared the trustee of constantly recalculating the various claims as the unpaid interest continually increases. The penalty for failure to file in the instant case was five per cent of the tax per month until the filing of the return, but it could not exceed twenty-five per cent of the tax.[44] A penalty is usually a lump sum, and, therefore, problems of continuous shrinking of the creditors' portion of the estate are not usually involved. The distinction is tenuous at best where the penalty will increase monthly for five months, each month reducing the shares of the other creditors and forcing the trustee to recalculate the amount of all the claims. In some instances, a penalty can be even more like interest.[45] For these reasons, disallowance of the penalty would seem to have been the only course open to the instant Court.

Estate Tax—Marital Deduction Disallowed on Surviving Spouse's Interest in a Trust As Not Constituting a Specific Portion of the Estate.—Plaintiff was the executor and trustee of the estate of the decedent, who had left a will which set up a trust. According to the terms of the will, the decedent's spouse was to receive $300.00 per month out of the income and principal of the trust until their youngest child reached 18 years of age, at which time the payments were to be increased to $350.00 per month. Furthermore, the spouse was given a testamentary power of appointment over the remainder. The Commissioner

41. Id. at 700 (separate opinion).

42. Ibid.; see Bankruptcy Act § 58(e), 52 Stat. 868 (1938), as amended, 11 U.S.C. § 94(e) (1964). The maximum extension granted for filing such returns is 15 days. Mim. 6157, 1947-2 Cum. Bull. 64, 66.

43. 384 U.S. at 682.

44. Id. at 680 n.5.

45. For example, in the case of In re Chicago & N.W. Ry., 39 F. Supp. 147 (N.D. Ill.), aff'd, 119 F.2d 971 (7th Cir. 1941), the penalty was one per cent of the unpaid tax per month until paid, thus accruing in the same manner and for the same length of time as interest. In all respects, therefore, this penalty accrued as interest, with the single exception that it was more burdensome.

disallowed a marital deduction as to any portion of the trust on the grounds that it did not meet statutory requirements.[1] The district court,[2] rejecting the government's arguments in part,[3] allowed a deduction for a part of the corpus of the trust.[4] The court of appeals reversed. *Northeastern Pa. Nat'l Bank & Trust Co. v. United States,* 363 F.2d 476 (3d Cir.), cert. granted, 87 Sup. Ct. 509 (1966).

The marital deduction, as embodied in section 2056 of the Internal Revenue Code of 1954, is an attempt to equalize the rights of surviving spouses in community property and common law states.[5] This aim is accomplished by allowing

1. The government's argument was that the estate "does not qualify for the marital deduction because the surviving spouse is not entitled to all of the income from the entire interest . . . ." Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 235 F. Supp. 941, 942 (M.D. Pa. 1964). (Footnote omitted.) The government here referred to Int. Rev. Code of 1954, § 2056(b)(5), "life estate with power of appointment in surviving spouse.— In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse . . . ."

The government's second argument was that the estate also "cannot fit within the definition of a specific portion because . . . the surviving spouse's rights in income must be a fractional or percentile share and not a fixed amount . . . ." Northeastern Pa. Nat'l Bank & Trust Co. v. United States, supra. Here the government relied on Treas. Reg. § 20.2056 (b)-5(c) (1958): "Definition of 'specific portion'. A partial interest in property is not treated as a specific portion of the entire interest unless the rights of the surviving spouse in income and as to the power constitute a fractional or percentile share of a property interest so that such interest or share in the surviving spouse reflects its proportionate share of the increment or decline in the whole of the property interest to which the income rights and the power relate. Thus, if the right of the spouse to income and the power extent [sic] to one-half or a specified percentage of the property, or the equivalent, the interest is considered as a specific portion. On the other hand, if the annual income of the spouse is limited to a specific sum, . . . the interest is not a deductible interest."

2. Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 235 F. Supp. 941 (M.D. Pa. 1964).

3. The court accepted the government's first argument, id. at 944-45, but rejected the second argument, id. at 945-46. See note 1 supra.

4. Id. at 947.

5. Mr. Justice Goldberg, in discussing the legislative intent behind the marital deduction, observed that "under a community property system, such as that in Texas, the spouse receives outright ownership of one-half of the community property and only the other one-half is included in the decedent's estate. To equalize the incidence of progressively scaled estate taxes and to adhere to the patterns of state law, the marital deduction permits a deceased spouse . . . to transfer free of taxes one-half of the non-community property to the surviving spouse. . . . [T]he primary thrust of this is to extend to tax-

up to a maximum of fifty per cent of the adjusted gross of the decedent's estate passing to the surviving spouse to qualify for a marital deduction.[6] The effect is to defer taxation of some part of the decedent's estate passing to the surviving spouse until the death of the survivor. To insure that estates would not escape ultimate taxation, the terminable interest rule was created.[7] This restriction on the marital deduction disqualifies a trust if the interest of the surviving spouse will fail on lapse of time or some other contingency.[8] This rule, however, resulted in preventing certain traditional methods of estate planning from qualifying for the marital deduction,[9] and so three exceptions to the terminable interest rule were made,[10] one of which was the life estate with an appropriate power of appointment.[11] Thus, where the surviving spouse is entitled to all the income produced from the corpus of a trust for the remainder of the survivor's life, with power in the survivor to appoint the entire corpus, the entire corpus of the trust qualifies for a marital deduction. Whereas previously only an entire trust could qualify for a deduction,[12] it later developed that a "specific portion" of the trust could qualify if that portion met the requirements.

Since the spouse in the present case was not necessarily entitled to all the income of the trust, it was clear that the entire trust did not qualify for a marital deduction.[13] The court was therefore faced with the question of whether a specific portion of the trust qualified.[14]

In *Gelb v. Commissioner*,[15] the surviving spouse was entitled to all the income from the trust estate, but the trustees had discretionary power to invade the corpus for up to $5,000.00 per year for the support of the decedent's daugh-

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payers in common-law States the advantages of 'estate splitting' otherwise available only in community property States." United States v. Stapf, 375 U.S. 118, 128 (1963). Accord, Dougherty v. United States, 292 F.2d 331 (6th Cir. 1961); Commissioner v. Estate of Ellis, 252 F.2d 109 (3d Cir. 1958). See generally Anderson, The Marital Deduction and Equalization Under the Federal Estate and Gift Taxes Between Common Law and Community Property States, 54 Mich. L. Rev. 1087 (1956); Polasky, Marital Deduction in Estate Taxation, 12 Ark. L. Rev. 1 (1957); Note, 107 U. Pa. L. Rev. 1176 (1959).

