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RECENT DEVELOPMENTS

CONSTITUTIONAL LAW — THE ELEVENTH AMENDMENT AS APPLIED TO STATE AGENCIES: A SURVEY OF THE CASES AND A PROPOSED MODEL FOR ANALYSIS.

I. INTRODUCTION

When a person institutes a suit against a state in federal court which is otherwise within the court's jurisdiction, he is confronted with the eleventh amendment as a potential bar to his action. The amendment provides:

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

When suit is against an agency of the state, such as a regulatory commission, a school district, or a social service administration, a question arises as to the scope of the amendment's protection. If the state agency is deemed the "arm" or "alter ego" of the state, it qualifies for the amendment's protection; conversely, if it is deemed a "citizen" it is not thereby protected. This Comment will address the question of when a state agency is considered the "alter ego" of the state, and when it is considered a "citizen" of the state, for eleventh amendment purposes. After a brief examination of the history of the amendment and the structural framework within which it operates, two methods of resolving the state agency problem will be explored: the method currently utilized by the courts, and a suggested model based upon the historical context of the amendment.

II. HISTORY

Article III of the Constitution provides, inter alia, that "[t]he judicial Power [of the United States] shall extend . . . to Controversies . . . between a State and Citizens of another State . . . ."2 In its first major decision, Chisholm v. Georgia,3 the United States Supreme Court was called upon to decide whether this language implied that a state could be

1. U.S. Const. amend. XI.
2. Id. art. III, § 2.
3. 2 U.S. (2 Dall.) 419 (1793).
sued in assumpsit in a federal court by a citizen of another state. Although familiar with the doctrine of sovereign immunity, which provides that a sovereign is not subject to suit without its consent, the Court held that a state could be sued in a federal court by a citizen of another state. In reaction to this decision, the eleventh amendment was passed in order to reaffirm the existence of the doctrine of sovereign immunity and its applicability to the states, and to protect state treasuries from suits based upon unpaid Revolutionary War debts.

By its terms, the eleventh amendment failed to protect the states from being sued in federal court by their own citizens. The United States Supreme Court had occasion to consider this omission in *Hans v. Louisiana*, which held that this additional protection from suits in federal

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4. *Id.* at 420. Chisolm, a citizen of South Carolina, had brought the action as executor of the estate of Farquhar, also a citizen of South Carolina, on a claim for goods delivered to the state of Georgia for which no payment had been received. *J. GOEBEL, 1 HISTORY OF THE SUPREME COURT OF THE UNITED STATES 726 (1971).*

5. *See* 2 U.S. (2 Dall.) at 437 (Iredell, J., dissenting).

6. *Id.* In fact, after the Constitution was written, but prior to its adoption, Alexander Hamilton wrote:

> It is inherent in the nature of sovereignty not to be amenable to the suit of an individual without its consent. This is the general sense, and the general practice of mankind; and the exemption, as one of the attributes of sovereignty, is now enjoyed by the government of every State in the Union. Unless, therefore, there is a surrender of this immunity in the plan of the convention, it will remain with the States... *THE FEDERALIST NO. 81* (A. Hamilton), at 125–26 (bk. 2 E. Bourne ed. 1937) (emphasis in original).

7. 2 U.S. (2 Dall.) at 419. Three of the Justices — Blair, Cushing, and Jay — based their decisions upon the belief that the states had surrendered their sovereignty to the Union when they adopted the language of article III. *Id.* at 450, 466, 469. For pertinent text of article III, *see* text accompanying note 2 supra. Justice Wilson believed that the states were never possessed of sovereign immunity. *Id.* at 453. Justice Iredell based his dissent upon the language of the First Judiciary Act, which, he said, limited the Supreme Court’s power to issue writs to those necessary for the exercise of its jurisdiction and “agreeable to the principles and usages of law.” *Id.* at 433–34 (Iredell, J., dissenting), quoting Judiciary Act of 1789, ch. 20, § 14, 1 Stat. 73 (repealed) (emphasis omitted). These principles of law, he concluded, encompassed the doctrine of sovereign immunity. Therefore, in his view, the Court’s power to issue writs was limited by that doctrine. 2 U.S. (2 Dall.) at 437. Justice Iredell suggested that article III of the Constitution had not displaced the doctrine. *Id.*

8. *J. GOEBEL, supra* note 4, at 734–36. The eleventh amendment became part of the Constitution in 1798. *Id.* at 740.

9. *Id.* at 734–36.

10. *See* *id.* at 734, where the author noted: “the prospect of being called to account for the liquidation of claims, just or not, was a powerful stimulant to political theory.” *Id.*

11. For the text of the eleventh amendment, *see* text accompanying note 1 *supra.*

12. 134 U.S. 1 (1890). Prior to the passage of the Judiciary Act of 1875, the federal courts possessed no generalized jurisdiction over suits “arising under the Constitution or laws of the United States,” Act of March 3, 1875, ch. 137, § 1, 18 Stat. 470. P. BATOR, P. MISHKIN, D. SHAPIRO, & H. WECHSLER, HART & WECHSLER’S THE FEDERAL COURTS AND THE FEDERAL SYSTEM 844–50 (2d ed. 1973) [hereinafter cited as HART & WECHSLER]. The major source of their workload was jurisdiction based upon diversity of citizenship. *Id.* This might account for the span of 92 years between
courts by the states' own citizens would also be afforded. An examination of the Hans decision sheds some light upon the nature of the eleventh amendment. The Court did not explicitly extend the amendment's coverage to include suits against a state by its own citizens; rather, it saw the amendment merely as an affirmation of the existence of state sovereign immunity. The Court agreed with the dissent's view in Chisholm that the grant of judicial power in article III was merely a grant of jurisdiction which was not intended to contravene substantive doctrines of state sovereign immunity. In effect, the Hans decision served to overrule Chisholm rather than extend the coverage of the eleventh amendment. Notwithstanding this distinction, courts have subsequently accorded sovereign immunity defenses in suits by citizens of the defendant states the same treatment as eleventh amendment defenses.

Even now — more than 175 years after its passage — the precise nature of the eleventh amendment is not clear. Some courts have failed to distinguish the amendment from the substantive doctrine it embodies, while others have addressed the distinction and noted the procedural problems it evokes. The disparity between the form of the amendment, by its terms a limit on federal judicial power, and its historical purpose as an

the passage of the eleventh amendment and the Supreme Court's first occasion to consider its applicability to a suit between a citizen and his or her own state.

15. See 134 U.S. at 12–14.
16. For the text of article III, see text accompanying note 2 supra.
17. 134 U.S. at 18–19, citing 2 U.S. (2 Dall.) at 429–50 (Iredell, J., dissenting). In support of its conclusion, the Court quoted from James Madison's defense of the grant of jurisdiction at the Virginia convention: "It appears to me that this [clause] can have no operation but this — to give a citizen a right to be heard in the federal courts; and if a State should condescend to be a party, this court may take cognizance of it." 134 U.S. at 14, quoting 3 Elliott's Debates 333 (2d ed. 1859).
20. See Cullison, supra note 18.
22. See, e.g., George R. Whitten, Jr., Inc. v. State Univ. Constr. Fund, 493 F.2d 177 (1st Cir. 1974), in which the lower court heard 67 pages of debate as to whether a motion based upon the eleventh amendment should be considered a motion to dismiss or a motion for summary judgment. Id. at 179.
23. In In re Ayers, 123 U.S. 443 (1887), the Supreme Court stated: "By the terms of [the eleventh amendment], it is a case to which the judicial power of the United States does not extend. The Circuit Court was without jurisdiction to enter-
affirmation of a substantive legal doctrine, has led to difficulties in keeping its operation within a cohesive analytical framework.\textsuperscript{24}

\section*{III. Analytical Framework}

In resolving the question of whether a state agency is the alter ego or a citizen of the state, two problem areas are encountered. First, it should be emphasized that a question of federal law is presented, since the court is interpreting the scope of an amendment to the United States Constitution.\textsuperscript{25} Because resolution of the question is generally based upon the nature of the state agency involved,\textsuperscript{26} which involves an inquiry into the state law pertaining to that agency,\textsuperscript{27} some courts have erroneously concluded that state law is determinative and binding.\textsuperscript{28} State court decisional law is binding as to the relationship of the agency to the state, and therefore highly instructive to a federal court in making its decision,\textsuperscript{29} but the court's ultimate determination of whether that relationship is sufficiently close so as to impart the state's eleventh amendment immunity to the agency is one of federal law.\textsuperscript{30}

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\textsuperscript{24} See generally Cullison, supra note 18.
\textsuperscript{27} For a survey of how the states have applied the doctrine of sovereign immunity to their agencies in their own courts, see Note, The Applicability of Sovereign Immunity to Independent Public Authorities, 74 HARV. L. REV. 714 (1961).
\textsuperscript{30} See cases cited in notes 25, 26 & 29 supra.
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The second problem area arises from the failure of some courts to distinguish the similar but distinct question of when a state agency is a citizen of the state for the purposes of diversity jurisdiction. Since a state itself is not a citizen within the meaning of the diversity jurisdiction statute, if the agency is held to be the alter ego of the state, an action between it and a citizen of another state also will not fall within the subject matter jurisdiction of the court. Since different consequences result from holding a state agency to be the alter ego of the state for purposes of diversity jurisdiction as opposed to the eleventh amendment, different considerations should control the issue's resolution. Therefore, it is submitted that the two inquiries need not necessarily result in the same conclusion. Unfortunately, there has been little consistency in the courts' approaches to this issue.


34. If there is some other basis for the federal court's jurisdiction (e.g., federal question jurisdiction, 28 U.S.C. § 1331 (1970)), the agency's citizenship for diversity purposes is irrelevant. If, on the other hand, there is no other basis for the court's jurisdiction, a determination that the defendant is the alter ego (and, therefore, not a citizen) of the state results in the automatic dismissal of the suit. The defendant may not waive this defect in the court's jurisdiction. See Mansfield, Coldwater & Lake Mich. Ry. v. Swan, 111 U.S. 379, 383-84 (1884). However, if a defendant is deemed to be the alter ego of the state for the purposes of the eleventh amendment, the suit may still continue in federal court if the defendant consents to such suit. See Parden v. Terminal Ry., 377 U.S. 184 (1964).

35. Because lack of diversity results in automatic dismissal from federal court, with no opportunity for the state to waive this jurisdictional defect, it is submitted that a narrower standard should be used for diversity purposes in determining when an agency is entitled to an alter ego status. Moreover, federal diversity jurisdiction was granted to prevent the supposed prejudice an out-of-state citizen might perceive in state court. See HART & WECHSLER, supra note 12, at 1051-53. Dismissing an out-of-state plaintiff's suit for lack of diversity, when in reality the defendant is quite closely connected to the state, forces the plaintiff to bring his claim in the atmosphere from which diversity jurisdiction was designed to save him.


Some courts have noted the distinction, but have simply asserted that their resolutions would be the same. See S.J. Groves & Sons Co. v. New Jersey Tpk. Auth., 208 F. Supp. 568, 571 (D.N.J. 1967); Krisel v. Duran, 258 F. Supp. 845, 848 (S.D.N.Y. 1966), aff'd, 386 F.2d 179 (2d Cir. 1967), cert. denied, 390 U.S. 1042 (1968).

Finally, some courts have succeeded in discussing the questions separately. See Moss v. Calumet Paving Co., 201 F. Supp. 426, 430-31 (S.D. Ind. 1962).
Once it is determined that the court otherwise has jurisdiction over the subject matter, the court must decide, as a matter of federal law, whether the state agency involved is the alter ego of the state for the purposes of the eleventh amendment. If the court so holds, the amendment protects the agency from being sued in federal court to the same extent as the state itself.\(^{37}\) However, this protection is not absolute. If the state's substantive law of sovereign immunity shields that agency from liability as well,\(^{38}\) there is no need for further inquiry. If, however, the state has statutorily or judicially waived its sovereign immunity, the court must determine whether that waiver extends to suit in federal court.\(^{39}\)

The extent of the waiver depends upon the intent of the legislature or court responsible for it, and is, therefore, a question of state law.\(^{40}\) Several courts have said that such a waiver of a constitutional right will not be inferred lightly.\(^{41}\) However, states have been held to have waived their eleventh amendment rights by their entrance into the realm of federally regulated activity.\(^{42}\) Whether such activity by the state constitutes a

37. The term "alter ego" has often been employed by the courts to mean that the agency embodies the attributes of the state and is entitled to its protection under the eleventh amendment. See, e.g., George R. Whitten, Jr., Inc. v. State Univ. Constr. Fund, 493 F.2d 177, 180 (1st Cir. 1974), quoting Charles Simkin & Sons, Inc. v. State Univ. Constr. Fund, 352 F. Supp. 177 (S.D.N.Y. 1973).

38. The complexities inherent in the interrelationship of the eleventh amendment's jurisdictional bar to suits against a state, and a state's own common law doctrine of immunity from liability, are noted in Miller, Service of Process on State, Local, and Foreign Governments Under Rule 4, Federal Rules of Civil Procedure — Some Unfinished Business of the Rulemakers, 46 F.R.D. 101, 105-13 (1969). See also Note, supra note 21, at 1480-82.

39. In Smith v. Reeves, 178 U.S. 436 (1900), the Supreme Court held that a state may permit suits against itself in its own courts, but deny that privilege to a plaintiff seeking to bring a similar action in a federal court. Id. at 441.


42. In Parden v. Terminal Ry., 377 U.S. 184 (1964), the Supreme Court held that, by beginning operation of an interstate railroad 20 years after Congress had created a cause of action against such railroads, the state of Alabama necessarily consented to the kind of suit that Congress authorized. Id. at 192. In Chesapeake Bay Bridge & Tunnel Dist. v. Lauritzen, 404 F.2d 1001 (4th Cir. 1968), the court, relying upon Parden, held that by building a bridge over navigable waters, the state of Virginia entered the federal domain of interstate commerce, thereby consenting to suits in admiralty. Id. at 1003-04. See also Petty v. Tennessee-Missouri Bridge Comm'n, 359 U.S. 275 (1959).

More recently, the Supreme Court held that Congress may, pursuant to its enforcement power granted in section 5 of the fourteenth amendment, enact legislation which provides for private suits against a state which would, in other contexts, be impermissible under the eleventh amendment. Fitzpatrick v. Bitzer, 96 S. Ct. 2666 (1976). This is consistent with the view that the fourteenth amendment has effected a pro tanto waiver or limitation of the eleventh amendment to the extent Congress effectuates the purposes of the fourteenth amendment by enacting appropriate legislation. See Edelman v. Jordan, 415 U.S. 651, 694 n.2 (1974) (Marshall, J., dissenting), noting this suggestion as made in an amicus brief in that case. Moreover, Fitzpatrick may signal the Court's ultimate acceptance of the position that Congress (but not
waiver of its immunity has been held to be a question of federal law. In sum, the practical effect upon the federal courts of holding an agency to be the alter ego of the state, and therefore protected by the eleventh amendment, is to permit the state to allow a suit against the agency in state court and at the same time prohibit that suit from arising in a federal court even though it may otherwise be within the federal court's jurisdiction.

If, upon review of the applicable state law, the federal court holds the state agency not to be the alter ego of the state for eleventh amendment purposes, the court must address a different set of issues. In that case, by definition, the agency is not clothed with the state's eleventh amendment immunity from suit in federal court. If the state also has waived the agency's state sovereign immunity in its own courts, it cannot deny that consent to suit in the federal courts. If, however, state law clothes the agency with sovereign immunity in its own courts, the results become difficult to reconcile with the issue being resolved. Where the federal court's jurisdiction is based solely upon the parties' diversity of citizenship, the decision in *Erie Railroad v. Tompkins* compels the court to grant the agency the same immunity from liability available to it under state law. Where, however, its jurisdiction is based upon the existence

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44. See notes 37-40 and accompanying text supra.
45. See note 37 supra.
46. See *Lincoln County v. Luning*, 133 U.S. 529 (1908), in which the Supreme Court held that where a federal court's jurisdiction is not barred by the eleventh amendment, and where the suit is otherwise within the scope of its jurisdiction as granted by the Constitution, a state may not defeat that jurisdiction by limiting suits against a county to the state courts within that county. Id. at 531, citing *Cowles v. Mercer County*, 74 U.S. (7 Wall.) 118, 122 (1868).
In *Markham v. Newport News*, 292 F.2d 711 (4th Cir. 1961), the Fourth Circuit addressed the specific contention of the defendant city that the doctrine of *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938) (see note 47 infra), compelled the federal court to give effect to a state statute which limited the right to sue a political subdivision of the state to courts of the state. 292 F.2d at 714-16. The court rejected the applicability of *Erie*, even though jurisdiction was predicated upon diversity of citizenship, relying instead upon a line of cases which denied states the right to preclude suitors from utilizing a federal court whose jurisdiction was otherwise proper. 292 F.2d 711. The court noted, however, that if the eleventh amendment had been applicable, a different result would have been reached. Id. at 716; see notes 39 & 40 and accompanying text supra.
47. 304 U.S. 64 (1938). In *Erie*, the Supreme Court held that in federal court suits based upon diversity of citizenship, the substantive law of the forum state must be applied. Id.
48. See *S.J. Groves & Sons Co. v. New Jersey Tpk. Auth.*, 268 F. Supp. 568 (D.N.J. 1967), in which the court stated: "A State institution, not protected by the Eleventh Amendment and also deemed a citizen, nonetheless may be immunized
of a federally created cause of action, the supremacy of federal law over state law and the absence of the constitutional limitation of the eleventh amendment combine to give the federal court power to override or acquiesce in the state's policy.

Thus, the practical effect upon the federal courts of holding an agency not to be the alter ego of the state, and therefore not protected by the eleventh amendment, is to give the federal court the power in some cases to override the state's policy of sovereign immunity even if the state has not actually or impliedly waived that immunity with respect to the agency involved.

IV. Resolution

In deciding whether a state agency is the alter ego of the state, courts have often framed the question in terms of whether the state is the real party in interest. This, in turn, has been resolved by examining a num-

from diversity suit because the doors of the State courts are closed to its adversary, and this Court, under Erie, must do likewise." Id. at 571.

The problem presented when federal courts attempt to apply state law was illustrated by Gerr v. Emrick, 283 F.2d 293 (3d Cir. 1960), cert. denied, 365 U.S. 817 (1961), in which the Third Circuit was called upon to decide whether the Pennsylvania Turnpike Commission was subject to liability under Pennsylvania state law. Since the Pennsylvania Supreme Court had not spoken on this precise issue, the Third Circuit based its decision upon analogous state court cases, and held the Commission liable. Id. This interpretation proved erroneous when the Pennsylvania Supreme Court subsequently held that the Commission was immune under state law. Rader v. Pennsylvania Tpk. Comm'n, 407 Pa. 609, 182 A.2d 199 (1962). The Third Circuit thereafter felt compelled by the decision in Erie R.R. v. Tompkins, 304 U.S. 64 (1938), to dismiss a suit based upon Rader, while upholding the inapplicability of the eleventh amendment that was implicit in Gerr. Harris v. Pennsylvania Tpk. Comm'n, 410 F.2d 1332 (3d Cir. 1969), cert. denied, 396 U.S. 1005 (1970). But the intrusion upon the state treasury in Gerr had already been accomplished.

A similar problem was avoided in Urbano v. Board of Managers, 415 F.2d 247 (3d Cir. 1969), cert. denied, 397 U.S. 948 (1970), wherein the court refused to dismiss the suit on the ground that the Board of Managers was immune from suit under the eleventh amendment. Id. at 252. However, in seeking to determine whether the Board had been provided with immunity from liability under applicable state law, the court found the law to be uncertain; therefore, it dismissed the case on grounds of abstention to enable the state courts to make a definitive interpretation. Id. at 253. For an overview of the court-developed doctrine of abstention, see Hart & Wechsler, supra note 12, at 985-1009.


50. No case has been found in which the court has articulated this reasoning as such. However, in the area of federally created rights, the federal courts are free to prescribe federal common law. See generally Hart & Wechsler, supra note 12, at 756-70. This includes the power to accept or reject state common law defenses. See Gordenstein v. University of Del., 381 F. Supp. 718, 721 n.6 (D. Del. 1974).

This situation is distinguishable from that in which the eleventh amendment otherwise applies to a state or its agency which is held to have waived its application. See notes 39-43 and accompanying text supra.

51. See notes 49 & 50 and accompanying text supra.

52. This phrase had its origin in a line of cases dealing with the substantially similar issue of whether, in a given case, the real party in interest is the individually
number of factors in the agency’s relationship with the state, the most significant being the effect that a judgment against the agency would have upon the state treasury. Other factors which have purportedly been considered by the courts include: the power and ability of the state agency to pay a judgment, the structural framework of the agency, legal title to the agency’s property in its name or the state’s, the governmental or pro-named state official or the state itself. See, e.g., In re Ayers, 123 U.S. 443 (1887). If the state is found to be the real party in interest, the eleventh amendment prohibits the suit from being maintained in federal court. Id. This same inquiry is relevant to whether a particular form of relief is available in federal court. See Edelman v. Jordan, 415 U.S. 651 (1974).

53. For a general survey of what factors have accounted for the courts’ decisions, see Comment, State Governmental Corporation Immunity from Federal Jurisdiction under the Eleventh Amendment, 72 Dick. L. Rev. 296 (1968); Note, supra note 27.

54. The following cases have held the agency to be the alter ego of the state: Ford Motor Co. v. Department of Treasury, 323 U.S. 459 (1945); Harris v. Tooele County School Dist., 471 F.2d 218 (10th Cir. 1973); Hamilton Mfg. Co. v. Trustees of the State Colleges, 356 F.2d 599 (10th Cir. 1966); O’Neill v. Early, 208 F.2d 286 (4th Cir. 1953).

55. The following cases have held the agency not to be alter ego of the state:


56. For the view that the effect of a judgment upon the state’s treasury is of overriding importance in determining whether the state is the real party in interest, see Note, supra note 21, at 1483-87.