6. Int. Rev. Code of 1954, § 2056(c)(1).

7. United States v. Stapf, 375 U.S. 118, 128 n.13; see Note, 107 U. Pa. L. Rev. 1176, 1177 (1959).

8. Int. Rev. Code of 1954, § 2056(b)(1). See generally Edwards, Marital Deduction Pitfalls—Methods of Losing the Marital Deduction, 16 W. Res. L. Rev. 247 (1965).

9. See Note, 107 U. Pa. L. Rev. 1176, 1178-79 (1959).

10. The three exceptions are interests conditioned on the widow's survival for a limited period, life estates with powers of appointment, and life insurance or annuity contracts. Int. Rev. Code of 1954, § 2056(b)(3), (5), (6); see Note, 16 W. Res. L. Rev. 190, 194-95 (1964).

11. Int. Rev. Code of 1954, § 2056(b)(5).

12. Int. Rev. Code of 1939, § 812(e)(1)(F), added by ch. 168, 62 Stat. 118 (1948); Gelb v. Commissioner, 298 F.2d 544, 549 (2d Cir. 1962).

13. 363 F.2d at 480-81.

14. Id. at 481.

15. 298 F.2d 544 (2d Cir. 1962).

ter.[16] The Commissioner argued that a treasury regulation required that a specific portion must be a fraction or percentage in order to reflect any increment or decline in the value of the property,[17] because otherwise, " 'there is no certainty that the value' of the entire corpus 'will be the same on the date of the surviving spouse's death as it was on the date of decedent's death,' . . . ."[18] Furthermore, the Commissioner contended that the legislative reports mentioned a fraction as an example of a specific portion.[19] Rejecting the Commissioner's arguments, the court, through Judge Friendly, pointed out that "Congress spoke of a 'specific portion,' not of a 'fractional or percentile share,' . . ."[20] and gave no indication that a change in the surviving spouse's share should be a controlling factor.[21] The court, after holding that use of a fraction as an example does not constitute an exclusive expression on the subject, proceeded to compute actuarily the portion of the trust entitled to a deduction. Thus, the court multiplied the $5,000.00 stipend by the mother's and daughter's joint life expectancies to establish the maximum portion to which the surviving spouse reasonably would not be entitled. This amount was then subtracted from the whole to arrive at the "specific portion" which would qualify for a marital deduction. It was admitted that this method was at least somewhat inaccurate.[22] But Judge Friendly answered this possible objection by pointing to the widespread use of actuarial tables in estate tax problems.[23]

The plaintiff in the instant case relied heavily on *Gelb*. The district court, in granting judgment for the plaintiff, agreed that *Gelb* was controlling,[24] and, using an actuarial method,[25] arrived at the sum necessary to produce an income of $300.00 per month for the surviving spouse's life. The instant court, in rejecting

16. Id. at 546 n.1.

17. He relied on Treas. Reg. § 20.2056(b)-5(c) (1958). See note 1 supra.

18. Gelb v. Commissioner, 298 F.2d 544, 550 (2d Cir. 1962), quoting from Treas. Reg. § 20.2056(b)-5(c) (1958).

19. 298 F.2d at 549. The example relied upon is, "if the decedent in his will provided for the creation of a trust under the terms of which the income from one-half of the trust property is payable to this surviving spouse with uncontrolled power in the spouse to appoint such one-half of the trust property by will, such interest will qualify as an exception from the terminable interest rule." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 319 (1954).

20. 298 F.2d at 550-51.

21. Ibid.

22. Id. at 551.

23. Id. at 551-52. The court documented the use of actuarial tables. Id. at 551 n.7.

24. Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 235 F. Supp. 941, 946 (M.D. Pa. 1964).

25. Id. at 947. The formula is based on United States Life Table 38 and can be found in Treas. Reg. § 20.2031-7 (1958). Simply stated, 3½%, the assumed interest yield, is multiplied by the present value of a right to receive $300.00 per month for the life expectancy of a 42-year-old surviving spouse. Therefore, the formula utilized was $300.00 × 12 × 17.3911 (the factor for the discount rate of 3½% for surviving spouse's life expectancy) × 1.0159 (the factor for monthly payments).

the actuarial method, raised the objection mentioned in *Gelb*, that it "does not . . . isolate that part of the trust corpus from which the surviving spouse is entitled to all the income."[26] The majority advanced four arguments to support its position. Initially, the court recognized the actuarial method as appropriate for annuities and by this fact inappropriate for determining a specific portion, since, under this method, the entire fund will have been dissipated at the survivor's death, and the factor of fund dissolution was in no way contemplated by the decedent.[27] Secondly, the court pointed to the incongruity of equating the $300.00 monthly stipend with the income yield. Under the trust agreement, the trustees had not been directed to invest the corpus so that it would yield a given monthly income. Since the trustees were only directed to pay the monthly stipend even if corpus had to be invaded, the stipend and income yield were hardly equivalent.[28] Thirdly, by definition, any computation of a specific portion must proceed from the value of the entire trust, rather than a capitalization of the monthly stipend, since capitalizing a monthly stipend under the actuarial method for determining a specific portion could reach a figure in excess of the value of the entire corpus.[29] Finally, the court indicated that the use of any variable factors other than life expectancy artificially inflates the portion by making constant factors which are variable.[30]

Judge Forman, for the instant court, distinguished *Gelb* on the basis that there was only one variable—life expectancy[31]—in that case in comparison with the many variables here—life expectancy, market conditions for investment purposes,[32] and the extent to which the corpus might be invaded.[33] As a result

26. 363 F.2d at 481.

27. Id. at 481-82. The factor 17.3911 in the formula represents the present worth of one dollar invested in an annuity at 3½% over the remaining life expectancy of the surviving spouse. The formula thus provides a discount value through a process of capitalizing at 3½% what are directed to be $300.00 monthly payments. If $63,663.43 is invested at age forty-two, the age of the surviving spouse at the decedent's death, that amount will provide the annuitant the required monthly payments for her entire life. But at death the entire fund will have dissipated. Ibid.

Although it did not affect its holding, the court mischaracterized the factor 17.3911 as the present worth of an investment of $1.00 over the remaining life expectancy. This factor actually represents the present worth of the total annuity fund which will yield an annuity of $1.00. See Treas. Reg. § 20.2031-7(f), Table 1 (1958).

28. 363 F.2d at 482.

29. Ibid. Capitalizing a $350.00 monthly stipend, the capital figure reached is $74,199.80, a sum in excess of the value of the entire corpus. Ibid.