57. The following cases have held the agency to be alter ego of the state: State Highway Comm’n v. Utah Constr. Co., 278 U.S. 194 (1929); Krisel v. Duran, 258 F. Supp. 845 (S.D.N.Y. 1966), aff’d, 386 F.2d 179 (2d Cir. 1967), cert. denied, 390 U.S. 1042 (1968).

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proprietary nature of the agency's function, the decisions of the state courts in related matters, the power of the agency to sue and be sued, the power of the agency to contract, and, the extent to which the state has pledged its credit to pay the agency's debts. By evaluating these factors, the courts have decided whether the federal courts could exercise jurisdiction over: cities and counties; school districts and school boards; other geographical entities; state-operated colleges and universities; highway

58. The following cases have held the agency to be alter ego of the state: Wihtol v. Crow, 309 F.2d 777 (8th Cir. 1962) (school district performing governmental function); Oklahoma Real Estate Comm'n v. National Bus. & Prop. Exch., Inc., 229 F.2d 205 (10th Cir. 1955) (real estate commission performing governmental function); Florida State Tpk. Auth. v. Van Kirk, 146 F. Supp. 364 (S.D. Fla. 1956) (turnpike authority performing governmental function).

The following case has held the agency not to be alter ego of the state: Reagan v. Farmers' Loan & Trust Co., 154 U.S. 362 (1894) (state does not have proprietary interest in railroad commission).

59. The following cases have held the agency not to be alter ego of the state: Harrison Constr. Co. v. Ohio Tpk. Comm'n, 272 F.2d 337 (6th Cir. 1959); Louisiana Highway Comm'n v. Farnsworth, 74 F.2d 910 (5th Cir.), cert. denied, 294 U.S. 729 (1935).

60. In Hopkins v. Clemson Agri. College, 221 U.S. 636 (1911), the Court held the agency not to be the alter ego of the state.

61. In Baton Rouge Contracting Co. v. West Hatchie Drainage Dist., 279 F. Supp. 430 (N.D. Miss. 1968), the court held the agency not to be the alter ego of the state.

62. In Charles Simkin & Sons, Inc. v. State Univ. Constr. Fund, 332 F. Supp. 177 (S.D.N.Y.), aff'd mem., 486 F.2d 1393 (2d Cir. 1973), the court held the agency to be the alter ego of the state.

63. The following cases have held the city or county not to be alter ego of the state: Lincoln County v. Luning, 133 U.S. 529 (1890); Brown v. Marshall County, 394 F.2d 498 (6th Cir. 1968); Markham v. Newport News, 292 F.2d 711 (4th Cir. 1961); Adams v. Harris County, 316 F. Supp. 938 (S.D. Tex. 1970), rev'd on other grounds, 452 F.2d 994 (5th Cir. 1971), cert. denied, 406 U.S. 968 (1972); N.M. Paterson & Sons, Ltd. v. Chicago, 176 F. Supp. 323 (N.D. Ill. 1959).

64. The following cases have held the school district or school board to be alter ego of the state: Harris v. Tooele County School Dist., 471 F.2d 218 (10th Cir. 1973); Wihtol v. Crow, 309 F.2d 777 (8th Cir. 1962); O'Neill v. Early, 208 F.2d 286 (4th Cir. 1953).

The following cases have held the school district or school board not to be alter ego of the state: Adams v. Rankin County Bd. of Educ., 524 F.2d 928 (5th Cir. 1975); Hutchison v. Lake Oswego School Dist. No. 7, 519 F.2d 961 (9th Cir. 1975); Fabrizio & Martin, Inc. v. Board of Educ., 290 F. Supp. 945 (S.D.N.Y. 1968).

65. The following case has held the district to be alter ego of the state: Fylypo v. Gulf Stevedore Corp., 257 F. Supp. 166 (S.D. Tex. 1966) (navigation district).

The following cases have held the district not to be alter ego of the state: Port of Seattle v. Oregon & Wash. R.R., 255 U.S. 56 (1921); Baton Rouge Contracting Co. v. West Hatchie Drainage Dist., 279 F. Supp. 430 (N.D. Miss. 1968).

66. The following cases have held the college not to be alter ego of the state: Long v. Richardson, 525 F.2d 74 (6th Cir. 1975); Brennan v. University of Kan., 451 F.2d 1287 (10th Cir. 1971); Hamilton Mfg. Co. v. Trustees of State Colleges, 356 F.2d 599 (10th Cir. 1966).

The following cases have held the college not to be alter ego of the state: Hopkins v. Clemson Agri. College, 221 U.S. 636 (1911); Hander v. San Jacinto Junior College, 519 F.2d 273 (5th Cir. 1975); Gordenstein v. University of Del., 381 F. Supp. 718 (D. Del. 1974).
commissions; 67 bridge and port authorities; 68 ratemaking bodies; 69 development commissions; 70 regulatory commissions; 71 treasury departments; 72 and employment security departments. 73

It is evident from the cited cases that in deciding a state agency’s amenability to suit in federal court, the courts have reached varying results while purporting to apply the same test — whether the agency is the alter ego of the state. It is submitted that this question should properly be resolved within the context of the purposes of the eleventh amendment. Viewing the amendment in its historical setting, those purposes are shown to have been twofold. One was to reaffirm the existence of sovereign immunity. 74 This was accomplished by passage of the amendment and by the Supreme Court’s subsequent acquiescence, in Hans v. Louisiana. 75

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68. The following case has held the port authority to be alter ego of the state: Missouri Pac. R.R. v. Travelers Ins. Co., 281 F. Supp. 100 (E.D. La. 1968).

The following cases have held the authority not to be alter ego of the state: Raymond Int’l, Inc. v. M/T Dalzelleagle, 336 F. Supp. 679 (S.D.N.Y. 1971); George A. Pullen Co. v. Coastal Plains, Inc., 290 F. Supp. 911 (E.D. La. 1968).

69. The following cases have held the ratemaking body not to be alter ego of the state: Missouri, Kan. & Tex. Ry. v. Missouri R.R. & Warehouse Comm’rs, 183 U.S. 53 (1901); Reagan v. Farmers’ Loan & Trust Co., 154 U.S. 362 (1894).

70. The following cases have held the commission to be alter ego of the state: George R. Whitten, Jr., Inc. v. State Univ. Constr. Fund, 493 F.2d 177 (1st Cir. 1974); Charles Simkin & Sons, Inc. v. State Univ. Constr. Fund, 352 F. Supp. 177 (S.D.N.Y.), aff’d mem., 486 F.2d 1393 (2d Cir. 1973); Krscl v. Duran, 258 F. Supp. 845 (S.D.N.Y. 1966), aff’d, 386 F.2d 179 (2d Cir. 1967), cert. denied, 390 U.S. 1042 (1968).

The following case has held the commission not to be alter ego of the state: Aerojet-General Corp. v. Askew, 453 F.2d 819 (5th Cir. 1971), cert. denied, 409 U.S. 892 (1972).


72. In Ford Motor Co. v. Department of Treasury, 323 U.S. 459 (1945), the Court held the department to be the alter ego of the state.

73. In Bowen v. Hackett, 387 F. Supp. 1212 (D.R.I. 1975), the court held the department not to be the alter ego of the state.

74. See text accompanying note 9 supra.

75. 134 U.S. 1 (1890); see notes 12-18 and accompanying text supra.
to its inherent political message. The amendment’s second purpose was to protect state treasuries which were at the time threatened by unpaid Revolutionary War debts. It is this second purpose upon which the courts should focus in deciding whether to accord the state agency the same protection as it would the parent state. Thus, it is submitted, the result should turn solely upon whether the state’s general treasury will be diminished by a resulting judgment, or whether, conversely, the agency is separately funded from sources other than the state’s general revenues.

The reason for the contradictory holdings in the cited cases may perhaps be due to the disparity between the issue presented and the consequences that flow from its resolution. First, if the question arises in a case within a federal court’s diversity jurisdiction, the only difference between granting and withholding eleventh amendment protection is that the plaintiff may have to bring his action in a state court to obtain relief. With little riding upon the outcome of its determination in this situation, a federal court might be loathe to override state policy. Second, if the question arises in a case based upon a federally created cause of action, the difference in result will be more severe. If eleventh amendment protection is afforded the agency, the plaintiff may be left without a cause of action which the court would otherwise have the power to hear if the agency was not thereby protected. There is a potential in federal question cases, therefore, for more onerous results if state policy is held to be controlling. Thus a court’s decision may be influenced by considerations that logically lay outside the proper scope of the issue. Moreover, once it is determined whether an agency is subject to the amendment’s protection, stare decisis may conclude the issue as to that agency for all subsequent cases.

The problem of how to reconcile the eleventh amendment with federally created causes of action is broader than the question of how to treat a state agency — it is inherent in the amendment itself as applied to the parent states as well as their agencies. The Supreme Court has recently taken another step in solving that problem by holding that the eleventh amendment is inapplicable when federal jurisdiction is created by Congress pursuant to its power under the fourteenth amendment. Perhaps that is just one step in a larger trend toward abrogation of the eleventh amendment for all federally created causes of action. But regardless of the evolution of the eleventh amendment vis-à-vis the states in general, its application to agencies of the states should be decided on a more rational and uniform basis.

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76. Id. at 12.
77. See note 10 and accompanying text supra.
78. See notes 37–39 and accompanying text supra.
79. See notes 49 & 50 and accompanying text supra.
81. See id. at 2672 (Brennan, J., concurring); Tribe, supra note 42, at 693–99; Cullison, supra note 18, at 14–35.
FEDERAL INCOME TAXATION — INCLUSION OF CONTINGENT CONSIDERATION IN AN INSTALLMENT SALES CONTRACT PREVENTS A TAXPAYER FROM REPORTING GAIN UNDER THE INSTALLMENT PROVISIONS OF SECTION 453.

I. INTRODUCTION

When a taxpayer sells an asset, realizing gain1 which is recognized under section 1002 of the Internal Revenue Code (Code),2 and receives in exchange a small amount of cash, debt obligations which by their terms are to be paid in installments over a period of years, and additional consideration which is either indefinite with respect to the dollar amount, contingent upon future events, or both,3 a problem arises as to whether he may avail himself of the installment method of reporting income as provided in section 453 of the Code.4 Two recent court of appeals decisions, Steen v. United States5 and Gralapp v. United States,6 while ostensibly giving the taxpayers relief by classifying this type of sales contract as an open transaction,7 have used that determination to deny them the benefits of section 453.

The initial findings by both courts — that because of the contingent consideration8 the amount realized under the entire contract was indefinite,

1. "Gain" is defined as "the excess of the amount realized . . . over the adjusted basis." I.R.C. § 1001(a). For the definitions of "adjusted basis," see note 9 infra.

2. "Amount realized" is defined as "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b).

3. Section 1002 states: "Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized." Id. § 1002.

4. The transaction should be distinguished from that involved in Commissioner v. Brown, 380 U.S. 563 (1965). In that case the total consideration was fixed, but the amount of each installment was dependent upon the current profits of the buyer. Id. at 567.

5. Section 453(b)(1) provides: "Income from — (A) a sale or other disposition of real property, or (B) a casual sale . . . of personal property . . . for a price exceeding $1,000, may . . . be returned on the basis and in a manner prescribed in subsection (a)." I.R.C. § 453(b)(1).

6. A person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. Id. § 453(a)(1).

7. Open transactions for tax purposes are those in which the consideration at the time of the agreement "had no ascertainable fair market value." Burnet v. Logan, 283 U.S. 404, 413 (1931). For a discussion of the significance of an open transaction, see note 11 and text accompanying notes 30—32 infra.

8. A seller may wish to include a contingency in the contract to give himself a hedge against inflation, whereas a buyer may desire such a contingency to protect himself against unforeseen development costs.
and the taxpayer was therefore entitled to defer the gain and the resultant taxes thereon, until he had recovered his adjusted basis—were in accordance with the Supreme Court's landmark decision in Burnet v. Logan. Although this appeared to be a victory for the taxpayer, both courts quickly made it a hollow one by holding that a fixed sales price, which is not present in this type of contract, is a prerequisite for use of the tax relief provided by section 453. The ultimate outcome is that a taxpayer may be required to remit cash to the Treasury in the year of sale which exceeds the amount received from the purchaser during that period.

The results of Steen and Gralapp appear to conflict with the ruling of the Colorado federal district court in National Farmers Union Service Corp. v. United States. In that case, the court permitted the taxpayer to treat the amount of the contingent consideration as a separate open transaction, but it did not foreclose the use of section 453 for reporting the gain attributable to the noncontingent consideration. Interestingly, the Gralapp court did not expressly overrule, nor did the Steen court distinguish, the decision in National Farmers Union.

After presenting a brief history of section 453 and the Supreme Court's reasoning in Burnet v. Logan, this Comment analyzes the Steen decision

9. The adjusted basis of most taxpayers' property is cost as modified by certain adjustments provided in section 1016 of the Code. See I.R.C. §§ 1012, 1016. For a discussion of Logan, see text accompanying notes 26–32 infra.


11. If a transaction is held to be an open one, the contingent payment is deemed to be part of the total sales price, and is not considered ordinary income, but rather, capital gain. See Burnet v. Logan, 283 U.S. at 413. Therefore, the taxpayer is afforded advantages of the section 1202 deduction of 50% of the net long-term capital gain. See I.R.C. § 1202.

12. Steen v. United States, 509 F.2d at 1403–04; Gralapp v. United States, 458 F.2d at 1160. Section 453(a) (1) indicates that it is necessary to determine the total contract price in order to ascertain the percentage of each installment which represents taxable gain. For the text of section 453(a) (1), see note 4 supra.

13. For example, if a high bracket taxpayer who is not using section 453 received $10,000 in cash and obligations with a fair market value of $90,000 in exchange for property in which his adjusted basis was $50,000, he would have a tax liability of $12,500 in the year of the sale by using the alternative tax provisions of section 1201(b) (tax equals 25% of first $50,000 of gain). This would be 25% more than his cash receipt.


15. [1967] 1 U.S. Tax Cas. at 83,484. In National Farmers Union, the sale price of an interest in a phosphate lease was $100,000, payable in four annual installments of $25,000 each. Id. Also, the seller was entitled to an additional $52,500 if and when a refund of a deposit was received by the buyer. Id. The Commissioner asserted that the total section 453 contract price should have been $152,500; thus, a larger portion of each installment should have been treated as gain. Id. The court rejected the Commissioner's argument, agreeing that the taxpayer's reporting of the $52,500 as ordinary income in the year of receipt was proper. Id.

Since the method asserted by the Commissioner was obviously more advantageous to the taxpayer, it must be assumed that the permissible time period for filing amended returns had elapsed.

16. Since the Steen decision followed Gralapp, this Comment will focus primarily upon Steen. However, Gralapp will be discussed for purposes of comparison, since
and suggests various approaches — including one based upon the rationale of the court in *National Farmers Union* — which Congress could take to remedy the problem. This Comment also suggests interim solutions to assist the taxpayer in avoiding the potentially adverse consequences inherent in contracts similar to those executed by the taxpayers in *Gralapp* and *Steen*.

II. **Historical Background**

A. **Section 453**

A general rule of federal income taxation is that all gains or losses realized are recognized in the year of sale or exchange.\(^\text{17}\) This rule operates satisfactorily when the consideration for the sale is paid entirely in cash or its equivalent. However, transactions in which cash and promises of future payment are exchanged for the taxpayer’s property pose a different problem in that, absent some particular relief, a taxpayer could be required to pay more federal income taxes in the year of exchange than he had actually received as a cash deposit.\(^\text{18}\)

As early as 1918, the Commissioner of Internal Revenue (Commissioner) recognized the difficulty caused by deferred payments, and promulgated regulations permitting the seller to report the income on the installment basis.\(^\text{19}\) In the Revenue Act of 1921, Congress approved the regulations, but failed to indicate any limits on the use of installment reporting.\(^\text{20}\) The principal difficulty with the regulations, as approved by Congress, was that the postponement of the recognition of gain would cause the Treasury to lose revenue during the years immediately following a taxpayer’s adoption of the *Steen* court could have pointed to the factual distinction between the cases as a basis for reaching a different result. *See* notes 70–76 and accompanying text *infra*.


18. *See* note 13 *supra*.

19. Article 117 of Treasury Regulation 33 provided in pertinent part:

In the case of a contract to sell real estate or other property on the installment plan, title remaining in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price.


It is interesting to note, however, that article 116 of the same regulation did not give similar treatment to transactions in which the title passed to the purchaser at the execution of the contract. Treas. Reg. 33, art. 116 (1918).

20. Section 202(f) of the Revenue Act of 1921 provided: “Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.” Revenue Act of 1921, ch. 136, § 202(f), 42 Stat. 231. Similar language was also used in the Revenue Acts of 1924 and 1926. *See* Revenue Act of 1924, ch. 234, § 202(e), 43 Stat. 256; Revenue Act of 1926, ch. 27, § 202(e), 44 Stat. 12.
of the installment method.\textsuperscript{21} In the Revenue Act of 1926, Congress resolved the problem by reapproving installment reporting while at the same time making a change to that method costly to the taxpayer.\textsuperscript{22}

Since 1926, Congress has made several minor changes to the installment accounting provisions,\textsuperscript{23} but it has continued to support the concept of allowing a taxpayer who has not received a substantial portion of his sales price in cash or its equivalent to defer the taxes attributable to the payments to be received in subsequent years.\textsuperscript{24} Indeed, an early articulation of the intent of Congress in allowing installment reporting would, even today, accurately summarize the policies underlying section 453:

The method of reporting income on the installment basis was enacted by Congress as a relief provision. The chief idea which motivated Congress in allowing the installment method of reporting income was to enable a merchant to actually realize the profit arising out of each installment before the tax was paid. In other words, the tax could be paid from the proceeds collected rather than be advanced by the taxpayer.\textsuperscript{25}

B. Open Transactions

Unlike the installment accounting provisions of section 453, the treatment accorded open transactions is not legislatively or administratively grounded, but is rooted in the United States Supreme Court’s decision in \textit{Burnet v. Logan}.\textsuperscript{26} The Logan Court, construing the Revenue Act of

\begin{enumerate}
\item In B.B. Todd, Inc., 1 B.T.A. 762 (1925), the Board of Tax Appeals asserted: To be sure, the period of collection of accounts is probably longer, losses are perhaps slightly higher; but neither of these factors, in view of the results in net profits, appears to the Board to warrant special and favorable treatment of this class of taxpayers at the expense of all other classes of taxpayers reporting income on the cash or accrual basis. \textit{Id.} at 766.
\item Revenue Act of 1926, ch. 27, § 1208, 44 Stat. 19. This section required a taxpayer who adopted the installment method to report as income in the current year that portion of the payments received which the gross profit bore to the total price. \textit{Id.} This was required even if the entire profit had already been reported in previous years. \textit{Id.} The 1926 Act did contain some refund provisions, but their effectiveness was weakened by the five-year statute of limitations. \textit{Id.} § 1113(a), 44 Stat. 116. The Internal Revenue Code of 1954 provides for adjustments in tax for amounts previously taxed. See I.R.C. § 453(c).
\item Section 453(b)(2) (A) was adopted in 1954 in order to eliminate the former requirement (see XII — 2 C.B. 57, 59 (1933)) that there be some downpayment in the year of the sale; at the same time, the section provided that all payments received during that year would be aggregated to determine if the permissible 30% downpayment limitation had been exceeded. I.R.C. § 453(b)(2) (A). Section 44 of the Revenue Act of 1934 changed the maximum downpayment limitation to the present 30%. Revenue Act of 1934, ch. 277, § 44 (b), 48 Stat. 694. Previously, the downpayment had been increased to 40%. Revenue Act of 1928, ch. 852, § 44 (b), 45 Stat. 805.
\item See I.R.C. § 453; note 4 supra.
\end{enumerate}

\textsuperscript{21} See I.R.C. § 453; note 4 supra.
\textsuperscript{26} 283 U.S. 404 (1931).
1916, held that income tax liability on the gain from the sale of stock for a downpayment plus a royalty conditioned upon future mineral extraction should not be based upon "resort to mere estimates, assumptions, and speculation." The Court stated that "[w]hen the profit, if any, is actually realized, the taxpayer will be required to respond." The Court distinguished a closed transaction — one in which the consideration had a present fair market value — from an open transaction — one in which the consideration "had no ascertainable fair market value [and thus] was not a closed one." The Court held that the taxpayer recognizing gain from an open transaction was entitled to "the return of . . . capital investment before [being subjected to] assessment of any taxable profit based on conjecture."

Since the Logan decision, the Commissioner has carefully scrutinized any attempt to apply the open transaction analysis to a particular set of facts. Treasury Regulation section 1.1001-1(a) states that "only in rare and extraordinary cases will property be considered to have no fair market value." Thus, the open transaction is viewed by the Commissioner as a taxpayer relief measure which should be applied sparingly.

In sum, both the congressional enactment of the installment accounting provisions of the Code and the Supreme Court's recognition of special tax treatment for open transactions stem from a cognizance of the inequities inherent in requiring a seller to pay taxes today on money he may or may not receive at some future date. The next section of this Comment will analyze how one court, while acknowledging the taxpayer's right to invoke the open transaction doctrine, relied upon that finding to bar use of section 453.

III. THE STEEK DECISION

A. The Rationale of the Steek Decision

In 1962, Steek and several associates entered into a contract for the sale of the controlling interest in a Utah mining corporation (Utex) to Atlas Corporation (Atlas). The total sales price was $12,980,000, of which $3,890,000 (or 29.9%) was paid at the closing. The remainder

28. 283 U.S. at 412.
29. Id. at 413.
30. The term "open transaction" was coined by subsequent commentators. See, e.g., Emory, The Installment Method of Reporting Income: Its Election, Use, and Effect, 53 CORNELL L. REV. 181, 186 (1968).
31. 283 U.S. at 413.
32. Id.
35. 509 F.2d at 1401. Steek and others had discovered uranium in Utah. Through a series of transfers, incorporations, and exchanges they reduced their holdings to stock in Utex Exploration Company. Id. at 1400-01.
36. Id.
was to be paid in installments. Steen's share of the total was $10,666,024 (82.17%), and he received $3,196,413 as his pro rata share of the down-payment as well as 82.17% of the installment obligations. Contemporaneously with the signing of the sales contract, some of the sellers entered into a management contract with Atlas, agreeing to operate the mine for a period of years. At the time of the agreement, the status of a Utah tax levied upon ore removed from the mine was in doubt; it was unclear whether the tax imposed a personal obligation upon the mine owner or merely created a lien against the mine property. This had significant economic consequences for the owner. In order to shift the risk of the tax burden to the seller, the purchase price was computed by assuming that the tax, which the parties estimated at $827,000 would be Atlas' personal liability when levied. However, the management contract included a proviso that the operators would receive, as additional compensation, the amount by which the $827,000 estimate exceeded the actual tax liability of Atlas. Subsequently, the Utah Supreme Court construed the state tax provisions as not imposing a personal obligation upon the owner, a result which caused the tax payments to be less than the estimated amount by approximately $500,000 of which Steen's share was $458,532. Steen elected to report his gain on the transaction under the section 453 installment method, thereby recognizing as long-term capital gain

37. *Id.* The notes were payable over a four-year period from August 1962 through December 1966. *Id.* In order to dramatize the tax consequences of the decision, it will be assumed that the notes were due over an eight-year period, and bore interest at the rate of 8% per annum.

38. *Id.*

39. First Security Bank of Utah, the trustee of a trust established for the benefit of Steen's children, was one of the sellers, but did not participate in the management contract. *Id.* at 1401 n.1.

40. *Id.* at 1401. Atlas wanted Utex personnel to continue to mine the property sold because of their proven mining ability. *Id.*

41. *Id.*

42. If the tax enforcement was restricted to execution on the mine property, the owner could work the mine out and abandon it to the tax collector after a few years. At this point, the worked-out mine would have only negligible economic value. However, if the tax was the personal liability of the owner, then all its assets would have been exposed to the collector's enforcing levy. See San Juan County v. Jen, Inc., 16 Utah 2d 394, 401 P.2d 952 (1965).

43. 509 F.2d at 1401.

44. Atlas Corp. v. State Tax Comm'n, 18 Utah 2d 57, 415 P.2d 208 (1966); see San Juan County v. Jen, Inc., 16 Utah 2d 394, 401 P.2d 952 (1965). Both decisions held that "the ad valorem tax against a mining property is not essentially different, though based on a net proceeds formula in determining valuation, than the tax on other real property." 18 Utah 2d at 58, 415 P.2d at 208. These decisions relieved Atlas of personal liability for the tax, and permitted it to abandon the mine to the tax collector's levy. See note 42 supra.

45. 509 F.2d at 1401.

46. *Id.*
90.62% of each dollar received in the year of actual receipt.\textsuperscript{47} When the contingent amount was received, he reported $445,942 as additional long-term capital gain from the Utex stock sale.\textsuperscript{48} The Commissioner argued that the income was not capital gain because it arose from an agreement for services rather than from the sale of an asset.\textsuperscript{49} Thus, the initial issue was whether the taxpayer was entitled to a $222,971 section 1202 deduction,\textsuperscript{50} which under present law would have prevented additional tax liability of approximately $156,080.\textsuperscript{51}

Holding that the contingent provision reflected a part of the purchase price for the asset, the court agreed with Steen's assertion that the contracts should be integrated.\textsuperscript{52} Since the contract had no ascertainable fair market value in the year of the sale, it did not give rise to taxable gain until the adjusted basis of the property was recovered; thereafter, Steen would recognize capital gain as he received the installment payments.\textsuperscript{53} However, the court, apparently on its own initiative, concluded that since part of the purchase price was not ascertainable, the entire contract price was contingent and the taxpayer was therefore barred from using the section 453 installment method.\textsuperscript{54} The court reasoned that precise determination of the total contract price was an implicit requirement of section 453.\textsuperscript{55}

As a result, Steen was deemed to have received the $3,196,413 downpayment and the present value of the installment obligations in the year that the contract was signed;\textsuperscript{56} thus, he immediately owed taxes on the amount by which this aggregate amount exceeded his adjusted basis in the property.\textsuperscript{57}

\textsuperscript{47} Id. The opinion of the court did not disclose Steen's adjusted basis in the property. In order to simplify the tax calculations, this Comment assumes that his adjusted basis was $1,000,000.

The 90.62% is determined by dividing the gross profit, $9,666,024, by the total amount received, $10,666,024, in accordance with the formula in section 453(a)(1) of the Code. For the text of section 453(a)(1), see note 4 supra.

\textsuperscript{48} 509 F.2d at 1401. Steen claimed a basis in the contingency of $12,590, which he deducted from the $458,532 gross receipt pursuant to section 1001(a) of the Code. Id. at 1401. The Commissioner did not contest Steen's asserted basis of $12,590, and the court accepted it as an undisputed fact; the opinion does not disclose the manner in which Steen calculated the $12,590 basis.

\textsuperscript{49} Id.

\textsuperscript{50} Section 1202 provides that "if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income." I.R.C. § 1202.

\textsuperscript{51} This Comment assumes that Steen was a single taxpayer with taxable income of $100,000 from sources other than the sale of the Utex stock. This places all additional income in an effective 70% tax bracket; conversely, any deduction that Steen would have been permitted causes a 70% tax saving. Seventy percent of the section 1202 deduction (see text accompanying note 50 supra) equals $156,080.

\textsuperscript{52} 509 F.2d at 1403; see notes 63–65 and accompanying text infra.

\textsuperscript{53} See text accompanying note 32 supra.

\textsuperscript{54} 509 F.2d at 1404.

\textsuperscript{55} Id. at 1402 n.2.

\textsuperscript{56} Id. at 1405; see note 87 supra.

\textsuperscript{57} 509 F.2d at 1404, quoting I.R.C. § 1001; see note 1 supra.
B. Evaluation of the Steen Decision

In holding that the contracts should be integrated, the Steen court accepted the lower court's finding as conclusive. Both the referee in bankruptcy and the district court, without considering the section 453 consequences, had concluded that the two agreements constituted a single transaction. In deferring to this finding, the Steen court cited several decisions which indicated that the lower court's conclusion could be overturned only if it was "clearly erroneous." It is submitted, however, that the cited cases might have been distinguished on the theory that they all involved appellate court deference to findings of the pre-1970 Tax Court, an independent agency in the executive branch of the government, rather than to those of an article III court, especially one under the direct supervision of the reviewing court of appeals.

58. When the action arose, Steen was the debtor in a chapter XII bankruptcy proceeding. 509 F.2d at 1400.

59. Id. at 1402.

60. 509 F.2d at 1402, citing Commissioner v. Duberstein, 363 U.S. 278 (1960) (particular transaction was either gift or compensation); Chism's Estate v. Commissioner, 322 F.2d 956 (9th Cir. 1963) (withdrawal from a corporation was dividend, loan, or salary); Cohn v. Commissioner, 226 F.2d 22 (9th Cir. 1955) (certain property held either for investment or for resale). It should be noted that all three foregoing cases had been appealed to article III courts from the pre-1970 Tax Court.


62. Article III of the Constitution grants to Congress the authority to ordain and establish inferior courts; such courts are vested with part of the judicial power of the United States. U.S. Const. art. III, § 1. The establishing legislation must comply with the limitations of that article. Glidden Company v. Zdanok, 370 U.S. 530, 552 (1962) (Clark, J., concurring). While article III requires that judges of courts created pursuant to the authority granted therein have lifetime tenure, U.S. Const. art. III, § 1, the legislation which created the United States Tax Court specifies a 15-year term for judges of that tribunal. I.R.C. § 7443(e).

63. The distinction which the court might have made can be highlighted by examining a prior Ninth Circuit decision. In Vernon v. Commissioner, 286 F.2d 173 (9th Cir. 1961), the court held that a court of appeals cannot retry facts on a petition to review a decision of the Tax Court. Id. If this is the "clearly erroneous" test which the Steen court espoused, then it is submitted that the criteria which are applied to findings of the district courts could be less rigid. This Comment does not purport to define the distinction between the scope of review used by a court of appeals in hearing appeals from decisions of the district courts and that applied to decisions originating in administrative or executive courts, but only intends to indicate a point on which the court could have distinguished the cited case law. It is recognized that section 7482 of the Code grants jurisdiction to the courts of appeals "to review the decisions of the Tax Court . . . in the same manner and to the same extent as decisions of the district courts." I.R.C. § 7482.

It is significant that the court cited Parker v. Commissioner, 166 F.2d 364 (9th Cir. 1948), for the proposition that the contracts should be integrated, but failed to notice that in the very same case the court of appeals had reversed a finding of a grantor's intent to retain a right in a trust by the Tax Court. Id. at 368-69.
Having given determinate weight to the lower court's finding, the Steen court proceeded to justify that finding without testing its accuracy. The authority upon which the court relied, although diverse in origin, merely addressed certain circumstances under which integration would be required.\textsuperscript{64} Although the court listed conditions which supported integration,\textsuperscript{65} it made no attempt to balance them with four countervailing factors: 1) the parties to the two contracts were not identical,\textsuperscript{66} 2) the state tax liability arose during the period of the management contract, and was not directly related to the sale or sale price;\textsuperscript{67} 3) the contracts for the sale and operation of the mine were clearly distinguishable with respect to subject matter; and 4) the purpose of the management contract was to employ the former owners' expertise in extracting the ore.\textsuperscript{68} It is suggested that in light of the adverse effect that integration had in this case, the court should have at least analyzed these distinctive elements and reached an independent conclusion regarding the decision to integrate the agreements.

Without examining any counterarguments to its finding that the entire sales contract was an open transaction\textsuperscript{69} because the contingency had no ascertainable value at the time of the sale, the court, apparently relying solely on Gralapp,\textsuperscript{70} held that section 453 was not available to a taxpayer with a truly open transaction.\textsuperscript{71} Again, in view of the tax consequences of such a decision, it is submitted that the court should have evaluated alternative approaches before strictly construing the Code.

\begin{enumerate}
\item Parker v. Commissioner, 166 F.2d 364, 367 (9th Cir. 1948); Kurz v. United States, 156 F. Supp. 99 (S.D.N.Y. 1957), aff'd, 254 F.2d 811 (2d Cir. 1958). \textit{Kurz} held that contracts should be integrated if they "are designed to effectuate the same purpose." 156 F. Supp. at 103. It is submitted, however, that the two \textit{Steen} contracts had distinct purposes — sale and operation. In Bullfrog Marina, Inc. v. Lentz, 28 Utah 2d 261, 501 P.2d 266 (1972), the Supreme Court of Utah integrated an employment contract with a lease to form a concession contract. \textit{Id.} at 267, 501 P.2d at 271. Neither contract would have served any useful purpose without the other. \textit{Id.} In \textit{Steen}, however, the sale of the mine could have been completed without the management contract. 509 F.2d at 1401.
\item These included the size of the transaction, the related subject matter of the two documents, and the contemporaneous negotiation, drafting, execution, and delivery of the contracts. 509 F.2d at 1403.
\item See note 39 and accompanying text \textit{supra}.
\item Taxes were levied on the annual proceeds derived from operation of the mine.
\item 509 F.2d at 1401. The court stated that "Atlas . . . want[ed] the Utex management personnel to continue because of their proven ability to operate [the mine]." \textit{Id.}
\item Id. at 1403–04.
\item Gralapp and his associates had sold their interests in oil and gas leases for a cash payment in the year of sale, promissory notes which were due the following year, and a contingent additional consideration based upon the present value of 48% of future net revenues to be calculated after 495,852 barrels of oil had been extracted. 458 F.2d at 1160. The taxpayer failed to assert that these were two separate contracts. \textit{Id.} at 1160 n.1. After recognizing the stipulated fact that the contingency could not be valued in the year of sale, the court concluded that "the value of the contingency under the sales agreement is by no means de minimis as an element of actual sales price." 458 F.2d at 1160 (emphasis added). For a discussion of the application of this standard to \textit{Steen}, see notes 74–77 and accompanying text \textit{infra}.
\item \textit{Id.} at 1402 n.2; see note 12 and accompanying text \textit{supra}.
\end{enumerate}
The court interpreted the de minimus language of *Gralapp* as propounding an absolute test. However, the *Gralapp* court, which denied the taxpayer use of section 453 only after finding that the amount of the contingency was not de minimus, stated: "We . . . do not accept as an absolute . . . the position of the government, that a taxpayer cannot properly elect in any instance to report on an installment basis the proceeds of a sale received on a contract having an open end selling price." The *Steen* court apparently ignored this qualifying language in the *Gralapp* opinion and failed to distinguish it on its facts. The difference between the 4% contingency in *Steen* and the 40% contingency in *Gralapp* would have been apparent to the *Steen* court had it considered the de minimus standard as a relative, rather than an absolute, test.

Alternatively, the court could have applied a rationale similar to that developed by the Supreme Court in *Corn Products Refining Co. v. Commissioner*. In that case, the Court relied upon what it considered the general congressional purpose, even though it was not expressed in the statute or clearly indicated in the legislative history. Utilizing this type of analysis, the *Steen* court could have found that Congress' intent to provide the taxpayer with a tax relief measure in section 453 should not be subordinated to the judicial imposition of inflexible prerequisites to use of the installment accounting provisions.

Another alternative would have been to apply the Tax Court's reasoning in *W.B. Rushing*. In *Rushing*, the court agreed with the taxpayer

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72. See note 70 and accompanying text supra.
73. 509 F.2d at 1403 n.8.
74. 458 F.2d at 1159–60.
75. 509 F.2d at 1401.
76. In *Gralapp*, the total consideration was $1,189,986, of which $549,986 was the contingent amount. 458 F.2d at 1161–62.
77. The court focused upon the "potential size of the contingency payment," 509 F.2d at 1403 n.8, citing for comparison Northern v. Nelson, 448 F.2d 1266 (9th Cir. 1971). *Northern*, however, involved a prisoner's claim of denial of due process; the court refused to award damages for the value of an old newspaper, saying that the value was de minimis. It is submitted that by using absolute size as the test of de minimis, the *Steen* court foreclosed any possibility of considering Steen's share of the tax refund from Atlas de minimis in relation to the total consideration received by him under the integrated contract.
78. 350 U.S. 46 (1951). The taxpayer in *Corn Products* argued that a corn future transaction was not a hedge; hence, it was entitled to report any profits as a gain from the sale of a capital asset. *Id.* at 48.
79. The Court found that the future transaction in this case was similar to a hedge, and that there was a congressional intention to tax profits from hedge transactions as ordinary income; therefore, this transaction would be so taxed. *Id.* at 53.
80. See notes 19–25 and accompanying text supra.
81. 52 T.C. 888 (1969). In *Rushing*, the taxpayer was allowed to exclude from his section 453 computation of sales price the present value of a note on which the maker was disputing his liability. *Id.* at 895.
that the Supreme Court decision in *North American Oil Consolidated v. Burnet*\(^82\) stood for the proposition that the computations of "gross profit" and "total contract price" under section 453 did not include the disputed amount.\(^83\) By replacing the word "disputed" with "contingent" a substitution which is by no means unreasonable, the Steen court could have afforded the taxpayer the relief intended by section 453.

**C. The Effect of the Decision on the Taxpayer**

The consequences of the Steen decision can best be illustrated by comparing the taxpayer's resulting liability, first, with that which would have followed from a holding that the contingency payment was ordinary income because the two contracts should not be integrated and, second, with that which would have ensued had the court integrated the contracts without precluding recourse to section 453.\(^84\) The following hypothetical computations apply 1977 tax law,\(^85\) including the tax preference provisions,\(^86\) and are designed to calculate how many 1977 dollars must be set aside in order to pay the total tax liability arising from the sale transaction as it becomes due.\(^87\)

---

82. 286 U.S. 417 (1932). In *North American Oil*, the taxpayer was not required to report as income on 1916 profits which were paid to a receiver in 1916 but which were not payable to the taxpayer until 1917. *Id.* at 423.

83. 52 T.C. at 895.

84. This could be accomplished either by finding the contingent amount relatively de minimis or by treating it as a nonmandatory element of the section 453 computations in accordance with *North American Oil*. *See* text accompanying notes 65, 66, 70 & 71 *supra*. This would yield a result identical to that which Steen had originally calculated when filing his tax returns. *See* notes 46-48 and accompanying text *supra*.

85. For illustrative purposes, this Comment assumes that Steen had taxable income of $100,000 per year, exclusive of the income attributable to the sale of the Utex stock, but including income attributable to the management contract. *See* note 51 *supra*.

Section 1202 permits a deduction of 50% of the long-term capital gain. *See* note 50 *supra*. Additionally, the first $50,000 of long-term capital gain is taxed at the alternative rate of 25%. *See* I.R.C. § 1201.

86. Section 56 of the Code provides that a 15% tax is levied on the amount by which items of tax preference — in this case, Steen's section 1202 deduction — exceed one-half of the tax liability under all other Code sections or $10,000. I.R.C. § 56. Prior to the enactment of the Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520 the tax was levied at the rate of 10% on the amount by which the items of tax preference exceeded the sum of the tax liability under all other Code sections and $30,000. Tax Reform Act of 1969, P.L. 91-172, § 301, 83 Stat. 580 (1969) (prior to 1976 amendment).

87. All future taxes are discounted at an annual interest rate of 7%. This assumption and those made in notes 37, 51 & 85 and in the text accompanying notes 85 & 86 *supra* also apply to the illustrations in notes 113 & 117 *infra*. 

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1. **The Liability Under the Steen Holding**

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Realized</th>
<th>Gain Recognized</th>
<th>§ 1202 Deduction</th>
<th>Taxable Portion of Gain</th>
<th>Tax</th>
<th>Present Value of Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<td>$9,666,024</td>
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Total Present Value of Tax Liability: $3,944,201

2. **If the Court Had Not Integrated the Contracts**

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<th>Amount Realized</th>
<th>Gain Recognized</th>
<th>§ 1202 Deduction</th>
<th>Taxable Portion of Gain</th>
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<th>Present Value of Tax</th>
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<td>234,423</td>
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<td>204,832</td>
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<td>846,121</td>
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<td>423,061</td>
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<td>204,832</td>
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<td>617,532</td>
<td>359,404</td>
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Total Present Value of Tax Liability: $3,277,628

---

88. See note 37 supra.
89. See text accompanying note 38 supra.
90. See notes 1 & 47 supra.
91. Amount realized of $10,666,024 minus adjusted basis of $1,000,000. See note 47 supra.
92. Contingency payment of $458,532 minus the $12,590 basis therein. See note 48 supra.
93. Fifty percent of the gain recognized. See note 50 supra.
94. Gain recognized less section 1202 deduction is the taxable portion of the gain.
95. See notes 51, 85 & 86 supra.
96. See note 87 supra.
97. The effect of this approach is to treat the contingency as ordinary income in the year of receipt. This is also the National Farmers Union approach (see note 15 supra), and is the result which the Steen court would have reached had it accepted the Commissioner's initial assertion. See 509 F.2d at 1401.
3. The Liability Under the Method Employed by the Taxpayer

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Realized</th>
<th>Gain Recognized</th>
<th>§ 1202 Deduction</th>
<th>Taxable Portion of Gain</th>
<th>Tax</th>
<th>Present Value of Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$3,196,413</td>
<td>$2,896,589</td>
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<td>$1,448,295</td>
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<td>$1,146,408</td>
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<td>423,060</td>
<td>423,061</td>
<td>328,784</td>
<td>234,423</td>
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<tr>
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<td>933,701</td>
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<td>933,701</td>
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<td>646,032</td>
<td>506,603</td>
<td>294,843</td>
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</table>

Total Present Value of Tax Liability: $3,213,067

The result attained by application of the latter approach would be consistent with the Tax Court’s construction of section 453 adopted in Rushing,99 whereas the former alternative represents a result which would follow from the method of reporting used in National Farmers Union.100 As the foregoing calculations demonstrate, application of the Steen rationale requires the taxpayer to pay immediately 20% more in taxes during the year of the sale than he receives in cash.101 This result is seemingly inconsistent with both the congressional intent underlying section 453102 and the Supreme Court’s reasoning in Logan.103 The inequity is further highlighted when it is observed that had the court merely accepted the Commissioner’s initial assertion that capital gain treatment should not have been given to the contingent payment, the present value of the tax liability would have increased only 1.8%,104 whereas under the eventual disposition of the case the present value of Steen’s tax liability increased 22.7%.105

98. Using section 453 installment accounting, and reporting the net amount of the contingency as long-term capital gain in the year of receipt. This is also the North American Oil/Rushing approach. See notes 81 & 82 and accompanying text supra.

99. See notes 81–83 and accompanying text supra.

100. See notes 14 & 15 supra.

101. The total first year tax liability is $3,845,720 on a downpayment of $3,196,413. See note 38 and accompanying text supra.

102. See notes 20–25 and accompanying text supra.

103. See notes 26–32 and accompanying text supra.

104. Compare table in text accompanying note 97 supra with table in text accompanying note 98 supra.

105. Compare table in text accompanying note 88 supra with table in text accompanying note 98 supra.
IV. Proposed Congressional Remedies

A. Justification for Congressional Action

Since the Tax Court's reasoning conflicts with that of two circuit courts of appeals, it can be anticipated that the Commissioner, bolstered by the Gralapp and Steen decisions, will scrutinize section 453 elections even more carefully. The probable result — a flurry of conflicting decisions — can be avoided if Congress amends section 453 to provide some flexibility in the definition of the "total contract price." In the alternative, congressional inaction might be judicially interpreted as acquiescence in the Steen and Gralapp decisions; the subsequent adoption of the Steen rationale by the other circuits would cause inequities similar to those illustrated above.

Any legislative reformulation of section 453 should be directed toward extending the installment accounting provisions to sellers in open transactions, while at the same time discouraging abuse by making the use of contingency provisions expensive. It is suggested that Congress could adopt a de minimus exception, an annuity approach, or ordinary income/long-term capital loss treatment.

B. The Proposals

1. De minimus Exception

This proposal, which reflects the Gralapp dictum, permits a taxpayer to use section 453 even if the contract contains a contingency, provided that the conditional amount does not exceed 5% of the total contract price. The taxpayer would report the contingent amount as long-term capital gain in the year of receipt. This approach, demonstrated above, is the one taken by the taxpayer in Steen; it is also consistent with the Tax Court's resolution of the Rushing case.