30. Ibid. Further, "the 3½ percent investment factor . . . is . . . unreal." Ibid.

31. Id. at 483. Indicating that Gelb could be distinguished, it was pointed out that there was no question in Gelb as to how much the corpus could be invaded, as $5,000.00 per year represented a maximum. Ibid. The court had already stated that the only acceptable variable was life expectancy. Ibid.

32. The majority pointed out that if the market conditions are poor, a greater amount must be taken from the corpus, while if they are good, the income must be accumulated. In either case there is no certainty. Id. at 484.

33. Whereas the trust in Gelb empowered the trustees to invade the corpus to the

of these variable factors, "the ratio between the maximum monthly income and the monthly stipend—the fraction of the entire corpus which would be the 'specific portion' for marital deduction purposes—may not be acceptably computed."[34]

In *Citizens Nat'l Bank v. United States,*[35] the Seventh Circuit reached the opposite conclusion on almost identical facts. Following *Gelb,* the majority rejected the Treasury Regulation in so far as it limited "specific portion" to a fractional share.[36] In considering the problem presented as to the variables and the use of actuarial tables, the court cited with approval the decision of the district court in the instant case.[37]

Although the instant court refused to consider the validity of the Treasury Regulation, it apparently agreed with *Gelb* as to the facts of that case.[38] Thus, the decision appears to support the proposition that a specific portion need not be a fractional share as long as the amount of the portion can be computed with reasonable accuracy. While the court here was not satisfied with the

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maximum extent of $5,000.00 per year for the support and education of the decedent's daughter, the trust in the present case authorized the trustees to pay an amount not exceeding $1,500.00 in the event of a serious illness or financial emergency. In Gelb, the lump sum amount to be invaded per year could be maximized. But here it would be impossible to determine the amount to be drawn in case of illness or emergencies. Thus, any formula predicated on such factors as constants must fail. Ibid.

In dissent, Judge Ganey wrote: "I do not take into consideration fluctuation, wide or narrow, of the value of the corpus or the income thereon, over what would be the life expectancy of the wife, since the marital deduction is taken only once, at the death of testator, and I determine then what would be its value and not what might ultimately happen." Id. at 487; cf. Jackson v. United States, 376 U.S. 503 (1964). Agreeing with the lower court, Judge Ganey saw no reason why "the field [should] lie fallow and [we should] adopt a sterile attitude of defeatism because the testator has not resorted to fractional or percentile figures." 363 F.2d at 488. Judge Ganey also rejected the majority's argument that Congress intended to extend the marital deduction only to those interests akin to a fee simple, id. at 482-83, saying that this did not bear on the issue since such reasoning would also disqualify this estate even if expressed in fractional terms, id. at 488. The majority gave as a further reason for denying the deduction the fact that the will qualified the monthly stipend by making it unassignable and not subject to the surviving spouse's debts. Id. at 485. The court had already concluded that the surviving spouse's interest did not conform to the intended fee simple because it was not subject to the "rise and fall of the market." Id. at 482.

34. Id. at 484. (Footnote omitted.) A similar result was reached in Flesher v. United States, 238 F. Supp. 119 (N.D.W. Va. 1965).

35. 359 F.2d 817 (7th Cir.), petition for cert. filed, 35 U.S.L. Week 3108 (U.S. Aug. 26, 1966) (No. 488). The surviving spouse was entitled to an income of $200.00 per month even if the corpus had to be invaded. The trustee was empowered to pay, inter alia, all costs and taxes out of the corpus. The same formula as found in Treas. Reg. § 20.2031-7 (1958), which was used in the district court in the instant case, was employed.

36. 359 F.2d at 821.

37. Ibid.

38. 363 F.2d at 483-84.

method used by the lower court, it did indicate that an acceptable method might be found "if the investment factors involved were constant and it could be determined that the maximum income that could be produced from the corpus in a month was, for example, \$500 then the relationship between the \$300 monthly stipend and the \$500 maximum income would define 'specific portion' for marital deduction purposes . . . ."[39]

The dissent in the instant case and the majority in *Citizens Nat'l Bank* argued, however, that the use of the actuarial formula, although not absolutely accurate, is reasonably accurate and within the legislative intent, and therefore should be employed in determining the amount of the marital deduction.[40]

While it is true that the variables in the instant case were such that any determination of a specific portion might in fact be grossly inaccurate, it seems harsh to deny the estate any deduction when it is clear that some portion of the trust will meet the requirements for the deduction. The government should have some legitimate interest involved before such a result is reached, and it would seem that here it does not. As Judge Friendly pointed out in *Gelb*, "the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work."[41] This being true, should the government complain of the possibility of error in any single case?

Res Judicata—*Successful Action by Passenger of One Automobile Against Driver of Another Bars Second Driver from Recovering Against First Driver in Subsequent Suit.*—An automobile owned by the Standard Electric Corporation and driven by Bernard Dresher collided with an automobile owned by Martin Cummings and driven by his wife Mary. Henry Dresher, Bernard's brother, was accompanying him at the time of the accident. The Dreshers brought separate suits against the Cummingses. These actions were tried jointly in the United States district court for the Southern District of New York. The jury decided in favor of passenger Henry, but the Cummingses were absolved of any liability to driver Bernard.[1] In announcing the latter verdict, the jury stated that it found Mary Cummings to be negligent, but denied recovery since it found Bernard Dresher contributorily negligent. The Cummingses then

39. Id. at 484 n.17. (Emphasis omitted.)

40. Id. at 487-88. The dissent reasoned that "since the surviving spouse is absolutely entitled to . . . \$300.00 per month, and if this amount is construed to represent income from corpus, then the amount of the corpus which would yield this income could be ascertained and regarded as qualifying as a 'specific portion' for the marital deduction." Id. at 487. The use of the actuarial formula employed by the district court was found not to "strain the statutory intent nor . . . work a change in the phrase 'specific portion', and is fully in accord with the mandate of the statute . . . ." Id. at 487-88.

41. 298 F.2d at 552.

1. Cummings v. Dresher, 18 N.Y.2d 105, 110, 218 N.E.2d 688, 691, 271 N.Y.S.2d 976, 979 (1966) (dissenting opinion).

instituted the present suit against Bernard Dresher and Standard Electric in the New York supreme court. The defendants argued that since Mary Cummings' freedom from contributory negligence was a necessary requisite to the Cummingses' success in their action, and, since that precise issue had been conclusively determined against them in the previous litigation, the complaint should be summarily dismissed on the ground that the prior litigation was an effective bar to any redress the plaintiffs might claim. The trial court and the appellate division denied the defendants' motion for summary judgment, but the court of appeals, with two judges concurring and another dissenting,[2] reversed and held that the previous adjudications were res judicata. *Cummings v. Dresher*, 18 N.Y.2d 105, 218 N.E.2d 688, 271 N.Y.S.2d 976 (1966).