106. See text accompanying notes 81-83 supra.


108. This would be consistent with the policy of ensuring that the Treasury does not incur large revenue losses when taxpayers change their methods of accounting. See I.R.C. § 453(c); note 24 and accompanying text supra.

109. See text accompanying note 74 supra.

110. See illustration at text accompanying note 98 supra.

111. For a discussion of Rushing, see notes 81-83 and accompanying text supra. This approach results in a benefit for the taxpayer because the lower contract price used in the section 453 computation means that the gross profit percentage will result in a minimum recognized gain during the precontingency years. For example, had Steen included the $445,942 contingency payment gain in the total contract price when he originally adopted the section 453 method of reporting, he would have recognized 90.95% of each dollar received in the precontingency years as income, rather than the 90.62% actually used. See note 47 supra. This would have increased his taxable income by approximately $4,300 in the year of the sale.
2. An Annuity Approach

Under an annuity approach, the seller's adjusted basis in the property would be divided by the number of years over which the contract price is to be paid; the portion of the total consideration received in a particular year which exceeds the basis allocated to that year would be long-term capital gain. Any basis not recovered in a particular year would be carried forward to the subsequent year, increasing the adjusted basis attributable to amounts received in that year. Should there be any unrecovered basis after the last year of the contract, the taxpayer could use it to offset other long-term capital gains which are realized within three years.

Under this approach the taxpayer receiving payments under an open transaction would have advantages similar to those provided by section 453. Although this method is not entirely consistent with the annuity provisions of section 72 of the Code, it is grounded in the same principles. Since the annuity section was part of the Supreme Court's rationale in

112. This method was suggested in Ginsburg, Taxing the Sale for Future Payments, A Proposal for Structural Reform, 27 U. So. Cal. 1975 Tax Inst. 1, 35.

113. The annuity approach, as applied to the Steen contract, would produce the following result:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Realized</th>
<th>Gain Recognized</th>
<th>§ 1202 Deduction</th>
<th>Taxable Portion of Gain</th>
<th>Tax</th>
<th>Present Value of Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<td>2</td>
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</tr>
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<td>410,596</td>
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<td>410,596</td>
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<td>227,333</td>
</tr>
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<td>821,191</td>
<td>410,595</td>
<td>410,596</td>
<td>318,843</td>
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<tr>
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<td>639,862</td>
<td>501,683</td>
<td>291,979</td>
</tr>
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</table>

Total Present Value of Tax Liability $3,231,333

114. Section 72(b) provides in pertinent part:
Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).
I.R.C. § 72(b). Under the approach offered in the text (see also text accompanying notes 94 & 95 supra) the basis is applied evenly to each year's receipt in lieu of the proportionate application of basis required by section 72.
Logan, the application of annuity treatment to an open transaction would be logical and not without some precedent.

3. Ordinary Income/Long-Term Capital Loss Treatment

This approach permits the taxpayer to estimate the total contract price, which he would then be required to use in the section 453 calculation. Every dollar received would be allocated proportionally between recovery of the adjusted basis and long-term capital gain until the adjusted basis was fully recovered. Thereafter, the taxpayer would be required to report all additional receipts as ordinary income. Although shrewd taxpayers might deliberately estimate an unreasonably high contract price, possibly foreclosing the full recovery of the adjusted basis, this attempt to avoid ordinary income treatment could be discouraged by a requirement that any unrecovered basis after all payments under the contract have been received must be treated as long-term capital loss.

115. 283 U.S. at 413–14. The Court explained: “If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here.” Id. at 414 (emphasis added).

116. In effect, this was the result reached in National Farmers Union. See notes 14 & 15 supra. Apparently the value of the contingency in that case was estimated to be zero.

117. The following illustrations demonstrate the results of applying the ordinary income/long-term capital loss approach to the Steen transaction. The first table shows the calculation of the tax liability using an estimate of $100,000 for the contingency; the second table is based upon an estimate of $700,000.

1. Using an estimate of $100,000

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Realized</th>
<th>Gain Recognized</th>
<th>§ 1202 Deduction</th>
<th>Taxable Portion of Gain</th>
<th>Tax</th>
<th>Present Value of Tax</th>
</tr>
</thead>
<tbody>
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<td>1</td>
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<tr>
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</table>

Total Present Value of Tax Liability $3,264,662

* $358,532 of this amount is ordinary income, because the taxpayer has underestimated his contingency by that amount.
C. Evaluation of the Proposals

It is submitted that each of the foregoing proposals is consistent with the intent of Congress in enacting section 453 of the Code, and that each could be incorporated into it either individually or as alternatives to be elected by the taxpayer. All are designed to discourage abuse by placing a ceiling on the contingency or by converting into ordinary income payments received in excess of the estimated total contract price, while requiring that any unused basis be carried forward as long-term capital loss. Although none of the proposals would generate the tax revenue provided by the Steen approach, one can assume that when Congress enacted section 453 it was not concerned with absolute maximization of Treasury revenue.

V. Interim Planning

A. An Entirely Open Contract

One interim solution which the tax planner should consider in order to avoid the hazards posed by contracts similar to those under review in Gralapp and Steen is the use of an entirely open contract. This rather simplistic approach contemplates making the total contract price conditional upon the occurrence of some uncertain future event. The seller, necessarily

2. Using an estimate of $700,000

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Realized</th>
<th>Gain Recognized</th>
<th>§ 1202 Deduction</th>
<th>Taxable Portion of Gain</th>
<th>Tax</th>
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Present Value of Tax Liability $3,222,949

The taxpayer would have a long-term capital loss carryforward of $241,468 — the difference between the estimate of $700,000 and the actual contingent amount received ($458,532).

118. The difference between the proposal which generates the lowest present value of tax liability and the one yielding the highest is less than 2% when applied to the Steen transaction. See notes 113 & 117 and text accompanying note 97 supra.

119. See illustration at text accompanying notes 88-96 supra.

120. The Senate report which accompanied the 1954 Code indicated an attempt to avoid a result similar to that in Steen if the seller received no payment in the year of sale. See S. Rep. No. 1622, 83d Cong., 2d Sess. 303 (1954).

121. For a discussion of this approach, see Note, "Open End" Selling Price Bars Installment Sale Treatment, 45 FLA. B.J. 34, 35-36 (1971).
denied section 453 treatment under Steen, is involved in one of those "rare and extraordinary cases [in which] property [is] considered to have no fair market value."122 Therefore, the seller would be permitted to recover his entire adjusted basis in the property before recognizing any gain.

The drawbacks of this solution are self-evident. A seller who surrenders title to a valuable asset desires a greater assurance of payment than that provided by an entirely open contract.123 By making the entire consideration contingent upon speculative future events, the seller assumes more of the characteristics attributable to a partner of the buyer,124 with liability limited to the value of his asset,125 and loses his similarity to a seller who has retained a security interest in the asset.126

B. Buyer's Option to Purchase Portion of Property Retained by the Seller

An alternative interim solution to the problem involves the sale of a substantial portion of the property for an ascertainable consideration,127 and the nominal sale of an option to the buyer for the purchase of the retained portion,128 exercisable at a future date for a price contingent upon uncertain future events.129 The seller would transfer the major portion of the property in exchange for an ascertainable payment, enabling him to use section 453, while retaining an ownership interest in a small portion thereof, subject to the option granted. Since the option is exercisable by the buyer alone, the Commissioner would have difficulty convincing a court to accept the integration rationale of Steen.

As does the open contract technique, this solution has some serious drawbacks. By retaining an interest in the property, the seller would, in

123. Since no tax is due until the adjusted basis has been recovered, the taxpayer can ensure the recovery of that amount by negotiating a minimum contract price equivalent to the adjusted basis. Thus, the taxpayer would subject only the potential profit to the risk inherent in an entirely open contract.
125. In some instances, the liability of the seller might not be so limited and he would be exposed to full personal liability. See generally id. at 335–36.
126. If the contingency is based on future profits, and the buyer becomes insolvent, and is adjudicated a bankrupt, the seller's security interest in the property would be limited to nonexistent profits; hence, the property would belong to the trustee for distribution to other creditors. J. White & R. Summers, Uniform Commercial Code 792 (1972). See generally Comment, Future Advance Security Systems and the Federal Tax Lien, 65 Nw. U.L. Rev. 820 (1970).
127. The consideration could consist of a downpayment of 30% or less and the balance in obligations of the buyer payable over a period of years. In this manner, gain from the fixed contract could be reported under section 453. See I.R.C. § 453.
128. The retained portion could be physically severable from the rest of the property, or the seller could continue to own the entire property as a tenant in common with the buyer.
129. The contingency could be based upon future profits of the buyer, the rate of inflation, or the increase in the value of the entire property.
effect, become a partner of the buyer in that property's development or use. He could be exposed to both tort and contract liability. The purchaser would be saddled with a partner who would be required to join in mortgage contracts, insurance agreements, and conveyances. If the parties tried to avoid some of these problems by arranging for the seller to give the buyer a power of attorney or relinquish his control over the asset through some other device, the option would tend to merge into the sale and the danger of a Steen type integration would become imminent.

VI. Conclusion

The immediate effect of the Steen and Gralapp decisions could be to discourage sellers of real estate or mineral rights from retaining a small interest in the future development of the enterprise unless they receive the full contract price, exclusive of the contingency, in the year of the sale. Such a result is contrary to the apparent congressional intent underlying section 453.130 This Comment strongly recommends that courts which have not faced the issue apply the Corn Products131 and North American Oil/Rushing132 rationales when it arises. More importantly, Congress has the obligation to define whatever permissible deviation from a fixed sales price is acceptable for purposes of section 453 of the Code. In the interim, sellers must carefully structure their transactions so as not to create a tax liability in the year of the sale which exceeds the amount of cash received.

Harry J.J. O'Neill

LABOR LAW — INJUNCTIONS — FEDERAL COURTS DO NOT HAVE JURISDICTION TO ENJOIN A SYMPATHY STRIKE EVEN THOUGH THE UNION'S RIGHT TO ENGAGE IN SUCH STRIKE IS SUBJECT TO THE ARBITRATION PROVISIONS OF ITS COLLECTIVE BARGAINING AGREEMENT.

Buffalo Forge Co. v. United Steelworkers (U.S. 1976)

Buffalo Forge Company (Buffalo Forge), an employer operating three separate plant and office facilities in the Buffalo, New York area,1 brought an action2 against the United Steelworkers of America3 (Union),

130. See notes 20–25 and accompanying text supra.
131. See notes 78 & 79 and accompanying text supra.
132. See notes 81–83 and accompanying text supra.

2. Jurisdiction was based on section 301(a) of the Labor-Management Relations Act. 29 U.S.C. § 185(a) (1970). That section provides:

Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce as defined in this
a union representing some of its employees, for an alleged breach of its collective bargaining agreement. For several years prior to the lawsuit, the Union had represented the production and maintenance (P & M) employees at all three facilities, and in the summer of 1974, the Union was also certified as the representative of the office and technical (O & T) employees. Thereafter, in the course of attempting to negotiate their first collective bargaining agreement, the O & T employees, on November 16, 1974, went out on strike and established picket lines at all three plants. Within five days of the picket lines' formation the P & M employees also struck at the Union's direction.

Buffalo Forge responded to the action of the P & M employees by filing suit in the United States District Court for the Western District of New York, alleging that the Union's act of directing the P & M employees to honor the O & T picket lines amounted to a direct violation of an express no-strike clause contained in their collective bargaining agreement. On the basis of this claim, Buffalo Forge asked the district court for damages, chapter, or between any such labor organizations, may be brought in any district court of the United States having jurisdiction of the parties, without regard to the amount in controversy or without regard to the citizenship of the parties.

Id. 3. The International Union and Local Union Nos. 1874 and 3732 were named defendants in this action. Local 1874 represented approximately 930 production and maintenance (P&M) employees at the Buffalo and Cheektowaga plants. Local 3732 represented approximately 83 P&M employees at the North Tonawanda plant. 386 F. Supp. at 406-07.

4. Buffalo Forge Co. v. United Steelworkers, 96 S. Ct. 3141, 3144 (1976). The contracts between each local and the company contained identical no-strike clauses as well as grievance and arbitration provisions for settling disputes over the interpretation and application of each contract. The no-strike clause (section 14b of the contract) provided in part: "There shall be no strikes, work stoppages or interruption or impeding of work. No officers or representatives of the Union shall authorize, instigate, aid or condone any such activity." Id. at 3143 n.1.

This pledge was repeated in connection with the grievance procedure in section 26 of the contract: "Should differences arise between the Company and any employee covered by this agreement as to the meaning of and application of the provisions of this agreement, or should any trouble of any kind arise in the plant, there shall be no suspension of work on account of such differences. . ." Id. at 3143.

The final section dealing with the grievance procedure, section 32, provided: "In the event the grievance involves a question as to the meaning and application of the provisions of this Agreement, and has not been previously satisfactorily adjusted, it may be submitted to arbitration upon written notice of the Union or the Company." Id. at 3144 n.2.

5. Id. at 3143.

6. Id. at 3144. Two other locals, which were not involved in this action, were also certified. Id.

7. Id.

8. Id.

9. 386 F. Supp. at 407. Buffalo Forge argued alternatively that the strike was the result of a dispute between the company and a group of drivers concerning the propriety of certain work assignments. Id. The district court found that there was insufficient evidence to support that allegation. Id. at 409. This finding was not challenged on appeal. Buffalo Forge Co. v. United Steelworkers, 517 F.2d 1207, 1211 n.7 (2d Cir. 1975).
an order to submit any underlying disputes to the contractual arbitration procedure, and a temporary restraining order and preliminary injunction against the strike, pending the outcome of the arbitration.10

The district court denied the request for a preliminary injunction,11 finding that the P & M employees' strike was not caused by a dispute over issues which were subject to arbitration12 and, therefore, was not within the narrow exception to the Norris-LaGuardia Act.13 articulated in Boys Markets, Inc. v. Retail Clerks Local 770.14 In affirming the district court's holding15 the United States Court of Appeals for the Second Circuit emphasized the fact that the narrow holding in Boys Markets could not be expanded to cover this situation without "virtually obliterating the policy of the Norris-LaGuardia Act."16 On writ of certiorari, the Supreme Court of the United States affirmed the judgment of the Second Circuit, holding that federal courts do not have jurisdiction to enjoin a sympathy strike even though the Union's right to engage in such a strike is subject to the arbitration provisions of its collective bargaining agreement. Buffalo Forge Co. v. United Steelworkers, 96 S. Ct. 3141 (1976).

The power of the federal courts to issue injunctions in labor disputes has been a matter of passionate controversy for over eighty years.17 The

10. 96 S. Ct. at 3144.
11. 386 F. Supp. at 410.
12. Id. at 409.
13. 29 U.S.C. §§ 101-115 (1970). Section 4 of the Norris-LaGuardia Act provides in part: No court of the United States shall have jurisdiction to issue any restraining order or permanent injunction in any case involving or growing out of any labor dispute to prohibit any person . . . from . . . doing any of the following acts: (a) ceasing or refusing to perform any work or to remain in any relation of employment; . . . (e) giving publicity to the existence of, or the facts involved in, any labor dispute, whether by advertising, speaking, patrolling or by any other method not involving fraud or violence; (f) assembling peacefully to act . . . in promotion of their interests in a labor dispute.
14. 398 U.S. 235 (1970), noted in 16 VILL. L. REV. 176 (1970). In Boys Markets, an employer sought an injunction against a union strike and picketing which were allegedly in violation of the arbitration and no-strike provisions of the employees' collective bargaining agreement. The Supreme Court held that a federal court could issue an injunctive order against a strike if the court first found that the parties were contractually bound to arbitrate the dispute and that the ordinary principles of equity would warrant such relief. Moreover, the Court said that the employer should be ordered to arbitrate as a condition to obtaining the injunction. Id. at 254.
15. On appeal, the parties stipulated that the district court's findings of fact were correct. The pertinent findings were as follows: 1) the O & T employees' strike and picket line were "bona fide, primary and legal"; 2) the Union had authorized and directed the P & M employees' work stoppage; and 3) although the P & M employees' strike had ended, it might resume at any time in the near future. 96 S. Ct. at 3145.
16. 517 F.2d at 1211.
17. For a discussion of the history and development of the legal theories involved, see F. FRANKFURTER & N. GREENE, THE LABOR INJUNCTION (1930). See also Vladeck,
controversy inspired several congressional attempts to limit that power\textsuperscript{18} culminating with the Norris-LaGuardia Act of 1932. By means of that Act, Congress completely withdrew the jurisdiction of the federal courts\textsuperscript{19} to issue injunctions against several specifically enumerated types of union activities.\textsuperscript{20}

For the next thirty-eight years, the federal courts rejected all arguments which sought to limit the effect of this act.\textsuperscript{21} Ultimately, however,

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18. Prior to the Norris-LaGuardia Act, Congress made at least two attempts to limit the availability of injunctions in labor disputes. In 1913, Congress attached a provision to an appropriations bill for the Department of Justice providing that none of the money was to be “spent in the prosecution of any organization or individual for entering into any combination or agreement having in view the increasing of wages, shortening of hours, or bettering the conditions of labor . . . .” See F. Frankfurter & N. Greene, supra note 17, at 141.

This largely unsuccessful effort was followed in 1914 by a more direct attack on the legal theory that was most often used as the basis for issuing injunctions. Congress enacted section 6 of the Clayton Act to prevent the utilization of the antitrust laws to stifle labor unions. 15 U.S.C. § 17 (1970). Section 6 of the Clayton Act states in part:

The labor of a human being is not a commodity or article of commerce. Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor, agricultural, or horticultural organizations, instituted for the purpose of mutual help . . . or to forbid or restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under the antitrust laws.

\textit{Id.}


20. 29 U.S.C. § 102 (1970). In addition to those activities listed in note 13 supra, the Act also forbids injunctions against:

(b) Becoming or remaining a member of any labor organization or of any employer organization . . . .

(c) Paying or giving to, or withholding from, any person participating or interested in such labor dispute, any strike or unemployment benefits or insurance, or other monies or things of value;

(d) By all lawful means aiding any person participating or interested in any labor dispute who is being proceeded against in, or is prosecuting, any action or suit in any court of the United States or of any State;

(g) Advising or notifying any person of an intention to do any of the acts heretofore specified; and

(h) Advising, urging or otherwise causing or inducing without fraud or violence the acts heretofore specified . . . .

\textit{Id.} § 104. The Act also set up strict procedural requirements to be followed before an injunction could be issued against any other labor activity not specifically exempt. \textit{Id.} § 107.

21. Attempts were made in several different contexts to limit the effect of the Act by narrowly defining the term “labor dispute,” as used in section 104. \textit{See} notes 13 & 20 supra. This type of argument was rejected in Lauf v. E.G. Skinner & Co,
in the *Boys Markets* case, the Supreme Court reversed an earlier decision that was directly on point and concluded that, despite the provisions of the Norris-LaGuardia Act, a federal court did have jurisdiction to issue an injunction against a union strike, when the strike resulted from a grievance that the union was contractually bound to arbitrate. The Court's complete reversal in position was justified both on the basis of the need to accommodate the congressional policy favoring arbitration with the policy behind the anti-injunction provisions of the Norris-LaGuardia Act, and on the basis of the need to develop a uniform national labor law. Following that decision, the courts of appeals divided on the question of whether a *Boys Markets* injunction was proper when the right to strike was the only arbitrable issue.


One exception to this pattern was a line of cases culminating in the decision in *Brotherhood of R.R. Trainmen v. Chicago River & Ind. R.R.*, 353 U.S. 30 (1957).

In that case, the Supreme Court held that a federal court did have jurisdiction to issue an injunction against a strike by a railway labor union over disputes pending before the National Railroad Adjustment Board. The holding was based upon the Court's finding that section 3 of the Railway Labor Act, which provided for arbitration of disputes, 45 U.S.C. § 153 (1970), applied, thereby requiring an accommodation between that Act and the Norris-LaGuardia Act in order to preserve the clear purpose of each statute. 353 U.S. at 40.

22. *Sinclair Ref. Co. v. Atkinson*, 370 U.S. 195 (1962). In *Sinclair*, an employer sought an injunction against a union strike and picketing which allegedly violated the no-strike provision of their collective bargaining agreement. 370 U.S. at 197. The Supreme Court held that the action was barred in the federal court by the anti-injunction provision of the Norris-LaGuardia Act, despite the strong federal policy favoring arbitration. *Id.* at 213–15.

23. 398 U.S. at 254.

24. *Id.* at 241.

25. The Third, Fourth, and Eighth Circuits adopted the view that the employer's right to an injunction was as broad as the grievance and arbitration clauses contained in their collective bargaining agreements. Based upon this view, they allowed injunctions against sympathy strikes upon a showing that 1) the dispute over the right to strike was covered by the arbitration agreement and 2) the injunction was warranted under the traditional equitable standards. See, e.g., *Valmac Indus. v. Food Handlers Local 425*, 519 F.2d 263 (8th Cir. 1975), *vacated*, 96 S. Ct. 3215 (1976); *Associated Gen. Contractors v. International Union of Operating Eng'rs*, 519 F.2d 269 (8th Cir. 1975); *Island Creek Coal Co. v. United Mine Workers*, 507 F.2d 650 (3d Cir.), *cert. denied*, 423 U.S. 877 (1975); *Armco Steel Corp. v. United Mine Workers*, 505 F.2d 1129 (4th Cir. 1974), *cert. denied*, 423 U.S. 877 (1975); *NAPA Pittsburgh, Inc. v. Automotive Chauffeurs, Local 926*, 502 F.2d 321 (3d Cir.) (en banc), *cert. denied*, 419 U.S. 1049 (1974), *noted in* 21 *VILL. L. REV.* 608 (1975); *Pilot Freight Carriers, Inc. v. International Bhd. of Teamsters*, 497 F.2d 311 (4th Cir.), *cert. denied*, 419 U.S. 869 (1974).

The Second, Fifth, and Sixth Circuits adopted a more restricted view. Those circuits uniformly agreed that an additional requirement for the issuance of an injunction was a showing that the strike was "over" an arbitrable dispute. See *Plain Dealer Publishing Co. v. Cleveland Typographical Union No. 53*, 520 F.2d 1220 (6th Cir. 1975), *cert. denied*, 96 S. Ct. 3221 (1976); *Amstar Corp. v. Amalgamated Meat Cutters*, 468 F.2d 1372 (5th Cir. 1972).

The Seventh Circuit allowed an injunction to issue against a sympathy strike in one case where there was an "exceptionally broad" arbitration clause, *Inland Steel Co. v. Local 1545, United Mine Workers*, 505 F.2d 293 (7th Cir. 1974), but refused...
In order to resolve this split among the circuits, the Supreme Court had to delineate the limits of the Boys Markets decision. The Court, consequently, found it necessary, first, to review briefly the policy reasons behind the limited exception set forth in the Boys Markets decision. The Court asserted that the narrow accommodation of section 4 of the Norris-LaGuardia Act to section 301 of the Labor-Management Relations Act, which had been articulated in Boys Markets, could be justified only on the basis of the strong congressional preference for privately agreed upon dispute settlement mechanisms.

Having thus explained the Boys Markets case, the Court proceeded to distinguish the instant factual situation from the Boys Markets situation. The distinction was drawn between a strike that was “precipitated by a dispute . . . subject to binding arbitration under the provisions of the contract,” as was the case in Boys Markets, and a strike “in support of sister unions negotiating with the employer,” which precipitated an arbitrable dispute as to whether or not the strike violated the collective bargaining agreement as was the case in Buffalo Forge. Reasoning that in the latter case the cause of the strike and the issues underlying it were not even subject to the arbitration provisions of the contract, the Court concluded that such a strike could not be deemed to have had the purpose or effect of denying or evading an obligation to arbitrate thereby rendering Boys Markets inapposite.

The Court next rejected the employer’s argument that an injunction was warranted merely because it had been alleged that the strike violated the express no-strike provision of the contract. Although it agreed that section 301 had created a “major role” for the federal courts in enforcement of collective bargaining agreements, the Court dismissed the contention that this role included the authority to enjoin actual or threatened contract violations except where it involved the enforcement of arbitration provisions. The Court supported this position by pointing out that, in

to issue injunctions in two other cases where the language of the arbitration clause was not as broad. See Hyster Co. v. Independent Towing Ass’n, 519 F.2d 89 (7th Cir. 1975), cert. denied, 96 S. Ct. 3220 (1976); Gary Hobart Water Corp. v. NLRB, 511 F.2d 284 (7th Cir.), cert. denied, 423 U.S. 925 (1975).
26. 96 S. Ct. at 3146-47.
28. 96 S. Ct. at 3148-49; see text accompanying notes 24 & 25 supra. As the Court noted, this congressional policy is articulated in 29 U.S.C. § 173(d). 96 S. Ct. at 3149.
29. Justice White, the author of the majority opinion, dissented in Boys Markets for the reasons stated in Sinclair, 398 U.S. at 261 (dissenting opinion).
30. 96 S. Ct. at 3146.
31. See note 14 supra.
32. 96 S. Ct. at 3147.
33. Id. The cause of the strike was the strike by the O & T employees. The issues underlying it were the contractual demands of the O & T employees. Id.
34. Id.
35. Id. at 3148.
36. Id.
the course of enacting the Labor-Management Relations Act, Congress had rejected a proposal to lift the Norris-LaGuardia Act’s prohibition against injunctions in suits brought to enforce collective bargaining agreements.37 In addition, the Court quoted from the dissent in Sinclair Refining Co. v. Atkinson,38 adopted in Boys Markets, to the effect that, in suits for contract violations brought under section 301, the anti-injunction policy of the Norris-LaGuardia Act should prevail unless the violation also threatened some additional public policy.39

Applying this analysis to the facts, the Court explained that the existence of the arbitrable issue of the right to engage in the sympathy strike was not a sufficient reason to override the express anti-injunction provisions of the Norris-LaGuardia Act.40 The majority expressed concern that a contrary holding would encourage the use of injunctions against a great variety of alleged breaches of contract despite the fact that the injunctions would otherwise violate the express prohibitions of section 104.41 Such an extension of the Boys Markets exception was viewed as a serious undermining of the policy of the Norris-LaGuardia Act.42

Finally, the Court noted that an injunctive order in a sympathy strike situation would unavoidably involve a “judicial preview” of the facts and law involved in a dispute and could thus potentially undermine private arbitration agreements43 by exerting a significant influence on the arbitrator’s eventual decision.44

In a dissenting opinion,45 Justice Stevens rejected what he claimed were the bases of the majority opinion.46 He then argued that the Boys

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40. 96 S. Ct. at 3148–49.
41. Id.; see notes 13 & 20 supra.
42. 96 S. Ct. at 3148–49.
43. Id. Referring to the grievance procedures, the Court commented: “Nowhere does it provide for coercive action of any kind, let alone judicial injunctions, short of the terminal decision of the arbitrator. The parties have agreed to grieve and arbitrate, not to litigate.” Id. at 3149.
44. Id. This “judicial preview” problem does not arise in the traditional Boys Markets case because the arbitrable dispute and the contract violation which allows the employer to obtain an injunction are separable. By contrast, in the Buffalo Forge situation the arbitrable issue of the employees right to strike was also the issue which the district court had to decide before it could issue an injunction.
45. Justice Brennan, the author of the majority opinion in Boys Markets, and Justices Marshall and Powell joined in Justice Stevens’ dissent.
46. 96 S. Ct. at 3150. In Justice Stevens’ view, the “principal bases” of the majority opinion were a literal interpretation of the Norris-LaGuardia Act and a fear that the federal judiciary would interfere drastically with the business of contract interpretation, heretofore reserved for arbitrators. He argued that the first basis was without merit because it had been “repeatedly rejected in cases in which the central concerns of the Act were not implicated.” Id. Justice Stevens felt that the second basis was totally unrealistic, and he claimed that, in any event, it had already been
Markets decision was based not solely upon the need to accommodate the Norris-LaGuardia Act with the congressional policy favoring arbitration, but also upon several other compelling factors. While Justice Stevens admitted that not all of these factors were equally compelling in the Buffalo Forge situation, he obviously felt that the decision should, nevertheless, be the same. However, recognizing the fact that federal judges were probably less expert in this area of contract interpretation than arbitrators would be, he suggested that injunctions should be issued only when the no-strike clause clearly applied. This last suggestion was specifically rejected by the majority.


In Gateway Coal, the Supreme Court held that the presumption in favor of the arbitrability of disputes extended to disputes over safety matters. 414 U.S. at 382. Justice Stevens’ “implicit rejection” argument is seemingly based upon the fact that the injunction was allowed despite the fact that the legality of the strike under the collective bargaining agreement was also at issue. Id.

7. 96 S. Ct. at 3150-55. According to Justice Stevens’ analysis, five prime reasons existed for the holding in Boys Markets. The first was the Court’s conclusion that an injunction enforcing a contractual agreement to arbitrate was not one of the abuses at which the Norris-LaGuardia Act was aimed. Id. at 3151. This conclusion was drawn from the declaration of policy stated in section 102 of the Act itself. That policy statement illustrates that the primary purpose of the act is to protect labor’s ability to organize and bargain collectively. Id., citing 29 U.S.C. § 102 (1932). The second reason for the Boys Markets decision was alleged to be the need to give effect to the policies expressed in section 301 of the Labor-Management Relations Act. 96 S. Ct. at 3152. The purpose of that section was to encourage collective bargaining agreements by making them mutually enforceable. In order to effectuate this goal, the Boys Markets Court found it necessary to make available to the employer the principal and most expeditious method of enforcing a no-strike agreement, i.e., an injunction. Id. The third reason was the precedent established in another line of cases wherein the language of the Norris-LaGuardia Act had not been given controlling effect. Id. at 3153. That line of cases culminated in a holding that a federal court could enjoin a strike by a railroad union over a dispute subject to mandatory arbitration under the Railway Labor Act. See note 21 supra. The fourth reason was the conflict between the availability of injunctive relief in federal courts and state courts. 96 S. Ct. at 3154. This conflict resulted from the Supreme Court’s decision in Avco Corp. v. Aero Lodge, 390 U.S. 557 (1968), which held that a section 301 action instituted in a state court could properly be removed to a federal court. Many employers, therefore, found that the former remedy of injunction available in the state courts had been effectively eliminated by the passage of section 301 of the Labor-Management Relations Act. This incongruous result was at odds with congressional intent not to allow the passage of section 301 to disturb the preexisting jurisdiction of the state courts. 96 S. Ct. at 3155; see 92 Cong. Rec. 5708 (1946) (remarks of Sen. Murray). The final reason asserted by Justice Stevens for the Boys Markets decision was the strong federal policy favoring settlement of labor disputes by arbitration, and therefore also favoring the enforceability of private agreements to arbitrate. 96 S. Ct. at 3155.

48. 96 S. Ct. at 3155-57. His conclusion was predicated upon his view of the purpose of the arbitration process. That purpose was the removal of any ambiguity in the collective bargaining agreement as it applied to an unforeseen set of facts. Id. at 3156. Since the decision of the arbitrator which removed that ambiguity was enforceable by injunction, he felt that an unambiguous clause in the collective bargaining agreement which clearly covered the situation should also be enforceable by injunction. Id.

49. Id. at 3158.

50. Id. at 3149.
The majority's opinion is susceptible to several criticisms in addition to those noted by the dissent. The entire decision rests on the premise that the strike in the instant case is distinguishable from the Boys Markets strike insofar as a sympathy strike has neither the purpose nor the effect of denying or evading an obligation to arbitrate. In fact, however, this contention may not be valid.

The key to the distinction was the Court's observation that neither the cause of nor the issue underlying the strike was subject to arbitration. While this observation may support the contention that the strike was not employed for the purpose of evading an obligation to arbitrate, it does not support the contention that the strike would not have the practical effect of evading such an obligation. The economic pressure inherent in a sympathy strike could force an employer to concede the nonarbitrable issues underlying the strike long before the arbitrable issue of the right to strike could be decided by the arbitrator. In such a case, the employer would generally have no incentive to pursue arbitration. The resulting frustration and interference with the arbitration agreement would be more subtle than in the typical Boys Markets situation, but would, nevertheless, still be present.

This was not the only aspect of the issue which the majority apparently declined to consider. Certainly, the Court was correct in asserting two facts: the simple allegation that a strike is a breach of contract is insufficient in itself to warrant an injunction; and Congress had rejected a proposal to lift the prohibition against labor dispute injunctions to the extent necessary to achieve the purpose of enforcing collective bargaining agreements. Indeed, both of these facts had already been at least implicitly recognized by the Boys Markets Court. The Boys Markets Court, however, extended the analysis beyond these bare indications of an anti-

51. Id. at 3147.
52. Id.
53. As the majority acknowledged, the issue of the applicability of the no-strike clause to the sympathy strike was subject to arbitration under the provisions of the contract. Id. at 3146.
54. Continuation of the action by the employer after the dispute has been eliminated will generally only tend to further disturb labor relations. The employer is thus forced to decide if the benefits to be derived from a possible award of damages are sufficient to justify the risk of inciting further labor disputes. See Boys Markets, Inc. v. Retail Clerks Local 770, 398 U.S. 235, 248 (1970).
55. 96 S. Ct. at 3148. Unless there is a dispute which both parties are bound to arbitrate, no injunction can be issued against a strike regardless of the fact that it is a breach of contract. See Boys Markets, Inc. v. Retail Clerks Local 770, 398 U.S. 235, 254 (1970).
57. The Boys Markets Court seemed to recognize the legislative history of section 301 both when it rejected the respondent's stare decisis argument, 398 U.S. at 240, and when it adopted the dissenting opinion in Sinclair, 398 U.S. at 249, citing Sinclair Ref. Co. v. Atkinson, 370 U.S. 195, 235 (1962) (dissenting opinion). The Court expressly recognized the breach of contract argument in its holding in Boys Markets. 398 U.S. at 254.
injunction policy, and found it necessary to try to accommodate the policies embodied in section 4 of the Norris-LaGuardia Act with those of section 301 of the Labor-Management Relations Act.58

By contrast, the Buffalo Forge Court refused to consider such an accommodation.59 Its refusal was derived primarily from its view of the strike as having no effect upon the arbitration process.60 When the strike is viewed in terms of its actual practical effect upon the arbitration process,61 however, this belief seems unfounded. The Boys Markets Court willingly attempted to accommodate the two statutes precisely because it found that an injunction, protecting the integrity of a private arbitration agreement, would not undermine the central policy of the Norris-LaGuardia Act.62

The majority in Buffalo Forge declared, moreover, that the policy favoring arbitration dictated that no injunction be issued in the instant case.63 First, the Court argued that the arbitration process would be frustrated by the issuance of an injunction because it would involve a decision by the federal court as to the merits of the factual and legal issues.64 This prior disposition on the merits, in the Court’s view, could so heavily influence the subsequent arbitrator that the dispute would effectively be decided at the preliminary injunction stage.65 In addition, the Court noted that the injunction could frustrate the arbitration process because the time and expense involved in relitigating the issue before the arbitrator might discourage the losing party from pursuing the arbitration.66 While both of these arguments present valid considerations, it is submitted that the majority placed little, if any, weight upon the fact that the refusal to issue an injunction presents at least as great a threat that the arbitration process will be frustrated by the strike-induced capitulation of the employer.67

Oddly enough, the Court did not emphasize the particular facts of Buffalo Forge even though such an emphasis would have lent additional support to their reasoning. Unlike the traditional Boys Markets situation, this case involved two distinct strikes. Since the O & T employees' strike

58. 398 U.S. at 249.
59. 96 S. Ct. at 3148.
60. The Court stated that accommodation was necessary only when a strike would interfere with and frustrate the arbitration process. Id. at 3149. The majority also argued that an accommodation should not be attempted because it might lead to a tremendous expansion in the availability of injunctions and such a result would be unacceptable because it would cut deeply into the policy of the Norris-LaGuardia Act. Id. at 3150.
61. See notes 53 & 54 and accompanying text supra.
62. 398 U.S. at 253.
63. 96 S. Ct. at 3149.
64. Id. at 3148-49.
65. Id. at 3149.
66. Id.
67. See notes 53 & 54 and accompanying text supra.
was clearly beyond the reach of an injunction, an injunction against that strike would certainly be inconsistent with the central purpose of the Norris-LaGuardia Act. Moreover, an injunction against the P & M employees’ sympathy strike would detrimentally affect the strength of the O & T employees’ strike. Thus, to the extent that the injunction would affect the O & T employees’ strike, it would arguably tend to frustrate the policy of the Norris-LaGuardia Act.

Simply because the Court failed to recognize and deal with these issues does not necessarily mean that its decision is unsupportable. For while it seems that some question exists as to the validity of the Court’s conclusion that an injunction in this case would seriously undermine the validity of the Norris-LaGuardia Act, at the same time it is not clear that the grant of an injunction would be any more effective in protecting arbitration agreements than this refusal to grant such relief.

Nevertheless, the decision agreed upon by the majority creates a serious problem. One of the justifications for the Boys Markets decision was the Court’s concern with preserving the jurisdiction of the state courts in section 301 suits involving requests for injunctive relief. Buffalo Forge has re-created a situation whereby the existence of federal court jurisdiction effectively eliminates a remedy — an injunction — which was formerly available in many state courts.

Having lost one remedy, employers in the future will be forced to search for an alternative course of action. One possible stratagem, already the subject of some litigation, consists of disciplinary action by the employer against those employees who engage in a sympathy strike. Even if the strike is not halted by such disciplinary action, it may allow the employer to argue that the ongoing strike is now, at least partially, “over”

68. Since there was no contract involved at that time, the strike could not be a breach of contract and there was no contractual obligation to arbitrate anything. See note 55 supra.

69. The general policy declaration of the act states that it is designed to insure the right of workers to engage in “concerted activities for the purpose of collective bargaining. . . .” 29 U.S.C. § 102 (1970).

70. See text accompanying notes 53, 54 & 58-62 supra.

71. See text accompanying notes 65 & 66 supra.

72. 398 U.S. at 244-46. See also note 47 supra.

73. At the time Boys Markets was decided, injunctive remedies for a breach of a collective bargaining agreement were available in approximately 36 states. Boys Markets, Inc. v. Retail Clerks Local 770, 398 U.S. at 247 n.15.

74. The Seventh Circuit recently held that disciplinary action against workers who refused to cross a picket line was not an unfair labor practice within the meaning of either section 8(a)(1) or section 8(a)(3) of the Labor-Management Relations Act, 29 U.S.C. § 158(a)(1), (3) (1970). The holding was based upon a finding that the dispute over the interpretation of a picket line clause was arbitrable and therefore employees had no right to honor the picket line prior to the arbitrator’s decision. NLRB v. Keller-Crescent Co., No. 75-1595 (7th Cir., filed Aug. 2, 1976). In finding the dispute to be arbitrable the Court had to distinguish its earlier decisions in Hyster Co. v. Employees Assoc., 519 F.2d 89 (7th Cir. 1975), and Gary Hobart Water Corp. v. NLRB, 511 F.2d 284 (7th Cir. 1975).
the arbitrable grievance of the disciplinary action, and therefore, subject to
an injunction, even under the guidelines set forth in Buffalo Forge.75

Another possible alternative for the employer, at least in some in-
stances, would be the institution of a proceeding with the National Labor
Relations Board (NLRB) to establish an unfair labor practice by the
union.76 An injunction against an unfair labor practice, however, can
seldom, if ever, be obtained through the NLRB in less than five to seven
days. In contrast, a standard Boys Markets injunction can often be ob-
tained in one day.

A final possibility for an employer lies in seeking a specific agreement
from the union that its members will not engage in sympathy strikes, and
a further agreement providing for immediate arbitration of a dispute as to
the precise nature of any strike.77 Such an agreement would probably
not permit an employer to get an immediate injunction since the strike
would still not be "over" an arbitrable grievance, but the expedited pro-
cedure would allow him to obtain an enforceable arbitrator’s decision78
within a much shorter period of time.

The importance of these alternative remedies will depend upon the
scope attributed to the Buffalo Forge decision. It is submitted that these
remedies, or other alternative remedies, will be very important since the
analysis adopted by the Court appears to indicate an intention to limit
the availability of a Boys Markets injunction to those cases in which there
is a direct chronological and causal relationship between the arbitrable
dispute and the strike.79 Nevertheless, it is unlikely that even this restric-
tive analysis will end the litigation of this "narrow but significant question
of labor law."80

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75. The Court specifically noted that the employer did not challenge the district
court’s finding that the P & M employees’ strike was not, even in part, a protest
over truck driving assignments. 96 S. Ct. at 3145 n.8.

76. An NLRB remedy would be available if the picket line which was being
honored amounted to a secondary boycott. Secondary boycotts are enjoinable as an

77. Such an agreement could probably only be obtained from a union, however,
at the price of some additional concession by the employer.

78. The Buffalo Forge majority acknowledged the fact that an arbitrator’s de-
cision would be enforceable by an injunction. Buffalo Forge Co. v. United Steel-
workers, 96 S. Ct. at 3148.

79. That appears to be the standard the Court has set by the use of the require-
ment that the strike be “over” an arbitrable grievance.

80. Buffalo Forge Co. v. United Steelworkers, 517 F.2d at 1208. The areas
surrounding this issue will probably continue to produce litigation as well. For ex-
ample, it is uncertain at this point whether, and to what extent, the courts will allow
an employer to “manufacture” the required factual situation. See note 75 and ac-
companying text supra. It is also unclear how the courts will deal with the disparate types
of remedies which are now available in the state and federal courts. As noted pre-
viously, the use of the removal process in conjunction with that disparity can effec-
tively eliminate an existing state remedy. See notes 72 & 73 and accompanying text
supra. The use of the removal process also raises a question as to whether a state
court injunction, issued prior to removal, must be dissolved by a federal court.

Daniel v. International Brotherhood of Teamsters (N.D. Ill. 1976)

Plaintiff, a member of Local 705 International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America (Local 705), worked for union-covered employers for twenty-two and one-half years. Because this employment had been interrupted for several months due to an involuntary lay off, the trustees of the Local 705 Pension Fund (Pension Fund) denied plaintiff his pension benefits. Alleging that this denial, as well as the maintenance and administration of the Pension Fund, violated section 17(a) of the Securities Act of 1933 (1933 Act) and section 10(b), and rule 10b-5 of the Securities Exchange Act of 1934 (1934 Act), plaintiff filed a class action against the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America (IBT), Local 705, the Pension Fund itself, and several trustees of the Pension Fund. The District Court for the Northern District of Illinois denied the defendants' motion to dismiss the complaint for lack of subject matter jurisdiction. Plaintiff appealed.


2. Id. Each employee participant of the Pension Fund was subject to an eligibility rule which required 20 years of continuous employment by the employee before he would become entitled to pension benefits. Id. at 544.

3. 15 U.S.C. § 77q(a) (1970). Section 17(a) provides in pertinent part:

   It shall be unlawful for any person in the sale of any securities . . .

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

   (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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

   (3) to engage in any transaction, practice, or course of business which operates . . . as a fraud upon the purchaser.

Id.

4. 15 U.S.C. § 78j(b) (1970). Section 10(b) provides in pertinent part: “It shall be unlawful for any person . . . (b) to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules . . . as the Commission may prescribe . . .” Id.

5. 17 C.F.R. § 240.10b-5 (1975) (rule 10b-5 promulgated under 15 U.S.C. § 78j(b) (1970)). Rule 10b-5 largely reiterates the language of section 17(a) with the additional scope of “fraud or deceit . . . in connection with the purchase or sale of any security.” See 17 C.F.R. § 240.10b-5 (1975). For text of section 17(a), see note 3 supra.

6. 410 F. Supp. at 544. Plaintiff contended that defendants' alleged sale of interests in the Pension Fund to employee participants of the fund involved fraudulent and intentional misrepresentations and omissions by failing to disclose material facts concerning the length and continuity of employment rules. Id.

Plaintiff also alleged violations of sections 302(c) (5) and (e) of the National Labor Relations Act, 29 U.S.C. §§ 186(c) (5), (e) (1970), and pendant claims of common law fraud, deceit, and breach of trust. 410 F. Supp. at 543.