The underlying purpose of the common law doctrine of res judicata[3] is to further the fundamental interest of the state that there "should be an end to litigation."[4] Its thrust is to cut off all unwarranted and unnecessary legal actions; its justification is that a party should be entitled to his day in court, but only once on any one cause of action.[5] However, the desire to prevent unnecessary litigation should not be realized at the cost of denying a party the opportunity to have the validity of his claim decided by a court of law.[6] To this end, res judicata and its companion doctrine, collateral estoppel,[7] have been traditionally circum-

2. Judge Bergan dissented. Judges Fuld and Van Voorhis concurred in a separate opinion which held the federal compulsory counterclaim rule, Fed. R. Civ. P. 13(a), to be controlling. The majority and dissent considered the rule to be immaterial since it had been raised neither in the lower courts nor before the instant bench. 18 N.Y.2d 105, 108, 113, 218 N.E.2d 688, 690, 693, 271 N.Y.S.2d 976, 978, 982 (1966).

3. A final judgment "rendered upon the merits by a court of competent jurisdiction is conclusive of the rights of the parties or their privies in all other actions on the points in issue and adjudicated in the first suit." Good Health Dairy Prods. Corp. v. Emery, 275 N.Y. 14, 17, 9 N.E.2d 758, 759 (1937); see Schuylkill Fuel Corp. v. B. & C. Nieberg Realty Corp., 250 N.Y. 304, 306-07, 165 N.E. 456, 457 (1929).

4. Israel v. Wood Dolson Co., 1 N.Y.2d 116, 118, 134 N.E.2d 97, 98, 151 N.Y.S.2d 1, 3 (1956).

5. Id. at 119, 134 N.E.2d at 99, 151 N.Y.S.2d at 4.

6. "Judicial finality . . . is a salutary doctrine only when it precludes unnecessary litigation without eliminating a litigant's day in court . . . ." Moore & Currier, Mutuality and Conclusiveness of Judgments, 35 Tul. L. Rev. 301, 302 (1961); accord, Commissioners of State Ins. Fund v. Low, 3 N.Y.2d 590, 595, 148 N.E.2d 136, 138, 170 N.Y.S.2d 795, 798 (1958).

7. Res judicata should be distinguished from collateral estoppel. The former applies when the same cause of action is sued upon. There the judgment is binding not only as to facts actually determined, but also as to those which might have been decided. Collateral estoppel operates when the causes of action are different; then the estoppel works only as to those matters actually litigated. For a more detailed treatment of the difference between these two doctrines see Friedman v. Park Lane Motors, Inc., 18 App. Div. 2d 262, 265-66, 238 N.Y.S.2d 973, 976-77 (1st Dep't 1963); 5 Weinstein, Korn & Miller, New York Civil Practice ¶ 5011.24 (1966 ed.). New York courts, including the instant one, tend to treat the two as indistinguishable. See 36 N.Y.U.L. Rev. 1158, 1159-60 & n.10 (1961).

scribed by the requirements of privity of parties,[8] mutuality of estoppel,[9] and identity of issues.[10]

Since Henry Dresher, in his suit against the Cummingses, recovered damages resulting from his personal injuries, that action unquestionably barred the Cummingses from ever again contesting with Henry the issue of their liability to him. The court of appeals, however, decided that the Cummingses were also precluded from contesting the issue of their liability to Bernard. The court must have reasoned from either of two premises. The first would be that since Henry Dresher's successful prosecution determined that Mary Cummings' negligence was the cause of the collision, the Cummingses were precluded from raising this

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The present note will generally use the term res judicata in discussing what actually is a collateral estoppel problem, since the instant court talks in terms of res judicata and the distinction would be of no practical importance here.

8. Privity limits the number of litigants against whom the judgment can be asserted. See Haverhill v. International Ry., 217 App. Div. 521, 522, 217 N.Y. Supp. 522, 523 (4th Dep't 1926), aff'd mem., 244 N.Y. 582, 155 N.E. 905 (1927); 1 Greenleaf, Evidence § 523 (16th ed. 1899); Restatement, Judgments § 83 (1942); cf. Romeo v. Western Express Co., 45 N.Y.S.2d 297 (Sup. Ct. 1943).

9. Mutuality defines those who may plead the prior adjudication. "'[O]ne of the essentials of an estoppel by judgment or res judicata is that both the litigants must be concluded by the judgment or it binds neither.'" Coca Cola Co. v. Pepsi-Cola Co., 36 Del. 124, 128, 172 Atl. 260, 261 (Super. Ct. 1934). (Italics omitted.) See Haverhill v. International Ry., 217 App. Div. 521, 525-26, 217 N.Y. Supp. 522, 527 (4th Dep't 1926), aff'd mem., 244 N.Y. 582, 155 N.E. 905 (1927).

Privity of parties and mutuality of estoppel are two sides of the same coin and frequently can be treated as conceptually identical. A sounder approach, however, would be to regard privity as the tie that must bind the one against whom the former judgment is asserted, while mutuality is the requirement that must be fulfilled by the party seeking to take advantage of the prior adjudication. Thus, "the highly important function of limiting the persons who may invoke the conclusive effect of a judgment is left entirely to the doctrine of mutuality." Moore & Currier, supra note 6, at 330. (Emphasis omitted.) See 36 N.Y.U.L. Rev. 1158, 1162 (1961).

10. See Restatement, Judgments § 68 (1942). The tendency today is to disregard somewhat the traditional res judicata requirements and instead pay more heed to the practicalities of each situation. E.g., Graves v. Associated Transp., Inc., 344 F.2d 894 (4th Cir. 1965); Bernhard v. Bank of America Nat'l Trust & Sav. Ass'n, 19 Cal. 2d 807, 122 P.2d 892 (1942); Israel v. Wood Dolson Co., 1 N.Y.2d 116, 134 N.E.2d 97, 151 N.Y.S.2d 1 (1956); Good Health Dairy Prods. Corp. v. Emery, 275 N.Y. 14, 9 N.E.2d 758 (1937); Friedman v. Park Lane Motors, Inc., 18 App. Div. 2d 262, 267-68, 238 N.Y.S.2d 973, 978-79 (1st Dep't 1963) (dissenting opinion).

One commentator summed up the contemporary judicial notion of privity thusly: "[T]he term 'privity' in itself does not state a reason for either including or excluding a person from the binding effect of a prior judgment, but rather it represents a legal conclusion that the relationship between the one who is a party on the record and the non-party is sufficiently close to afford application of the principle of [res judicata] . . . ." Vestal, Preclusion-Res Judicata Variables: Parties, 50 Iowa L. Rev. 27, 45 (1964). See also Developments in the Law—Res Judicata, 65 Harv. L. Rev. 818, 861-62 (1952).

question in a subsequent action against Bernard.[11] The alternative premise would be that the unnecessary explanation by the jury, that they had decided that both drivers were negligent, was a binding determination of Mary Cummings' negligence.

Implicit in the first premise is the assumption that, if Mary Cummings were negligent towards passenger Henry, she must also have been negligent towards his driver Bernard. This assumption is, however, contrary to existing New York law. In *Daly v. Terpening*,[12] the court observed that "the positions of the driver and the passenger in the automobile are different . . . ."[13] Thus what "would be causative negligence of [one driver] . . . in so far as the passenger was concerned, may not be causative negligence as far as the [other] driver . . . was concerned . . . ."[14] The *Daly* decision went no further than this general principle. However, the supreme court of appeals of Virginia, in *Ferebee v. Hungate*,[15] considered this issue in more detail and observed that "the question of the last clear chance may be a pertinent issue between the two drivers, whereas it was of no concern to the [passenger] . . . ."[16] Mary's negligence, therefore, might have been a proximate cause of the collision as to Henry Dresher, but Bernard Dresher

11. The majority opinion borrowed some sweeping language on this point from Israel v. Wood Dolson Co., 1 N.Y.2d 116, 134 N.E.2d 97, 151 N.Y.S.2d 1 (1956), which was regarded as the breakthrough decision in New York in the struggle to end the harshness of the mutuality rule. The case received immediate notice: 23 Brooklyn L. Rev. 149 (1957); 42 Cornell L.Q. 290 (1957); 35 Texas L. Rev. 137 (1956). Justice Clark of the Second Circuit, however, had reviewed New York law on the subject more than ten years earlier and had concluded: "It seems to me reasonably clear that New York is committed to applying the exception [to mutuality] along broad lines to accord the defensive protection of estoppel of a former judgment to those whose liability must be founded, if at all, upon just the same issue as has been previously litigated." Riordan v. Ferguson, 147 F.2d 983, 993 (2d Cir. 1945) (dissenting opinion).

12. 261 App. Div. 423, 26 N.Y.S.2d 160 (4th Dep't) aff'd mem., 287 N.Y. 611, 39 N.E.2d 260 (1941). Terpening had instituted two actions against driver Mrs. Daly for damages arising out of a collision between the latter's and Terpening's vehicles. The first was for wrongful death of Terpening's spouse, a passenger in his auto who died of the injuries sustained therein. The second Terpening brought on his own behalf. Following a joint trial, a judgment was rendered for Terpening in the death action, but against him in the other. When Mrs. Daly later sued Terpening for her damages, he set up the defense of res judicata, claiming that the plaintiff's negligence had been conclusively settled. The appellate court denied his contention.

13. Id. at 426, 26 N.Y.S.2d at 163.

14. Id. at 427, 26 N.Y.S.2d at 164. Accord, Clark v. Naufel, 328 Mich. 249, 43 N.W.2d 839 (1950); Commissioners of State Ins. Fund v. Low, 3 N.Y.2d 590, 148 N.E.2d 136, 170 N.Y.S.2d 795 (1958); Neenan v. Woodside Astoria Transp. Co., 261 N.Y. 159, 184 N.E. 744 (1933) (by implication); cf. Hassenplug v. Victor Lynn Lines, Inc., 71 F. Supp. 70 (E.D. Pa.), aff'd mem., 163 F.2d 828 (3d Cir. 1947); Grijalva v. Elkins, 132 Colo. 315, 287 P.2d 970 (1955); Ordway v. White, 25 Misc. 2d 633, 204 N.Y.S.2d 209 (Sup. Ct. 1960), aff'd mem., 14 App. Div. 2d 498, 217 N.Y.S.2d 334 (4th Dep't 1961).

15. 192 Va. 32, 63 S.E.2d 761 (1951).

16. Id. at 40, 63 S.E.2d at 767.

might have been in a position to avoid the accident in the final moments. New York recognizes the last clear chance doctrine, and a party can recover, even though he would otherwise have been held negligent, if he can establish the requisites for applying the doctrine.[17] Therefore, the jury's decision allowing Henry to recover damages might be completely irrevelant in a later action brought by the Cummingses against Bernard.[18]

The second premise from which the instant court might have deduced its holding presents the issue of whether the court could have properly relied upon the gratuitous findings of the federal jury. Under prior New York law,[19] determinations by the trier of fact became adjudicated only when they formed the basis of the verdict.[20] Where only a general verdict had been called for,[21] any additional and immaterial conclusions that the jury volunteered were not binding in subsequent actions.[22] This was so even if the jury's statements related to issues raised by the pleadings[23] or if their observations later appeared in the court's

17. See, e.g., Kumkumian v. City of New York, 305 N.Y. 167, 111 N.E.2d 865 (1953); Chadwick v. City of New York, 301 N.Y. 176, 93 N.E.2d 625 (1950); Elliott v. New York Rapid Transit Corp., 293 N.Y. 145, 56 N.E.2d 86 (1944); Hernandez v. Brooklyn & Queens Transit Corp., 284 N.Y. 535, 32 N.E.2d 542 (1940). See also 41 N.Y. Jur. Negligence §§ 70-75 (1965) and authorities cited therein.

18. A similar situation involves the right of one tortfeasor to litigate issues of negligence with another tortfeasor after a third party has recovered in a negligence action against both of them. Minkoff v. Brenner, 10 N.Y.2d 1030, 180 N.E.2d 434, 225 N.Y.S.2d 47 (1962) (memorandum decision), held that res judicata was inappropriate in this situation and appeared to affirm the earlier case of Glaser v. Huette, 232 App. Div. 119, 249 N.Y. Supp. 374 (1st Dep't), aff'd mem., 256 N.Y. 686, 177 N.E. 193 (1931). The Minkoff court did not write an opinion, but one commentator has aptly suggested that the rationale employed involved the recognition that while the co-defendants had litigated the question of their negligence towards the plaintiff, their conduct toward one another was still in issue. 30 Fordham L. Rev. 820, 822-23 (1962).