7. 410 F. Supp. at 543.
jurisdiction and failure to state a claim upon which relief could be granted, \(^8\) holding that the complaint alleged the sale\(^9\) of a security\(^10\) for purposes of the antifraud provisions\(^11\) of the 1933 and 1934 Acts (collectively Securities Acts). Daniel v. International Brotherhood of Teamsters, 410 F. Supp. 541 (N.D. Ill. 1976), appeal docketed, No. 76-1855 (7th Cir. Sept. 1, 1976).

The dismissal of defendants' motions represented a departure by the Daniel court from the standard position of the Securities and Exchange Commission (SEC)\(^12\) and the consensus of legal thought,\(^13\) which previously has held that becoming entitled to an interest in a noncontributory,\(^14\) compulsory\(^15\) pension plan does not constitute the sale of a security for purposes of the Securities Acts. In 1941, SEC Commissioner Purcell stated that the 1934 Act did not apply to pension plans financed solely by employer contributions because interests in such plans were giftlike, and therefore did not constitute a sale to the employee of anything.\(^16\)

8. Id. at 545-46. Defendants argued that Congress' enactment of legislation specifically designed to handle employee pension funds demonstrates congressional belief in the inapplicability of the Securities Acts to such funds; and that the SEC has determined that no sale of a security is involved in noncontributory, compulsory employee pension plans. Id. at 546. Defendants also contended that the complaint was barred by the state statute of limitations, id. at 544, citing Ill. Rev. Stat. ch. 121-1/2, § 137.13(d) (West Supp. 1976), and that there was a lack of subject matter jurisdiction and failure to state a claim upon which relief could be granted under the National Labor Relations Act. Id. at 554.


10. Section 2(1) of the 1933 Act provides: "When used in this subchapter, unless the context otherwise requires — (1) the term 'security' means any note, stock . . . certificate of interest or participation in any profit-sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security' . . ." 15 U.S.C. § 77b(1) (1970).


11. See notes 3-5 supra.

12. See notes 16 & 18 infra.

However, it should be noted that in January 1977 the SEC reportedly "lined up behind Daniel" in asserting its jurisdiction over such case despite objections by the Lab. Dept. and SEC Chairman Hill. Pension Cheating Charged. Phila. Sun Bulletin, Jan. 23, 1977, § 10, app. 1, col. 6.

13. See note 17 infra.

14. A "noncontributory" pension plan is one in which the employer bears the total financial burden, as opposed to a contributory plan where there is joint financing by the employer and the employee. Pensions: Problems and Trends 30 (D. McGill ed. 1955).

15. A "compulsory" pension plan is one in which there is an "automatic deduction from salary which is compulsory in the sense that it is an incident of the job and is accepted as part of the job." Feldman & Rothschild, Executive Compensation and Federal Securities Legislation, 55 Mich. L. Rev. 1115, 1124-25 (1956-57) (footnote omitted).

16. Hearings on Proposed Amendments to Securities Act of 1933 and Securities Exchange Act of 1934 Before the House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 907 (1941) [hereinafter cited as 1941 Hearings]. The SEC reasoned that these interests were giftlike because the employees were deemed to
Purcell added that when membership in a pension plan was compulsory, in the sense that it was a condition of employment, no voluntary investment decision has been made by the employee, and therefore no reason existed to require compliance with the registration process of the Securities Acts. In 1948, the Seventh Circuit recognized that interests in a pension fund were not gifts, but rather, were "wages" within the definition of section 9(a) of the National Labor Relations Act, and therefore subject to collective bargaining. Although the line of cases following this theory have made no payments for them. Id. at 908. In addition, Commissioner Purcell stated that the Securities Acts did apply to pension plans which involved the sale of a security. Id.

17. Id. Existing legal thought supports the SEC's view that the employee who had to either take pension benefits or quit was not exercising his volition in the manner contemplated by the Securities Acts. See Hipple & Harkelroad, Anomalies of SEC Enforcement: Two Areas of Concern, 24 EMORY L.J. 697, 705 (1975). See also Mundheim & Henderson, Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans, 29 LAW & CONTEMP. PROB. 795, 807-10 (1964).

18. 1941 Hearings, supra note 16, at 908, 950. Commissioner Purcell reasoned as follows: The purpose of the registration process of the Securities Acts is to disclose to prospective investors the essential facts about securities which they are asked to buy, and if the employees are given no choice as to whether to buy or refuse to buy there hardly seems any point in the registration process.

19. Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948), cert. denied, 336 U.S. 960 (1949). The Inland Steel court reasoned that an employee's interest in a pension plan differed from a mere gift because the interest represented a portion of the employee's remuneration for services performed, and, thus, was part of the reason he chose a particular job. 170 F.2d at 253. See also NLRB v. Niles-Bement-Pond Co., 199 F.2d 713 (2d Cir. 1952).


21. Inland Steel Co. v. NLRB, 170 F.2d 247, 251 (7th Cir. 1948), cert. denied, 336 U.S. 960 (1949). One court has noted that a noncontributory, unilaterally imposed pension plan is no less compulsory in nature than a plan bargained for by a union. See Lucas v. Seagrave Corp., 277 F. Supp. 338, 343 (D. Minn. 1967).

Historically, three broad theories on the nature of pension plans have existed. They have been variously described as gifts, unilateral contracts, and deferred wages. B. AARON, LEGAL STATUS OF EMPLOYEE BENEFIT RIGHTS UNDER PRIVATE PENSION PLANS 4-14 (1961). The gift category, chronologically the earliest, was based upon the reasoning that pensions were no more than gratuities, lacking legal enforceability by the employee-donee. Id. at 5-9. The contract theory held that a pension plan was the employer's binding obligation to deliver the pension, generally to the employee who knew of the plan and continued his employment in reliance upon it. Id. at 9-10. The third category viewed pensions as wages deferred until a later date; the employee was deemed to have had the choice between an immediate wage increase and a pension plan, and having decided on the pension plan, was entitled to view the benefits as deferred compensation. Id. at 10-14. This final category drew much of its support from the Inland Steel decision. Id.

Another theory, which could be classified as a subcategory of gifts, held that pensions were no more than human depreciation, and that the employer owed a moral obligation to his employees to provide for full depreciation of the employee in the form of old age pensions. PENSIONS: PROBLEMS AND TRENDS 28 (D. McGill ed. 1955), citing STEEL INDUSTRY BOARD, REPORT TO THE PRESIDENT OF THE UNITED STATES ON THE LABOR DISPUTE IN THE BASIC STEEL INDUSTRY 55 (Sept. 10, 1949).

22. See, e.g., NLRB v. Niles-Bement-Pond Co., 199 F.2d 713 (2d Cir. 1952) (even bonus payments may be "wages" within section 9 of the NLRA). It should
implicitly suggested that an acquisition of such an interest was a "disposition . . . for value," the SEC has continued to maintain it no-sale stance.\(^\text{24}\)

Concurrently with the development of the SEC's firm no-sale position regarding interests in a noncontributory, compulsory pension plan, Congress enacted massive pension legislation,\(^\text{25}\) culminating in the comprehensive Employee Retirement Income Security Act of 1974 (ERISA).\(^\text{26}\)

Against the background of this longstanding SEC position and the proliferation of comprehensive pension reform legislation, the instant case was the first federal decision 1) to consider the extent to which an interest in a noncontributory, compulsory pension plan involved the sale of a security within the meaning of the Securities Acts in light of the recent enactment of ERISA and other pension legislation, and 2) to consider the applicability of the protections of the antifraud provisions of the Securities Acts to interests in such plans.

Focusing upon the legislative history and remedial nature of the Securities Acts, the court began its analysis with a brief discussion of whether the Securities Acts were facially applicable to employee pension plans. In deciding this issue the court examined the legislative history of the Securities Acts,\(^\text{27}\) and concluded that the history disclosed both con-

be noted that opinions which appear to disagree with the Inland Steel decision were generally concerned that a cause of action would arise under an unjust enrichment or unilateral contract theory, and not under a deferred wages theory. See, e.g., Connell v. United States Steel Corp., 516 F.2d 401 (5th Cir. 1975); Knoll v. Phoenix Steel Corp., 465 F.2d 1128 (3d Cir. 1972), cert. denied, 409 U.S. 1126 (1973).

23. The concept of a "disposition . . . for value" is derived from the definition of "sale" in the 1933 Act. For the text section, see note 10 supra.


26. 29 U.S.C. \§\§\ 1001-1381 (Supp. V 1975). It should be noted that Congress enacted ERISA in significant measure because of the lack of employee information and adequate safeguards for the operation of such plans. Id. \§\ 1001. The stated policy of ERISA was to protect plan participants' interests in benefit plans by requiring disclosure, reporting, remedies, and sanctions. Id. \§\ 1001. The coverage of ERISA extends to any employee benefit plan maintained in interstate commerce. Id. \§\ 1003.

27. 410 F. Supp. at 547. To reach this question the court disposed of two preliminary matters. First, the court responded to defendants' argument that the three-
gressive and SEC recognition that, to the degree employee pension plans involved the sale of a security, the Securities Acts applied to such plans.28

The Daniel court next considered the defendants' contention that the large-scale enactment by Congress of specialized pension legislation29 evidenced a congressional belief that the Securities Acts were inapplicable to employee pension plans, notwithstanding the fact that such plans might have satisfied the definition of security within the meaning of the Securities Acts.30 Rejecting the defendants' interpretation, the court stated that the prolific amount of pension legislation could be explained by the fact that pension plans had "unique characteristics" which were inadequately regulated by the Securities Acts, and which therefore required the enactment of more specialized, complementary regulations.31 To substantiate this view, the court observed that ERISA was aimed only at the ongoing administration of pension plans, as opposed to the "regulation of the circumstances of entry,"32 i.e., the sale of a pension plan interest, with which the Securities Acts were concerned.

Confronted with the extensive procedural requirements of the pension laws, the Daniel court next discussed whether the application of the anti-fraud provisions of the Securities Acts were necessarily precluded by the existence of this pension legislation.33 In this regard, the court referred to the savings clauses of the Welfare and Pension Plans Disclosure Act

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28. Id. at 547, 549. The court examined, in particular, a proposed amendment to the 1933 Act which would have exempted from registration certain offerings made solely to employees of an issuer. This amendment was rejected in conference because it was felt that employee plan participants required the protection of the Securities Acts as much as other investors. 410 F. Supp. at 547, citing H.R. Rep. No. 1838, 73d Cong., 2d Sess., 41 (1934).

29. See note 25 supra. It should be noted that ERISA's coverage did not extend to the cause of action alleged in the instant case because of the express exclusion by ERISA of any causes of action, acts, or omissions arising before January 1, 1975. 29 U.S.C. § 114(b) (1).

30. 410 F. Supp. at 547.

31. Id. at 548.


33. 410 F. Supp. at 549.
(1958 Act)\textsuperscript{34} and the Investment Companies Amendment Act of 1970,\textsuperscript{35} which denied exemption from liability provided by any law affecting pension plans, and to the House Report on the 1970 Act,\textsuperscript{36} which stated that exemption from the registration requirements of the Securities Acts did not mean exemption from the antifraud provisions of those acts.\textsuperscript{37} On the basis of this evidence, the court concluded that noncontributory, compulsory employee pension plans were not beyond the scope of the antifraud provisions of the Securities Acts.\textsuperscript{38}

The final issue the court faced was whether plaintiff's acquisition of an interest in the Pension Fund constituted the sale of a security\textsuperscript{39} for Securities Act purposes.\textsuperscript{40} Initially, the court had to determine whether a "security" existed.\textsuperscript{41} Noting that an investment contract is one of the terms included in the definition of "security,"\textsuperscript{42} the court employed the definition of "investment contract" set forth by the United States Supreme Court in \textit{SEC v. W. J. Howey},\textsuperscript{43} which required: "A contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of . . . a third party . . . ."\textsuperscript{44} Finding that the Pension Fund constituted a common enterprise,\textsuperscript{45} that the trustees had sole power of control over the fund, and that profits were expected in the form of pension benefits,\textsuperscript{46} the court concluded that plain-

\begin{itemize}
  \item \textsuperscript{34} Id., citing 29 U.S.C. § 309(b) (1970).
  \item \textsuperscript{36} 410 F. Supp. at 549, citing \textit{H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 10 (1970)}.
  \item \textsuperscript{38} 410 F. Supp. at 549. The court also mentioned that the justifications for exemption from the procedural requirements of the Securities Acts did not constitute justification for the inapplicability of the antifraud provisions of the Securities Acts. \textit{Id.} As the court noted, "Since these antifraud provisions do not impose an undue burden on anyone, there is no reason why they should not remain as remedies available to employees for use in cases where fraud of the kind covered by these sections has been committed." \textit{Id., quoting Mundheim & Henderson, supra} note 17 at 814.
  \item \textsuperscript{39} \textit{See} notes 9 & 10 supra.
  \item \textsuperscript{40} 410 F. Supp. at 549–53. The court noted that this issue had to be resolved because the antifraud provisions of the Securities Acts require: 1) the use of the jurisdictional means, 2) in the making of material misrepresentations, omissions to state material facts or use of manipulative and fraudulent devices, in connection with 3) a sale of a security. \textit{Id.} at 549.
  \item \textsuperscript{41} \textit{Id.} at 550–51.
  \item \textsuperscript{42} \textit{See} note 10 supra.
  \item \textsuperscript{43} 328 U.S. 293 (1946).
  \item \textsuperscript{44} \textit{Id.} at 298–99. This formulation "has become a generally accepted definition of an investment contract." \textit{SEC} Securities Act Release No. 5347, 38 Fed. Reg. 1735 (1973).
  \item \textsuperscript{45} The \textit{Daniel} court also referred to the traditionally acknowledged "need for a liberal construction of the word 'security'" in order to effectuate the remedial purpose of the disclosure requirements of the Securities Acts. 410 F. Supp. at 550.
  \item \textsuperscript{46} \textit{Id.} at 551.
\end{itemize}
tiff's interest in the Pension Fund constituted a security. In support of this conclusion, the court noted that the Securities Acts were designed to prevent fraud in the sale of securities and to protect investors. The *Daniel* court stated that because pension plan participants have had a great need for the protection afforded by the Securities Acts, a need not fulfilled by any of the pension acts, the conclusion that an interest in this plan was a security, was consistent with the remedial nature of the Securities Acts.

The court then considered the Securities Acts' definition of "sale" to determine whether that term of art applied to the plaintiff's acquisition of an interest in his pension plan. The court adopted the theory that employer contributions to pension funds on behalf of employees represented a large portion of the wages received by employees for services performed. The court noted in this respect that there was no economic difference between the situation in the instant case and one where an employee receives the employer's contribution as part of his salary, which the employee then remits in cash to the pension fund — the latter situation representing the traditionally acknowledged sale of a security. The court concluded that the plaintiff had therefore given value for his interest in the Pension Fund.

In addition the court stated that since employees must approve the union-negotiated formula for dividing earnings between pension fund and salary, the ultimate responsibility for the allocation lies with them. In the court's view, this vote represented a voluntary investment decision, and therefore the SEC policy of finding no voluntary purchase in such situations was rejected.

Despite the realistic approach taken by the *Daniel* court in finding the SEC's no-sale position to be untenable, analytical problems remain.

47. *Id.* at 552.
48. *Id.* at 551.
49. *Id.*
50. *Id.* at 552.
51. See note 9 *supra*.
52. 410 F. Supp. at 552-53.
53. *Id.* at 552, citing Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949); S. REP. No. 1440, 85th Cong., 2d Sess. 4 (1958).
54. 410 F. Supp. at 553.
56. 410 F. Supp. at 553.
57. *Id.* The *Daniel* court recognized that a majority vote prevailed in union decisions, but determined "that this did not negate the fact that this majority decision is but an aggregate of many individual decisions." *Id.*
58. *Id.* The court observed that in other circumstances the SEC did not "look behind the purchase for the state of mind of the investor to determine whether in fact the purchaser 'desired'" to buy the security, and added that the SEC should not do so here either. *Id.*
59. This realistic approach is reflected in the writing of one commentator who stated: "The fact is that employers and unions, in increasing numbers, are negotiating
For example, if the employer's contributions are really no more than wages deducted from the employee's paycheck, it is difficult to understand why the employee who leaves his job before his rights have vested has no claim to that portion of the funds representing his "wages." The court also did not consider whether an employer who did not want to be "sold" an interest in the Pension Fund could have received more money in his paycheck instead. If he could not have, then it becomes more difficult to justify viewing the employer's contributions as essentially part of the employee's wages, deferred to a later date.

Even accepting the Daniel court's sale approach, it is submitted that the court's determined attempt to hold the antifraud provisions of the Securities Acts applicable to the pension plan in question tainted its analysis of pension legislation, ERISA in particular, in several respects. First, the Daniel court failed to evaluate the apparent similarities between the applicable provisions of the Securities Acts and ERISA, even though these similarities appear to weaken the court's stance that ERISA was not designed to be displacing legislation. Both the Securities Acts and ERISA require filings and annual reports containing substantially similar material. Both impose criminal and civil sanctions for improper disclosure. Furthermore, the court's determination that disclosure under pension legislation did not satisfy the Securities Acts' requirements of disclosure in a form understandable to the investor, ignored the language

pension plans as if they represented wages deferred." B. AARON, supra note 21, at 13 (emphasis supplied). Another commentator has noted: "[m]ost employees believe that money paid into the pension fund by their employer is theirs because they earned it." R. NADER & K. BLACKWELL, YOU AND YOUR PENSION 12 (1973).

60. The denial of such rights has been summarized by one court as follows: "Courts have been uniformly reluctant to grant terminated employees vested rights in a non-contributory pension fund where the terms of the pension contract have not been literally met." Lucas v. Seagrave Corp., 277 F. Supp. 336, 342 (D. Minn. 1967).

Even under ERISA's elaborate vesting requirements there is no apparent correlation between the amount of time worked and employer contributions, and the amount of money received by the employee who discontinued employment prior to the vesting of pension rights. See 29 U.S.C. §§ 1051-1061 (Supp. V 1975). Instead, the ERISA formula appears to be an equitable approximation of the employee's benefits in his pension fund at a given time. See 29 U.S.C. § 1053 (Supp. V 1975).


64. 15 U.S.C. §§ 77x, 78j (1970); 29 U.S.C. §§ 1131, 1132 (Supp. V 1975). In addition, a recent regulation promulgated under ERISA elaborates upon the effects of improper disclosure, possibly in an attempt to avoid fraudulent disclosure practices. The regulation states in pertinent part: "The style and format of the ERISA notice shall not have the effect of misleading, misinforming or failing to inform participants and beneficiaries of a plan . . . . [I]naccurate or misleading explanatory material will fail to meet the requirements of this section . . . ." 41 Fed. Reg. 16,957 (1976) (emphasis added).
of ERISA requiring comparable disclosure. Moreover, in attacking the 1958 Act as an example of pension legislation requiring the plan participant, as opposed to the offeror, to initiate disclosure, the court failed to recognize that ERISA, which is similar in approach to the Securities Acts, does not require the plan participant to initiate disclosure except in limited circumstances. All these similarities would tend to rebut the court's argument that ERISA merely complements the Securities Acts.

Second, the court's analysis did not sufficiently point out the significant differences between the Securities Acts and pension legislation even though these differences lend strong support to the court's holding. For example, the Securities Acts require disclosure at the time of the offer, whereas ERISA requires disclosure only after the employee has already become a plan participant. As a result, the prospective beneficiary of a noncontributory, compulsory pension plan does not have the advantage of ERISA's elaborate disclosure requirements at the time he must choose his employment and enter into a pension plan. Furthermore, the court failed to show that, whereas ERISA requires disclosure concerning the way an employee might forfeit his personal rights in the plan and not regarding the quality of the pension plan as an investment, the Securities Acts require disclosure of all material facts so that a potential purchaser can make an informed investment decision. By omitting to mention these differences the court did not adequately underscore ERISA's complementary position with respect to the Securities Acts.

Despite the decision's analytical problems, the Daniel court's narrow holding that the antifraud provisions of the Securities Acts are applicable to noncontributory, compulsory pension plans has considerable merit. The enactment by Congress of comprehensive pension legislation did not man-

65. Section 102(a) (1) of ERISA provides: "The summary plan description ... shall be written in a manner calculated to be understood by the average plan participant." 29 U.S.C. § 1022 (Supp. V 1975).

The regulations proposed under ERISA elaborate upon this requirement by providing that in instances where at least 50 employees or 50% of the plan participants are illiterate in English, the summary plan description must be prominently displayed in the language most comprehensible to them, and must assist them in coming to an understanding of their rights and obligations under the plan. 40 Fed. Reg. 246-54 (1975).

66. It should be noted that section 111(a) (1) of ERISA repealed the 1958 Act, except as to events which occurred before the enactment of ERISA. See 29 U.S.C. § 1031 (Supp. V 1975).

67. Sections 102 and 104 of ERISA require disclosure to be made to plan participants by the plan administrator through summary plan descriptions and annual reports. See id. §§ 1021, 1023 (Supp. V 1975). However, it should be noted that the participant is required to initiate disclosure, in writing, to acquire information about the current status of his benefit rights. Id. § 1025.


69. See notes 62 & 63 supra.


date the preemption of other laws affecting pension plans. 72 ERISA, in particular, did not preempt any state 73 or federal law affecting securities. 74 Most importantly, the differences between the Securities Acts and the most recent and comprehensive pension law, ERISA, reveal that standing alone, ERISA's antifraud provisions contain many gaps which could, at least potentially, be filled by complementary provisions of the Securities Acts. 75

Although the Daniel decision broached the subject of the propriety of the SEC's no-sale approach to noncontributory, compulsory pension plans, the major impact of the decision will undoubtedly be the increased use of the antifraud provisions of the Securities Acts by unhappy pension plan participants. If it is subsequently determined that ERISA was meant to be displacing legislation, it is submitted that Daniel may nonetheless encourage an expansion of the scope of ERISA's own antifraud measures.