19. Purpora v. Coney Island Dairy Prods. Corp., 262 App. Div. 908, 28 N.Y.S.2d 1008 (2d Dep't 1941), is markedly similar to the instant case. In the initial action the jury stated that both sides were at fault in an auto accident. The defendant, the plaintiff in the first suit, asserted that this previous determination barred the plaintiff in the later suit from recovering, but the court discounted this contention and ruled that the special and gratuitous verdict was unwarranted and not binding.

20. Cambria v. Jeffery, 307 Mass. 49, 29 N.E.2d 555 (1940); House v. Lockwood, 137 N.Y. 259, 33 N.E. 595 (1893); Raga v. S.S. Kresge Co., 274 App. Div. 966, 84 N.Y.S.2d 776 (4th Dep't 1948) (memorandum opinion).

21. "[I]t is clear from the record that the Judge [in the district court] was requiring the jury to return a general verdict . . . ." Cummings v. Dresher, 18 N.Y.2d 105, 113, 218 N.E.2d 688, 693, 271 N.Y.S.2d 976, 982 (1966) (Bergan, J., dissenting).

22. Purpora v. Coney Island Dairy Prods. Corp., 262 App. Div. 908, 28 N.Y.S.2d 1008 (2d Dep't 1941); Carrig v. Oakes, 173 Misc. 793, 20 N.Y.S.2d 585 (Sup. Ct.), aff'd mem., 260 App. Div. 989, 24 N.Y.S.2d 135 (4th Dep't 1940); Hollywood Cartage Co. v. Wheeling & Lake Erie Ry., 85 Ohio App. 182, 88 N.E.2d 278 (1948).

23. Karameros v. Luther, 279 N.Y. 87, 17 N.E.2d 779 (1938).

official reports.[24] Since the federal jury could have denied recovery to Bernard by simply finding that he alone was negligent,[25] the gratuitous statement that Mary was also negligent would not have been binding in the present action under prior New York law.

Unfortunately, the majority's opinion is not entirely clear and the possibility that Henry's adjudication was the deciding factor cannot be completely discounted. However, since the majority largely ignored the question of Henry's adjudication,[26] and discussed only the "definite and unmistakeable Federal court jury finding as to both drivers being at fault,"[27] it probably intended simply to overrule the well-established doctrine that gratuitous holdings have no validity.

There is, indeed, good reason to reconsider and perhaps modify the legal effect given to gratuitous jury findings. In a situation such as the one presented by the instant case, where a party has an opportunity to, and does in fact, fully litigate a particular issue,[28] any determination of fact by the jury which is relevant to the litigated issue should be considered an adjudication to which the res judicata doctrine could apply. On the other hand, the doctrine should not extend to instances where the volunteered statement bears no relevance to the dispute.[29]

There may be some difficulty in applying such a test. For example, in *Karameros v. Luther*,[30] a husband sued his wife to have their marriage declared void. She asserted that in a previous action in which she applied for a separation, the defendant pleaded the affirmative defense of no marriage, but withdrew the defense upon trial.[31] The court denied her the separation and found that a valid

24. McLoughlin v. Arlon Motors, Inc., 43 N.Y.S.2d 227 (Sup. Ct. 1943).

25. Restatement, Judgments § 68, illustration 10 (1942), gives this example: "A and B, while operating automobiles, have a collision. A brings an action against B, alleging that the collision was caused by the negligence of B. B denies that he was negligent and alleges that the collision was due to A's negligence. The trial court, sitting without a jury, finds that the collision was caused by the negligence of both A and B, and gives judgment for B. Thereafter B brings an action against A to recover the damage to his person and automobile resulting from the collision. B is not precluded from maintaining this action by the finding in the prior action that B was guilty of negligence and by the judgment in that action, since the judgment was based upon the negligence of A, and the finding that B was negligent was not material to the judgment."

26. 18 N.Y.2d at 106-08, 218 N.E.2d at 689-91, 271 N.Y.S.2d at 976-78.

27. Id. at 107, 218 N.E.2d at 689, 271 N.Y.S.2d at 977. Counsel for the plaintiff discussed the Daly case, but made no explicit reference to the last clear chance doctrine. Brief for Plaintiff, pp. 12-14, Cummings v. Dresher, 18 N.Y.2d 105, 218 N.E.2d 688, 271 N.Y.S.2d 976 (1966).

28. It might be argued that all Mary wished to show in the first action was that Bernard was negligent. This proven and his suit dismissed, she would then sue him in the state court. However, this seems unlikely. Mary could not know with certainty that Bernard would be found negligent and therefore would certainly wish to defend herself fully.

29. E.g., Karameros v. Luther, 279 N.Y. 87, 17 N.E.2d 779 (1938).

30. 279 N.Y. 87, 17 N.E.2d 779 (1938).

31. In the Karameros case, it is unclear at exactly what point during the trial the defense was withdrawn.

union existed. The New York court of appeals, in the second action, held that the finding of a valid marriage was not res judicata. The instant case perhaps overruled *Karameros*. But a question of fairness to the husband is raised; obviously he wished to litigate the marriage's validity at a later date. Should he be penalized for his decision? The extent of the evidence on the marriage presented in the first suit perhaps should be considered. The instant case offers no solution to this problem, and, unfortunately, resolution must lie with later courts.

Securities Regulation—Complaint Seeking Recovery Under Rule 10b-5 Dismissed Upon a Finding That Alleged Misrepresentations Were for a Purpose Other Than Defrauding Purchasers.—Quarterly and annual reports of the Belock Corporation concealed substantial overcharges to the government, with the result that the report overstated the corporation's assets, past income, and prospective income. When the overcharges became public, the price of Belock securities dropped. The plaintiffs alleged that they purchased their securities in reliance on the accuracy of the reports. The complaint also alleged that the defendants, directors of the corporation, knew or should have known that the reports were false, and that the dissemination of the reports " 'was intended to, and did have the effect of artificially inflating the market prices of Belock' securities."[1] Recovery was sought under section 10b of the Securities Exchange Act of 1934[2] and rule 10b-5.[3] The court dismissed the complaint for failure to state a claim on the ground that the fraud was not " 'in connection with the purchase or sale of any security . . .' " as required by section 10b.[4] *Heit v. Weitzen*, CCH Fed. Sec. L. Rep. ¶ 91701 (S.D.N.Y. June 9, 1966).

1. Heit v. Weitzen, CCH Fed. Sec. L. Rep. ¶ 91701, at 95580 (S.D.N.Y. June 9, 1966).

2. 48 Stat. 891 (1934), 15 U.S.C. § 78j (1964): "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— . . . .

(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. The Securities and Exchange Commission promulgated rule 10b-5: "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." 17 C.F.R. § 240.10b-5 (1951).

4. Heit v. Weitzen, CCH Fed. Sec. L. Rep. ¶ 91701, at 95580 (S.D.N.Y. June 9, 1966). The court stated as a further objection that there was an insufficient allegation of fraud.

Since the falsification of the reports was for the purpose of concealing the overcharges to the government—and not for the purpose of defrauding purchasers of the corporation's securities—the court concluded that the complaint was "devoid of the statement of any facts that the fraud complained of was perpetrated by the defendants 'in connection with any purchase or sale' of Belock's stock or debentures."[5] The court quoted from *Howard v. Levine*[6] as follows:

> The instant complaint is fatally defective for the allegations here do not show the gravamen of defendants' activities to be any wise "in connection with the purchase or sale of any security" as those words have been construed in their statutory setting. Whatever fraud is alleged here (it is in bare skeletal form) is directed against the government, notwithstanding its possible incidental market impact. Furthermore, defendants or persons associated with them did not participate in the security transactions involved.[7]

The final sentence quoted goes beyond the question of purpose and suggests an attempt to return to the requirement of some semblance of contract privity between defendant and plaintiff in a suit under rule 10b-5. In support of its statement, the *Howard* court cited *Joseph v. Farnsworth Radio & Television Corp.*,[8] a case in which the defendants, wishing to dispose of their stock holdings,

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Here, the court relied on the case of Howard v. Levine, Dkt. No. 65 Civ. 2148, L. S.D.N.Y., Nov. 24, 1965. The Howard court cited two cases in support of its dismissal of the complaint on grounds of insufficient allegation of fraud. In O'Neill v. Maytag, 230 F. Supp. 235 (S.D.N.Y.), aff'd, 339 F.2d 764 (2d Cir. 1964), there was no misrepresentation by the defendants. In Weber v. C.M.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965), the complaint did not allege scienter on the part of the defendants. The instant complaint clearly alleged both misrepresentation by the defendants and purchase by the plaintiffs. The allegation of scienter, however, was less clear. In one paragraph of the complaint, the plaintiffs alleged that the defendants " 'had knowledge or notice' " of the falsity of the reports. CCH Fed. Sec. L. Rep. ¶ 91701, at 95578. The terminology used in the Howard complaint was: " 'The defendants had or were charged with knowledge of the facts alleged . . . .' " Id. at 95580. It is conceded that this allegation standing alone would not be sufficient to withstand a motion to dismiss. In another paragraph, however, the complaint alleged that "the dissemination [of the statements] . . . was 'intended to, and did, have the effect of artificially inflating the market prices of Belock's' securities." Id. at 95578. Further, in a memorandum in opposition to the defendants' motion to dismiss, the plaintiffs said that "the defendants knew that the statements and reports issued, filed and disseminated were false . . . ." Memorandum of Plaintiffs in Opposition to the Motion to Dismiss, p. 10, Heit v. Weitzen, CCH Fed. Sec. L. Rep. ¶ 91701 (S.D.N.Y. June 9, 1966). Since in deciding a motion to dismiss the court must construe the complaint in the light most favorable to the plaintiff, it would seem that the court should have either found the allegation sufficient to withstand such a motion, or dismissed with leave to amend. Since the court did neither, it can be concluded that the insufficiency of this segment of the complaint was not pivotal, and that the thrust of the decision was toward the issue of purpose.

5. CCH Fed. Sec. L. Rep. ¶ 91701, at 95580.
6. Dkt. No. 65 Civ. 2148, S.D.N.Y., Nov. 24, 1965.
7. CCH Fed. Sec. L. Rep. ¶ 91701, at 95580.
8. 99 F. Supp. 701 (S.D.N.Y. 1951), aff'd, 198 F.2d 883 (2d Cir. 1952).

had issued a false report concerning their company in order to induce purchase of its stock by the public. The plaintiffs had purchased the stock, although from persons other than the defendants. Their complaint alleged that the defendants "knew that 'persons such as the plaintiffs and others similarly situated' would rely . . ."[9] on the reports in purchasing stock, but it failed to allege reliance by the plaintiffs on the accuracy of the reports. The court dismissed the complaint, referring to a need for some "semblance of privity" between the plaintiffs and the defendants.[10] The applicability of that decision to a case like the instant case is limited by two factors: the failure to allege reliance and the failure of the court to explain the phrase "semblance of privity." The nature of the securities market is such that strict contract privity is rarely found and almost impossible to establish. It is likely that the court would have been satisfied in that case had the defendants' sale and the plaintiffs' purchase been approximately contemporaneous. The court accordingly excepted from the range of its decision a situation in which there was contemporaneity and reliance, and it granted the plaintiffs leave to amend their complaint.[11] Subsequent courts have refused to require either contract privity or even participation by both parties in a transaction of purchase or sale.[12] The defendants in the instant case did not attempt to argue for such a requirement.

Remaining to be determined is the minimum connection required when the misrepresentation is made through the medium of a false financial report. To require that the fraud be aimed at the particular plaintiffs involved would be an effective return to a privity requirement; such a strict limitation has been rejected by the courts.[13]

9. Id. at 704.

10. Id. at 706.

11. Id. at 706-07.

12. E.g., Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962), where insiders deliberately announced a low dividend, intending to depress the price of the stock so that they could acquire it themselves. When the plaintiffs, who had sold their stock because of the low dividend, brought suit, the court refused to grant a motion to dismiss because of lack of privity. The court noted that "the fact that there is no privity of contract does not amount to a fatal defect . . . ." Id. at 245. Accord, New Park Mining Co. v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963), where the court said that "a purchaser or seller . . . is not limited . . . to an action against the other party to the purchase or sale; he can sue a third person if in connection with the purchase or sale that person defrauded him. . . . It is immaterial whether the purchase or sale was part of a larger scheme of corporate mismanagement if the elements of a claim under Section 10(b) and Rule 10b-5 are otherwise present." Id. at 266. In one case, the entire discussion of the privity issue was as follows: "Finally, there is no requirement of privity between plaintiffs and defendants, nor of any 'semblance of privity,' for recovery in Section 10(b) actions." Brennan v. Midwestern United Life Ins. Co., CCH Fed. Sec. L. Rep. ¶ 91817, at 95799 (N.D. Ind. Sept. 23, 1966). See, e.g., Errion v. Connell, 236 F.2d 447 (9th Cir 1956); Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 978 (S.D.N.Y. 1964); cf. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 293 (1966).