By extending the coverage of the antifraud provisions of the Securities Acts to encompass the noncontributory, compulsory pension plan of the instant case, the Daniel court has created additional safeguards and remedies to further protect the frequently defrauded pension plan participant. 76 Although the court's position would have been more effectively articulated had a more ambitious comparison of pension legislation and the Securities Acts been undertaken, the Daniel decision nonetheless represents an innovative approach to this unchartered area of the law.

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72. See SEC v. Garfinkle, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,020 (S.D.N.Y. 1975) (complaint in reference to beneficiaries of a union welfare fund were held to be subject to the Securities Acts, and ERISA was held not to have exclusive jurisdiction).
74. Id. § 1144(d).
75. Section 506 of ERISA recognizes the need for the regulatory arm of employee benefit plans, the Secretary of Labor, to arrange for cooperation and assistance from other governmental agencies, including the SEC. 29 U.S.C. § 1134 (Supp. V 1975). One district court has suggested that this indicates that ERISA was not intended to stand alone. SEC v. Garfinkle, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,020 (S.D.N.Y. 1975).
76. It has been estimated that as few as eight percent of pension plan participants in plans with vesting requirements of at least 11 years will ever receive benefits from their pension fund. See Daniel v. International Bhd. of Teamsters, 410 F. Supp. at 551, citing INTERIM REPORT OF ACTIVITIES OF PRIVATE WELFARE AND PENSION PLAN STUDY, S. Rep. No. 92-634, 92d Cong., 2d Sess., at 15, 115-53 (1972).
SECURITIES LAW — Proxy Regulation — A Fact is Material Under SEC Rule 14a-9 Only if There is a Substantial Likelihood that a Reasonable Investor Would Consider It Important.


Upon the acquisition of 34% of the outstanding voting securities of TSC Industries, Inc. (TSC), National Industries, Inc. (National) succeeded in placing five of its nominees on TSC's ten-member board of directors. The TSC board, with the National nominees abstaining, subsequently adopted a plan for TSC to liquidate and sell all of its assets to National in exchange for National securities, which were to be distributed to TSC shareholders. In order to secure approval of the plan by the shareholders of each corporation, TSC and National issued a joint proxy statement recommending approval of the plan and soliciting proxies to that effect. Claiming that the omission of certain facts which were relevant to the degree of National's influence over TSC's management and which had

1. TSC Indus., Inc. v. Northway, Inc., 96 S. Ct. 2126, 2129 (1976). National had acquired this interest by purchasing a block of stock owned by Charles Schmidt, the principal shareholder, founder, and director of TSC. Id. After the sale of the Schmidt family holdings, Schmidt and his son resigned from TSC's board of directors. Id. The plaintiff's complaint alleged that Schmidt and certain members of his family had violated SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), by transferring control of TSC in such a way as to aid and abet National in acquiring the remainder ownership of TSC for a fraudulently low consideration. Northway, Inc. v. TSC Indus., Inc., 361 F. Supp. 108, 118 (N.D. Ill. 1973). The district court, finding that the plaintiff was able to adduce no evidence in support of its allegations, granted the Schmidts' motion for summary judgment. Id. This disposition was affirmed on appeal. Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324 (7th Cir. 1975).

2. 96 S. Ct. at 2129. National's president and chief executive officer became chairman of the TSC board, and National's executive vice president became chairman of the TSC executive committee. Id.

3. Id. The plan provided for an exchange ratio whereby a holder of TSC common stock would exchange each such share for one-half of a share of National series B preferred stock, and one-and-one-half National warrants. Id. at 2129 n.1. Each share of TSC preferred stock could be exchanged for six-tenths of a share of National series B preferred and one National warrant. A National warrant entitled the holder to purchase one share of National common stock at a fixed price. National series B preferred stock was convertible into three-quarters of a share of National common. Id.

4. Id. at 2129. In their answer, the defendants admitted that proxy solicitation was an essential step in the accomplishment of the proposed sale and liquidation. Northway, Inc. v. TSC Indus., Inc., 361 F. Supp. 108, 112 (N.D. Ill. 1973). For a discussion of the legal implications of this admission, see note 21 and accompanying text infra.

5. The proxy statement disclosed the extent of National's stock position in TSC and revealed that five of the ten TSC board members were also directors of National. 96 S. Ct. at 2134. However, the statement failed to reveal that National's chief executive officer was also the chairman of TSC's board of directors and that National's executive vice president became the chairman of TSC's executive committee. Id. The proxy statement also failed to disclose that in prior reports filed with the SEC, both TSC and National had stated that there existed a possibility that National might be deemed to "control" TSC under SEC Rule 12b, 17 C.F.R. §§ 240.12b-2(a), (f), (k) (1976). 96 S. Ct. at 2134.

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a bearing upon the favorability of the proposed exchange to TSC shareholders\(^6\) rendered the joint proxy statement materially misleading. Northway, Inc., one of TSC's shareholders, filed a complaint\(^7\) in the United States District Court for the Northern District of Illinois alleging that National and TSC had thereby violated section 14(a) of the Securities Act of 1934 (Exchange Act)\(^8\) and SEC Rule 14a-9\(^9\) promulgated there-

6. The joint proxy statement revealed that an investment banking firm had rendered a favorable opinion on the fairness to TSC shareholders of the exchange of TSC stock for National securities. 96 S. Ct. at 2135. The proxy statement represented that this opinion was based in part upon "the substantial premium over current market values represented by the securities being offered to TSC shareholders . . . ." Id. at 2135–36. By reference to a table of current market values which appeared four pages later in the proxy statement, a TSC shareholder could compute the apparent increase in the market value of his shareholdings which would result from the contemplated exchange of securities. Id. at 2136. Such a computation indicated that the proposed exchange would yield a 21.2% premium to TSC shareholders. Id. However, the proxy statement failed to reveal that the investment banking firm's opinion was based not strictly upon the figures presented in the proxy statement, but rather upon the conclusion that as a result of the issuance of additional warrants in the transaction, the value of the stock would be diluted and decline substantially from the current market price of $5.25, which was set out in the proxy statement, to a predicted value of $3.50. Id. When calculated using the latter value, the actual market premium to be received by TSC shareholders in the transaction was far less than that which was apparent on the basis of the information presented in the proxy statement. Id.

Moreover, the proxy statement failed to reveal that National and a mutual fund, Madison Fund, Inc., had made purchases of National securities accounting for 8.5% of all recorded transactions in National common stock during the interim between National's acquisition of the Schmidt interests and the issuance of the joint proxy statement. Id. at 2138–39. The plaintiff contended that non-disclosure of these facts, together with a failure to reveal that National's board chairman was also a director of Madison and that Madison's president and chief executive was a salaried consultant to National, prevented it from discovering an alleged manipulation by National and Madison of the prices of National stock for the purpose of decreasing the value of the proposed exchange to TSC shareholders. Id.

7. The complaint was filed the day before the shareholder meeting which was called to consider the proposed liquidation and sale of assets. Id. at 2130. While requesting injunctive relief, plaintiff failed to move for a temporary restraining order. Id. Upon the implementation of the plan, plaintiff amended its complaint to seek monetary damages, restitution, and other equitable relief. Id. at 2130.

8. 15 U.S.C. § 78n(a) (1970). Section 14(a) provides in pertinent part: "It shall be unlawful for any person . . . 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, to solicit or permit the use of his name to solicit any proxy . . . ." Id.

Section 14(a) of the Exchange Act was enacted by Congress in the belief that "[i]t air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934). Its basic purpose was to provide stockholders with sufficient information to ensure their informed choice when consulted for approval of corporate transactions. J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964).

9. 17 C.F.R. § 240.14a-9 (1976). The Securities and Exchange Commission (SEC) promulgated rule 14a-9 pursuant to the broad mandate of section 14(a). For the text of section 14(a), see note 8 supra. Rule 14a-9 provides in pertinent part:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the cir-
under. The district court, holding that the evidence presented a genuine issue of fact as to whether the facts omitted from the joint proxy state-

...cumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading...

17 C.F.R. § 240.14a-9 (1976). In addition, the SEC enacted other rules mandating specific disclosures in proxy statements which were required to be filed with the Commission and distributed to shareholders. See 17 C.F.R. §§ 240.14a-3 to 14a-8, 14a-11, 14a-101 (1976).

10. 96 S. Ct. at 2129. The plaintiff also brought a claim under SEC Rule 14a-3, 17 C.F.R. § 240.14a-3 (1976). 96 S. Ct. at 2129. The substance of that claim was that National had obtained control of TSC, as defined by the SEC rules, and had failed to disclose this fact in the joint proxy statement. 96 S. Ct. at 2129; see SEC Rule 12b-2(f), 17 C.F.R. § 240.2(f) (1976). Rule 14a-3 prohibits the solicitation of proxies unless each person solicited is furnished with a proxy statement containing the information specified in Schedule 14A. 17 C.F.R. § 240.14a-3 (1976). Item 5(e) of Schedule 14A requires that a change in control of the corporation be disclosed. See 17 C.F.R. § 240.14a-101, Item 5(e) (1976). Hence, if National "controlled" TSC, its failure to disclose this fact would violate the proxy rules per se. The district court denied summary judgment on the basis that the evidence concerning whether National actually controlled TSC was conflicting. 361 F. Supp. at 111. This ruling was upheld on appeal. 512 F.2d at 329. The Supreme Court did not reach this issue.

Most shareholder attacks upon corporate reorganizations are confined to actions brought under rule 14a and allege deception in the proxy materials by which approval of the proposed transaction is obtained. 2 A. BRONDBERG, SECURITIES LAW § 6.5 (1975). However, the substantive protection against unfairness in corporate reorganizations afforded to the investing public by the federal securities laws is not limited to the proxy rules.

An alternative mode of regulating deceptive proxy solicitations is through the use of SEC Rule 10b-5; 17 C.F.R. § 240.10b-5 (1976), which makes it unlawful to use any fraudulent, deceptive, or manipulative device, act, or practice in connection with the purchase or sale of a security. Id. It has been held, for purposes of the rule, that securities issued or surrendered in a merger or other reorganization are "purchased and sold" by the shareholders of the acquired corporation and that a shareholder aggrieved by fraudulent practices occurring "in connection with" such reorganization may be awarded relief under the provisions of that rule. Dashe v. Susquehanna Corp., 380 F.2d 262, 266–67 (7th Cir.), cert. denied, 389 U.S. 977 (1967); H.L. Green Co. v. Childree, 185 F. Supp. 95, 96 (D.D.N.Y. 1960); cf. Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967). Although the impact of this judicial concept will be minimal where the proxy rules are capable of providing adequate protection to minority shareholders, the potential applicability of rule 10b-5 to corporate reorganizations will be extremely important where the proxy rules do not apply. A. BRONDBERG, supra at 133–38 nn.92 & 93.

Another dramatic development in the area of federal regulation of corporate reorganizations is the SEC's promulgation of rule 145, 17 C.F.R. § 230.145 (1976). Effective January 1, 1973, rule 145 rescinded rule 133, 17 C.F.R. § 230.133 (1976). See 37 Fed. Reg. 23636 (1972). Rule 145 essentially provides that where a reorganization plan includes a proposal for an exchange of securities (e.g., a statutory merger, stock for assets with a distribution to shareholders) and the applicable state law requires it to be submitted to a vote of a corporation's shareholders, the provisions of the Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (1970) (Securities Act), are applicable to the transaction. See 17 C.F.R. § 230.145 (1976). Under the rule, a reorganization proposal is deemed to be an offering of securities within section 2 of the Securities Act. Id. Section 5 of the Securities Act would therefore apply to require that the reorganization proposal be registered with the SEC and that written offers (e.g., the proxy statement itself) be made by a prospectus that meets the requirements of section 10 of the Securities Act. See 15 U.S.C. §§ 77e, 77j (1970). Failure to comply with these requirements would result in liability under section 12(1) of the Act, and any false or misleading statements made in the registration statement, prospectus,
ment were material,12 denied plaintiff's motion for summary judgment on the issue of liability. On appeal,13 the United States Court of Appeals for the Seventh Circuit disagreed and ruled that the TSC-National proxy statement was materially misleading as a matter of law.14 However, the United States Supreme Court, finding that the court of appeals had applied an improper standard of materiality, reversed, holding that an omitted or misstated fact is material within the purview of the federal proxy rules only "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."15 TSC Industries, Inc. v. Northway, Inc., 96 S. Ct. 2126 (1976).

The problem of defining "materiality" for the purpose of federal securities regulation16 was first treated by the Supreme Court in Mills v.

or proxy statement would result in liability under section 11 or section 12(2) of the Securities Act, which provides procedural advantages to the plaintiff as compared to actions brought under section 14a of the Exchange Act. See 15 U.S.C. §§ 77k, 77l (1970).

11. Rule 56(c) of the Federal Rules of Civil Procedure requires that there be no genuine issue as to any material fact before a summary judgment may be entered. See Fed. R. Civ. P. 56(c).

12. 361 F. Supp. at 114, 116. It is not clear what standard of materiality the court applied in reaching this conclusion. At one point the court observed: "To establish a violation [of rule 14a–9, the] plaintiff must prove . . . that the misstatement or omission were material in the sense that they 'might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.'" Id. at 111, 112, quoting Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970). In denying the plaintiff's motion for summary judgment, however, it is evident that the court relied upon a more stringent test of materiality:

While the court believes that [the omissions] might have been considered important by TSC shareholders, it cannot conclude that these facts were so obviously important that reasonable minds could not differ on the issue; that is, as to whether they would have a significant propensity to affect the voting process. Id. at 114.

13. The appeal was interlocutory in nature and was taken by leave of the court pursuant to 28 U.S.C. § 1292(b) (1970). 96 S. Ct. at 2130.

14. 512 F.2d at 333, 335–36. The legal standard of materiality employed by the court was that an omitted fact is material if a "reasonable stockholder might consider [it] important." Id. at 330.

15. 96 S. Ct. at 2133. When the Court applied this standard to the uncontested facts of the case, it found that the established omissions were not "so obviously important to an investor, that reasonable minds cannot differ on the question of materiality," and that summary judgment was therefore inappropriate. Id. at 2133, 2140, quoting Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974).

Electric Auto-Lite Co.,\textsuperscript{17} where the Court attempted to explicate the elements of a section 14(a) private damage action.\textsuperscript{18} The crucial issue in \textit{Mills} was whether the grantor of a proxy is required to prove, as a substantive condition precedent to recovery under section 14(a), that an omission of fact from a proxy solicitation actually had a decisive effect upon shareholder voting.\textsuperscript{19} A unanimous Supreme Court rejected the imposition of this requirement of causation in fact as being contrary to the remedial purposes of the statute\textsuperscript{20} and held that a causal relationship between the proxy violation and the plaintiff's alleged injury sufficient to warrant private relief is established by proof that: 1) the misstatement or omission was material, and 2) that the proxy solicitation itself was "an essential link in the accomplishment of the transaction."\textsuperscript{21} Although the \textit{Mills} materiality is tantamount to a designation of the scope of disclosure which is required in order to comply with the mandate of the securities laws.

18. \textit{Id.} at 381-86. In J.I. Case Co. v. Borak, 377 U.S. 426 (1964), a unanimous Supreme Court found that a private cause of action was available under section 27 of the Exchange Act, 15 U.S.C. § 78aa (1970), to those shareholders who had been injured as the result of a violation of the SEC's proxy rules. 377 U.S. at 430-31. However, the Court did not pass on the substantive elements of such a cause of action.
19. In \textit{Mills}, the shareholders claimed that a merger had been approved by them on the basis of materially false and misleading statements in proxy materials and asserted a claim for damages based upon rule 14a-9. 396 U.S. at 378. The Seventh Circuit, holding that causation was a necessary element of a private action for damages under section 14(a), reversed the district court's adjudicaiton of relief. \textit{Id.} at 380. Noting that a requirement of proof of reliance by thousands of shareholders would be a very difficult burden to impose upon a plaintiff--shareholder, the court of appeals held that if the transaction was unfair, causation would be presumed. \textit{Id.} Even though the court of appeals agreed with the district court's determination that defendants had in fact violated rule 14a-9, the court held that since the transaction was fair, the plaintiffs had not established a causal relationship between approval of the proposed merger by a requisite number of shareholders and the violation of rule 14a-9. \textit{Id.}
20. The Court noted that reliance, especially reliance upon a nondisclosure, by thousands of shareholders would be extremely difficult to demonstrate. \textit{Id.} at 382 n.5. Imposition of a requirement of such difficult proofs would make enforcement of section 14(a) by a private damage action exceedingly burdensome, even where a violation of the statute is clear, and would thus thwart the purpose of the Exchange Act by effectively denying a remedy for its violation. \textit{Id.} at 382 n.5, 385.

Moreover, where a material nondisclosure is proved, the Seventh Circuit's presumption that the shareholders have relied upon misleading statements (\textit{see note 19 supra}) would allow a court to exercise its judgment as to the advisability of a transaction. 396 U.S. at 381-82. This result is wholly inconsistent with the Exchange Act's policy of allowing such judgments to be made by the shareholders. \textit{Id.} at 382. Thus, it was thought that the presumption adopted by the Seventh Circuit would be inimical to the rights which section 14(a) affords to shareholders. \textit{Id.} at 381-82, 384-85.
21. 396 U.S. at 385. This two-pronged test was responsive to the traditional requirements of causation in a common law action sounding in deceit. Had the \textit{Mills} Court treated a private damage action under rule 14a-9 as an action at common law to recover damages for fraud, two elements would have to be shown in order to demonstrate a causal link between a violation of rule 14a-9 and the alleged injury to the shareholders. The first of these elements would be reliance upon the misrepresentation or nondisclosure by the individual shareholders. \textit{Id.} at 380. The \textit{Mills} Court acknowledged that reliance was an element of a common law action in deceit, but seemed to interpret the concept of reliance to require that the injured party would not have
Court expressly declined to pass on the materiality of the omission from the Auto-Lite proxy statement, it indicated that the scope of disclosure required by the concept of materiality encompasses all information which \textit{might} [be] considered important by a reasonable shareholder. The Court referred to this as a \textquote{requirement that the [nondisclosed information] have a significant propensity to affect the voting process.}

taken the action which damaged him \"but for\" the defrauding party's misrepresentation. \textit{Id.} at 380 (\textit{semble}). It should be noted, however, that this is not the common law test of reliance. The common law required only that the misrepresentation exert a \textquote{material influence} upon the defrauded party or play a \textquote{substantial part} in his decision. \textsc{W. Prosser, Handbook of the Law of Torts} 715 (4th ed. 1971); \textsc{Restatement of Torts} § 546 (1938). When, as evidenced by the first prong, the \textit{Mills} Court allowed materiality to stand alone as sufficient proof of causation, it in effect created a presumption that the shareholders had \textquote{relied} in the common law sense of that term. For a discussion of the legal effect of such a presumption, see \textsc{Note, Causation and Liability in Private Actions for Proxy Violations}, 80 \textsc{Yale L.J.} 107, 135–38 (1970–71).

The second common law element of causation would require that a sufficient number of shareholders have relied so as to have potentially affected the consummation of the transaction. 396 U.S. at 385. The Court's \textquote{essential link} prong creates a presumption of this fact as well. For a discussion of this issue, see \textsc{Note, supra} at 107–34; 21 \textsc{Case W. Res. L. Rev.} 787 (1969–70).

22. 396 U.S. at 381 n.4.

23. \textit{Id.} at 384 (dictum) (emphasis added). Among the cases cited by the \textit{Mills} Court as lending some support to its use of this particular language were \textit{List v. Fashion Park, Inc.}, 340 F.2d 457 (2d Cir.), \textit{cert. denied}, 382 U.S. 811 (1965), and \textit{General Time Corp. v. Talley Indus., Inc.}, 493 F.2d 159 (2d Cir. 1968), \textit{cert. denied}, 393 U.S. 1026 (1969). In \textit{List}, the Second Circuit held that both materiality and reliance were necessary prerequisites to recovery under rule 10b–5. The court's definition of materiality, however, was somewhat ambiguous. At one point the \textit{List} court indicated that a fact is material if a reasonable investor \textquote{would} attach importance to it. 340 F.2d at 462. Shortly thereafter, the court held that a fact is material if its disclosure \textit{might} affect the value of a corporation's stock. \textit{Id.}, citing \textit{Kohler v. Kohler Co.}, 319 F.2d 634, 642 (7th Cir. 1963).

In \textit{General Time}, however, a case involving section 14(a), the same court held that a fact is material if "there is a substantial likelihood that a misstatement or omission may have led a stockholder to grant a proxy to the solicitor or withhold one . . . whereas in the absence of this he would have taken a contrary course." 403 F.2d at 102.

The \textit{Mills} Court also cited the \textit{Second Restatement of Torts}, which states that a fact is material if \"[i]t is one whose existence or non-existence a reasonable man would attach importance to in determining his choice of action in the transaction in question . . .\" \textsc{Restatement (Second) of Torts} § 538(2)(a) (Tent. Draft No. 10, 1964).

Because of the various standards adopted by the cited authorities, it is highly questionable whether the \"might\" language employed by the \textit{Mills} Court represented an accurate articulation of its thinking.

24. 396 U.S. at 384 (dictum) (emphasis supplied by the Court). The Court noted that this materiality requirement was found in the express terms of rule 14a–9 and held that the requirement adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

\textit{Id.}

In a subsequent rule 10b–5 case, the Supreme Court held that proof of reliance with regard to a nondisclosure was not necessary where the defendant had violated a positive duty of disclosure to the plaintiff, \textit{provided} the undisclosed fact
Prior to the *Mills* decision, essentially two judicial standards of materiality were applied in securities fraud cases. One such test held that a fact was material if it *would* have been considered to be important by a reasonable investor. The other viewpoint, formulated in *General Time Corp. v. Talley Industries, Inc.*, sought to measure materiality by inquiring as to whether there existed a substantial likelihood that disclosure of a fact would cause an investor to pursue a course of action contrary to that which he would have chosen absent disclosure. The *Mills* dicta fostered the development of a third judicial definition of materiality which viewed as material a fact which *might* be important to a reasonable investor. However, *Mills* did not abrogate the application of the other two tests, and all three formulations of materiality continued to be applied by the courts with relative indifference to the crucial distinctions between them until

was material. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972). The Court stated that undisclosed facts were material "in the sense that a reasonable investor *might* have considered them important in the making of [his] decision." *Id.* (emphasis added). However, the Court did not repeat the "significant propensity" language found in *Mills*.