13. E.g., Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).

False reports issued for the purpose of inducing purchase or sale by the public have been found to be a sufficient connection.[14] No previous case, however, has turned primarily on the fact that the report was issued for a purpose other than that of defrauding purchasers. In *Texas Continental Life Ins. Co. v. Dunne*,[15] the defendants sold municipal bonds worth $2,000,000 to B. J. Cage, who paid $335,000 in cash and gave a note for the remainder. The prospectus issued by the defendants did not mention the fact that the sale of the bonds was on credit. The plaintiff bought the bonds from Cage in reliance on the prospectus. The value of the bonds depended upon Cage's meeting the payments on the bonds. He defaulted, and they became worthless. The plaintiff based its suit on the fact that there was an intentional misrepresentation by the defendants. No allegations were made concerning the defendants' motives or goals. Yet the Sixth Circuit ruled that "the conspiracy did not terminate when the bonds were sold to Cage. The fraud permeated and affected the entire issue of bonds which defendants placed in the channels of trade and any purchaser had a right to rely on the prospectus . . . ."[16] Three elements are common to the *Texas Continental* case and the instant case: lack of actual contract privity; reliance on a false report; and a scheme whose purpose was not that of defrauding purchasers.[17] Yet the *Texas Continental* court found liability because of the plaintiff's "right to rely" on the report and because the practice of resale was "well known" to defendants.[18]

This position is consistent with the common law, which provides a primary source for interpretation of the Securities Exchange Act.[19]

> The existence in the federal securities laws of such undefined terms as "fraud" and "misconduct" indicate that these terms were expected to be understood against the background of common law. . . .

14. E.g., Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964), where false financial reports were filed to induce purchase by the public. This was held to be a sufficient connection with the ensuing purchases, despite the lack of contract privity.

15. 307 F.2d 242 (6th Cir. 1962).

16. Id. at 249.

17. The ultimate purpose of the scheme was the use of the proceeds of the sale by the city to make improvements which would benefit the property of the defendants' employer. The plaintiff did not introduce evidence to prove the defendants' intent to defraud. The court held that "the intentions of the defendants are properly inferable from their acts . . . ." Ibid. This statement was the extent of its discussion of intent and purpose.

18. Ibid.

19. Civil liability under rule 10b-5 was derived first from use of the common law rule that violation of a statute passed to protect members of a certain class gives rise to a cause of action by a member of that class. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). In Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951), the court required that a complaint under rule 10b-5 allege "fraud," clearly referring to the common law. See also McClure v. Borne Chem. Co., 292 F.2d 824, 836 (3d Cir.), cert. denied, 368 U.S. 939 (1961); Ellis v. Carter, 291 F.2d 270, 273 (9th Cir. 1961); Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961).

Thus, almost all courts which have considered the basis for a cause of action under 10b-5 have placed reliance upon the common law principle . . . that civil liability should exist against the violator of a legislative . . . enactment who causes harm to the interest intended to be protected by the enactment.[20]

Professor Loss has concluded that "because of the legislative background it seems reasonable to assume at the very least that the most liberal common law views on these questions should govern under the statutes."[21]

It is well settled in the common law that intent and purpose are not coterminal, as was suggested by the *Howard* court in its reference to the market impact of the false reports as "incidental." Cases such as *Garratt v. Dailey*[22] have established that when a person knows with substantial certainty that a certain act will have a certain result, he cannot do the former without intending the latter.[23] Motive and purpose are not relevant on the issue of intent. Dean Prosser is explicit on this point:

> It is well settled that, except as to the issue of punitive damages, [the ultimate purpose] . . . is of no importance. The fact that the defendant was disinterested . . . will not absolve him from liability, so long as he did in fact intend to mislead. . . .
> There is of course no difficulty in finding the required intent to mislead where it appears that the speaker believes his statement to be false.[24]

In the instant case, it was alleged that the defendants knew with substantial certainty that investors would rely on the financial reports, as such reports are a primary source of information for the public. The allegation should have been sufficient, unless some policy consideration justified limiting liability under rule 10b-5 beyond the limitations of the common law. The defendants suggested in their memorandum that if the plaintiffs recovered in the instant case, a cause of action would lie every time a corporation president embezzled money, causing a tumbling market in his company's stock.[25] They placed the instant case on a level with every case where corporate mismanagement was not reflected in the books. If purchasers of stock were allowed to recover every time that there was corporate mismanagement, a legitimate question of public policy might be raised. However, that situation is not found in the instant case, where it was alleged that the persons responsible for issuing the report knew at the time they did so that the report was false.

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20. Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L.J. 658, 666 & n.42 (1965). This comment is an excellent apology for the use of common law principles in applying the securities statutes.

21. 3 Loss, Securities Regulation 1435 (2d ed. 1961). (Footnotes omitted.)

22. 46 Wash. 2d 197, 279 P.2d 1091 (1955). Accord, Bristol-Myers Co. v. Picker, 302 N.Y. 61, 96 N.E.2d 177 (1950), in which it was stated that "it is axiomatic that one intends the natural consequences of his own acts . . . ." Id. at 71, 96 N.E. 2d at 182.

23. Accord, Pollock, Torts 34 (9th ed. 1912).

24. Prosser, Torts § 102, at 715 (3d ed. 1964). (Footnotes omitted.)

25. This is the example used in the Memorandum of Defendant Stanley R. Grant in Support of the Motion to Dismiss, p. 30, Heit v. Weitzen, CCH Fed. Sec. L. Rep. ¶ 91701 (S.D.N.Y. June 9, 1966).

The Securities Exchange Act was enacted in order to protect investors and safeguard the public interest. The plaintiffs here are within the protected class. If their cause of action were sustained, corporate insiders would be held to a higher standard of honesty in publishing financial information for the buying public.[26] If the decision in the instant case is followed, the purpose underlying an insider's fraud will shield him from liability to those whom the statute was passed to protect. It seems, therefore, that the public interest would be better served by making purpose and motive as irrelevant under rule 10b-5, as they are in the common law.

26. In the landmark case of Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931), a similar question of public policy was discussed. The court noted that the liability of an accountant who was negligent in preparing a balance sheet was limited, while that of one who issued the same balance sheet deliberately was not. In cases of fraud, any foreseeable plaintiff could recover. The point made by court was that too severe a penalty for negligence might discourage men from entering the field, while a stringent penalty for dishonesty would not affect honest men. It is submitted that the same reasoning applies under 10b-5.