This test of materiality is identical to that employed at common law. *Restatement* (Second) of *Torts* § 538(2)(a) (Tent. Draft No. 10, 1964). In addition, it is the test adopted in the ALI *Fed. Sec. Corp.* § 256(a) (Tent. Draft No. 2, 1973).


28. For cases applying this standard, see note 30 infra.

29. Since the *Mills* "might standard" of materiality was mere dicta (see notes 22-24 and accompanying text *supra*), subsequent courts were not bound by it. Moreover, the "significant propensity" language employed by the Court in connection with its citation to authority supporting the "would" and *General Time* standards of materiality lent clear support to the proposition that these were still viable standards of materiality. *See* notes 23 & 24 and accompanying text *supra*.

30. For examples of cases employing varying standards of materiality, see *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 373-75 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (fact material under section 14(e) if it would be important to reasonable investor); Kaufmann v. Lawrence, 386 F. Supp. 12, 15 (S.D.N.Y. 1974) (fact material under section 14(e) and rule 10b-5 if it would be important); Sonesta Int'l Hotels Corp. v. Wellington Assocs., 483 F.2d 247, 251 (2d Cir. 1973) (fact material under section 14(e) if it might be important); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 269 (3d Cir. 1972), *cert. denied*, 409 U.S. 874 (1973) (fact material under rule 10b-5 if it might be important); Scott v. Multi-Amp Corp., 386 F. Supp. 44, 66 (D.N.J. 1974) (fact material under rule 14a-9 if it might well be considered important); Ross v. Longchamps, 336 F. Supp. 434, 441 (E.D. Mo. 1971) (fact material under rule 14a-9 if it might be considered important); Beatty v. Bright, 318 F. Supp. 169, 173 (S.D. Iowa 1970) (fact material under section 14(a) if it might be considered important); Colonial Realty Corp. v. Baldwin-Montrose
the Second Circuit's consideration of the issue in *Gersle v. Gamble-Skogmo, Inc.*31

In *Gersle*, which involved an alleged violation of rule 14a-9,32 the court held that the "would" test was the only correct standard for defining "materiality."33 In so doing, the Second Circuit explicitly rejected the "might" standard as being "unrealistic" in that it set too low a threshold for the imposition of a duty of disclosure.34 However, the Second Circuit's unambiguous definition of materiality was not followed by the Seventh Circuit in the instant case. The court of appeals in *TSC Industries* specifically rejected the "would" test in holding that any test of materiality which does not require inclusion of facts in a proxy statement which might influence a reasonable shareholder would seriously undermine the prophy-

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31. 478 F.2d 1281 (2d Cir. 1973).

32. In *Gersle* it was claimed that the defendants had employed misleading proxy statements to solicit proxies authorizing approval of a merger. The nature of the alleged deception was that the acquiring corporation had misrepresented its business plans concerning the disposition of the assets of the acquired corporation. *Id.* at 1284-89.

33. *Id.* at 1302. In addition to the court's adoption of the "would" standard, it seemingly approved the application of the *General Time* standard. See *id.* However, when the court examined the facts of the case to determine whether the misstatements were material, it applied the "would" standard exclusively. See *id.* at 1302-03.

Before the court even reached the materiality issue, it held that negligence was sufficient to impose liability under rule 14a-9. *Id.* at 1298-1301. The court reasoned that a proxy statement served much the same function as a registration statement under the Securities Act. *Id.* at 1300. Following this analogy, the court observed that the imposition of a broad standard of culpability for violation of the proxy rules would serve the salutary purpose of reiterating the high degree of care owed by management to its shareholders in the preparation of proxy solicitations. *Id.* Moreover, the court found that the imposition of liability based upon negligence would be consistent with the purpose and language of section 14(a) itself and with the structure of the securities laws as a whole. *Id.* at 1299; accord, *Richland v. Crandall, 262 F. Supp. 538, 553 n.12 (S.D.N.Y. 1967)*; see *Kohn v. American Metal Climax, Inc., 458 F.2d 255, 289 (3d Cir. 1972) (Adams, J., concurring and dissenting). But cf. *Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375, 1377 (1976)* (scienter required to impose civil liability under rule 10b-5).

For a discussion of the view that the definition of materiality should be tied to the level of culpability required for finding a violation of a securities regulation as a means of limiting liability, see *Kirkland, Misleading Proxy Statements, 31 Bus. Law. 1449 (1976).*

34. 478 F.2d at 1302. Judge Friendly, writing for the court, suggested that the difference between the "would" and "might" standards may be "gossamer." However, he went on to note that the latter standard was "too suggestive of a mere possibility" to be employed in levying the very heavy damages which may be involved in a rule 14a-9 action. *Id.* This would be especially true where the issue is being tried to a jury. *Id.* at 1302 n.22.

One year after the *Gersle* decision, the Fifth Circuit, in sustaining the propriety of a jury instruction which had mandated application of the common law "would" standard, eschewed application of a "might" standard of materiality as too speculative to serve as a reliable guide in fixing liability under section 14(a). *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 603-04 (5th Cir.), *cert. denied, 419 U.S. 873 (1974).*
The Supreme Court granted certiorari in the instant case in order to resolve this apparent conflict between the circuit courts of appeals. Writing for a unanimous Court, Justice Marshall rejected the Seventh Circuit's reading of Mills in favor of the Gerstle line of analysis which views the "significant propensity" language of Mills and not its "might affect" dictum as suggesting the appropriate definition of materiality. Moreover, even the "significant propensity" language was not considered to be controlling in the instant case. Since the Mills Court had specifically declined to rule on the question of whether the omitted facts there were material, the "significant propensity" language was presented only by way of dicta to give "some sense of the notion" of materiality prior to the Court's consideration of the causation issue. Thus, the TSC Industries Court felt unconstrained by Mills' articulation of materiality and held that a definition of the term "material" could be considered de novo.

Having rejected Mills as controlling precedent, the Court defined its task in formulating a standard of materiality under rule 14a-9 as determining "how certain it must be that the [omitted or misrepresented] fact would affect a reasonable investor's judgment." In making this determination, the Court initially reaffirmed its prior construction of section 14(a) as remedial legislation designed by Congress to ensure disclosure by management in order to afford shareholders an adequate opportunity to make an informed choice when consulted for approval of a corporate transaction.

35. Northway, Inc. v. TSC Indus., Inc., 512 F.2d 324, 330-32 (7th Cir. 1975). The Seventh Circuit viewed the difference between "would" and "might" as a distinction between an objective test of probable reliance and a test which assessed the materiality of a fact in terms of its relevance to the proposed transaction. Id. at 331 n.13. The court then observed that the application of a probable reliance ("would") standard would undercut the spirit of Mills:

It would make little sense to hold that causation is established by a more lenient standard than materiality. In fact any test of materiality which requires a finding of some probability that the omitted fact would affect the voting process necessitates the same difficult proofs the Supreme Court sought to avoid by eliminating the need for independent proof of causation or reliance. Id. at 331. Having eliminated probable reliance as a mode of defining materiality, the court's "might" test of materiality was phrased in terms of relevance: "We believe that relevancy alone is the critical test of materiality and that when relevant facts are withheld from a proxy solicitation, materiality is established independent of any proofs of probable reliance or causation." Id. at n.13.

36. 96 S. Ct. at 2130.

37. Id. at 2132; accord, Smallwood v. Pearl Brewing Co., 489 F.2d 579, 604 (5th Cir.), cert. denied, 419 U.S. 873 (1974); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973) (significant propensity language "closer to the right flavor" of proper test).


39. Id.

40. Id. at 2131.

41. 96 S. Ct. at 2132. The Court then elaborated upon the relationship between this congressional policy and a section 14(a) private damage action. Apparently re-stating its Mills position, the Court observed that in a private suit for damages
The Court stressed, however, that this policy does not compel unlimited dissemination of information to security holders; rather, the intention of the proxy regulations themselves imposes an inherent limitation upon the scope of the disclosure. 42 Specifically, the Court warned that overdisclosure of information in proxy statements may create a serious impediment to informed decisionmaking by causing the shareholder to become inundated with information of arguable significance. 43 The Court perceived that, in view of the fact that enormous liability may attach for violations of rule 14a-9, a standard of materiality which was too low would encourage management to engage in gross overdisclosure with its attendant confusion and resulting incursion into the shareholders’ right of informed corporate suffrage. 44 Reasoning that the Seventh Circuit’s “might” standard of materiality was so low that it presented these dangers, the Supreme Court rejected the “might” formulation, holding that the interest in protecting investors would best be served by a standard of materiality that requires disclosure of a fact only “if there is a substantial likelihood that a reasonable shareholder would consider it important to deciding how to vote.” 45

Justice Marshall, however, hastened to point out that this standard does not require a showing that the disclosure of a fact would have “caused” a shareholder to change his vote; rather, the Court's test of materiality was held to require only a showing that “the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” 46 Applying its newly

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42. Id. at 2132-33.
43. Id.
45. 96 S. Ct. at 2133.
46. Id. The TSC Industries Court’s caveat appears to be merely an elaboration upon an observation which was made in Mills. In Mills, the Supreme Court had emphasized that section 14(a) guarantees to shareholders the right to all material information relevant to their decision. 396 U.S. at 384. Failure to supply this information is itself an actionable wrong. Hence, the nature of the information which was not disclosed need not have been such as would have affected the shareholder’s decision in the sense that its disclosure would have caused him to change his vote; rather, the purpose of the section is thwarted, and liability may be imposed, where that informa-
created test to the facts in the instant case, the Court concluded that the grant of a summary judgment was inappropriate, since the omissions were not "so obviously important to an investor, that reasonable minds cannot differ on the question of materiality."\textsuperscript{47}

The critical problem faced by the \textit{TSC Industries} Court was how to formulate an acceptable standard of materiality in a way which would not emasculate the thrust of its holding in \textit{Mills}.\textsuperscript{48} The \textit{ratio decidendi} of \textit{Mills} was that a determination of the actual effect of a misstatement on the behavior of shareholders, particularly with reference to an undisclosed fact, could not be made with any degree of certainty.\textsuperscript{49} In view of this difficulty, a requirement that the plaintiff prove actual causation\textsuperscript{50} would completely...

\textsuperscript{47} 96 S. Ct. at 2133, 2140, \textit{quoting} Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970).

\textsuperscript{48} While it may be difficult to obtain summary judgment where materiality is in issue, the Court made it clear that there might be some cases — for example, where the undisclosed facts were "obviously suggestive of control" — in which the omission would be deemed to be material as a matter of law, thus making such a disposition appropriate. 96 S. Ct. at 2135 n.15. Moreover, the Court reemphasized the power of the SEC to promulgate rules requiring disclosure of specified information. \textit{Id.} at 2140. Failure to make such required disclosure would per se result in liability for violation of section 14(a) regardless of the "materiality" or "nonmateriality" of the fact omitted. \textit{Id.} For an example of the specific disclosures which the SEC requires in proxy statements, see SEC Schedule 14A, 17 C.F.R. \textsection 240.14a-101 (1976).

\textsuperscript{49} This problem is quite different from that of whether the \textit{Mills} "might be important" dictum was, of its own force, controlling on the issue of materiality. The Court quite properly concluded that this language had no such effect. \textit{See} 96 S. Ct. at 2132. This conclusion is supported by the fact that the \textit{Mills} "definition" of materiality was dictum, and that it did not represent a clear articulation of the Court's perception of materiality at that time, but was employed merely to provide a "sense" of the notion. \textit{See} notes 29 & 38 and accompanying text \textit{supra}.

\textsuperscript{50} \textit{See} 96 S. Ct. at 2132.

The Court's holding with respect to causation had a dual aspect. The shareholder did not have to prove that "but for" the nondisclosure, he would have voted differently. Moreover, he did not have to prove actual reliance in the classic sense that the misrepresented fact actually formed a substantial, but not necessarily controlling, part in his decision. Proof of materiality would create a presumption of such reliance and allow the shareholder to recover. For a discussion of this aspect of \textit{Mills}, \textit{see} note 21 and the accompanying text \textit{supra}.
thwart the remedial purpose of the securities laws either by precluding the availability of relief entirely or by allowing the retrospective judgment of the factfinder as to the merits of the proposed transaction to be substituted for the informed prospective judgment of the shareholders themselves.\textsuperscript{51}

Analysis of the range of choices available to a court in formulating a standard of materiality demonstrates how the essence of Mills can be subtly undercut by the adoption of one standard over another. At one end of the materiality continuum, a number of courts have defined materiality as nothing less than a requirement that the nature of a fact be such that its disclosure would have caused a reasonable shareholder to take a contrary course of action.\textsuperscript{52} Such a standard completely destroys the vitality of the Mills decision. The test would require proof that a misstatement or omission was of such a nature that it would have a decisive effect upon the voting and would allow the substitution of the factfinder's judgment as to the advisability of a proposed corporate action for that of the shareholders — results which Mills determined were noxious to the remedial purpose of section 14(a).\textsuperscript{53} Hence, the instant Court's implicit rejection of the objective causation-in-fact test of materiality\textsuperscript{54} is consistent both with its prior rulings and with the purpose of the proxy rules.

At the other end of the materiality spectrum, the "might be considered important" standard adopted by the Seventh Circuit\textsuperscript{55} represents a determination that any fact which is logically relevant to a shareholder's decision on a proposed transaction is material.\textsuperscript{56} Such a test comes into minimum conflict with the policy embodied by Mills, for it is entirely objective and requires no prediction as to the probable effect of disclosure upon a shareholder, reasonable or otherwise. However, as adequately pointed out in

\textsuperscript{51} Worthy of reiteration at this point is the fact that Mills expressed particular concern for allowing the shareholders to make their own decisions based upon all material facts. See 396 U.S. at 381. When shareholders have been denied this right, the policy of section 14(a) demands that an effective remedy be available. The Court held that such redress should not be denied them on the basis of a judge's decision as to the wisdom of the transaction. 396 U.S. at 381; see note 21 and accompanying text supra.

\textsuperscript{52} See note 27 and accompanying text supra.

\textsuperscript{53} The sheer impropriety of this standard as a test for materiality was manifest in Mills. There the Court noted that a nondisclosure which effectively thwarted "the informed decision at which the statute aims" is actionable "regardless of whether the [facts] were such that a reasonable stockholder would have approved the transaction after more careful analysis." 396 U.S. at 384 n.6.

\textsuperscript{54} The Court's rejection of this test was clearest when it pointed out that its new standard "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote." 96 S. Ct. at 2133.

\textsuperscript{55} See note 35 and accompanying text supra.

\textsuperscript{56} Id. Conceivably, the "might be important" test could represent something more than the relevance of a fact to a proposed transaction. However, when the word "might" is perceived by the person applying the test as suggesting a degree of probability higher than logical relevance, the reality to that person of the distinction between "might" and "would" becomes questionable. Hence, for the sake of clarity, this discussion will assume, as did the Seventh Circuit, that a test couched in terms of "might" is tantamount to a standard based upon relevance. Id.
Justice Marshall's opinion, such a low threshold of materiality has the fatal disadvantage of requiring the dissemination of so much information that it would destroy the utility of the federal proxy rules.57

A more acceptable middle ground in reconciling the conflict between the policy of Mills and the equally weighty policy of providing management with some sense of certainty in communicating information to its shareholders is represented by the Gerstle "would" standard.58 This standard comports with Mills by focusing attention upon the qualitative significance of the information itself rather than by requiring the factfinder to usurp the judgment of the shareholders by assessing the impact of a factual disclosure upon behavior. Yet it, too, has a tendency to weaken the underpinnings of Mills. Mills declared that the assessment of the operative significance of information was within the province of the shareholders in the first instance.59 The "would" test, which requires the factfinder to determine with certainty the actual significance of a given fact, invades this province to some extent.60 However, in order to avoid this incursion entirely, the Court would be relegated to employing a test of materiality based solely upon relevance with its attendant problems of overdisclosure.61

While Justice Marshall's opinion in TSC Industries suggested that, of the three judicial approaches to materiality, the Gerstle outlook is in greatest harmony with the policy against overdisclosure,62 he impliedly recognized the tendency of a "would" standard to detract from the practical results which Mills intended;63 his attempt to reconcile these competing considerations is a tour de force of judicial finesse. It should be noted that the standard adopted by Marshall requires only that there be a substantial likelihood that a reasonable shareholder would consider a fact significant.64 By not requiring complete certainty as to whether a reasonable shareholder would consider a particular fact important, the opinion

57. For a discussion of the fact that overdisclosure of information is more detrimental than helpful to shareholders and can itself result in liability for violation of rule 14a-9, see note 44 and accompanying text supra.
58. For a discussion of Gerstle, see notes 32-34 and accompanying text supra.
59. 396 U.S. at 381.
60. The implication of the "would" test is that a plaintiff will be denied recovery even if he proves that it is likely, but not beyond doubt, that a nondisclosed fact would influence a reasonable investor. Such a result is inconsistent with the declared policy under section 14(a) of "resolving doubts in favor of those the statute [was] designed to protect." Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970).
61. For a discussion of the problems which the "might" test has engendered with respect to overdisclosure, see notes 43-45 and accompanying text supra.
62. 96 S. Ct. at 2133.
63. This implicit recognition is found in the fact that the Court did not adopt the longstanding "would" standard verbatim, but rather modified it. See note 45 and accompanying text supra.
64. 96 S. Ct. at 2133. It is interesting to note that one year prior to the Supreme Court's adoption of this standard, a federal district court had employed identical language in defining materiality for the purposes of an action brought under rule 14a-9. See Mayer v. Development Corp., 396 F. Supp. 917, 927 (D. Del. 1975). The TSC Industries opinion did not cite this decision.
allows the shareholders' interest in relevant information some leeway where doubt exists as to the importance of a fact.\textsuperscript{66} Thus, by combining the "substantial likelihood" language with the traditional "would be important" language, Marshall's formulation requires that the shareholders be provided with as great an amount of information as is consistent with the policy against overdisclosure.

The Court's consideration of a proper definition of materiality was confined solely to assessing "how certain it must be that [a] fact would affect a reasonable investor's judgment."\textsuperscript{66} Looking beyond the Supreme Court's resolution of this narrow issue, it must be asked whether a "reasonable person" approach to materiality is adequate to serve the Court's professed purpose of defining materiality in such a way as to afford corporate management some degree of certainty regarding what information can be withheld from investors without incurring liability.\textsuperscript{67} Since there is no empirical method of singling out a "reasonable investor" and predicting how he would have acted,\textsuperscript{68} the factfinder necessarily possesses wide discretion in making a determination of materiality where the issue is formulated solely in terms of a "reasonable person" standard.\textsuperscript{69} Under such a standard, management must likewise determine the materiality of a particular fact on the basis of its visceral reactions as to its importance and can only hope that its viewpoint will correspond to the equally discretionary reaction of the judge or jury.\textsuperscript{70} Such a result is hardly consistent with the Supreme Court's theoretical conception of materiality as providing a sufficiently ascertainable standard of disclosure. Thus, viewed by itself, the \textit{TSC Industries} reason-

\textsuperscript{65} See note 60 supra.
\textsuperscript{66} 96 S. Ct. at 2131 (emphasis added).
\textsuperscript{67} See id. at 2132-33. At common law, the professed purpose of the materiality requirement in deceit actions was that of "promoting stability in commercial transactions." W. PROSSER, supra note 21, at 719. Still, it can earnestly be questioned whether the common law "reasonable person" standard effectuated this purpose. In view of the fact that actions in deceit could be brought with respect to a wide variety of business transactions, the common law test of materiality is probably the best that could be formulated in order to accommodate the factual differences existing among the range of situations to which the tort applies. In the area of federal securities regulation, however, where the factual deviations are not as broad, it is possible to delineate a standard more narrowly tailored to the articulated purpose of stability. For a discussion of such standards, see note 71 infra.
\textsuperscript{69} The breadth of this discretion is indicated by the \textit{TSC Industries} Court's analogy between a determination of negligence by a jury and a determination of materiality. 96 S. Ct. 2133 n.12.
\textsuperscript{70} See Kripke, \textit{Rule 10b-5 Liability and "Material" "Facts,"} 46 N.Y.U.L. Rev. 1061, 1068-76 (1971). Professor Kripke notes the "earnest attempt" of the Second Circuit to formulate a workable standard of materiality in terms of the "reasonable man," but rejects such a standard as incapable of consistent application. \textit{Id.} at 1068-69. He then suggests that in certain contexts the question of whether a fact is material is "unimportant" because such a determination cannot be made with "any degree of certainty." \textit{Id.} at 1075. Therefore, he proposes that the standard for imposition of liability should be "whether, after reasonable investigation under the circumstances, the persons accused of misrepresentation reasonably believed that the presentation which they made was a fair one." \textit{Id.} (emphasis in the original).
able investor standard is not likely to be a helpful tool in assessing the nature of management's responsibility in the preparation of proxy materials.\textsuperscript{71}

However, the \textit{TSC Industries} decision is not wholly illusory in providing guidance as to the materiality determination. When the decision is analyzed with emphasis upon its conceptual underpinnings, rather than upon the specific language of its reasonable investor standard, a somewhat more manageable conception of the proper \textit{focus} of the materiality inquiry emerges.

A basic predicate of the \textit{TSC Industries} decision was its implicit recognition that there is a broad range of facts with varying degrees of relevance to the transaction for which approval by proxy is sought.\textsuperscript{72} The crux of the court's opinion was that a proper standard of materiality would effectuate a balance between the shareholders' right to be apprised of these relevant facts and the danger that dissemination of too much information would result in more confusion than clarity.\textsuperscript{73} This rationale has led the Court to suggest that in determining whether a substantial likelihood exists that a

\begin{itemize}
  \item \textsuperscript{71} See \textit{id.} at 1069. Alternative approaches to defining materiality have been undertaken. One approach, suggested in a rule 10b-5 case, would find that a fact is material if its disclosure would cause a fluctuation in the market price of a corporation's securities. \textit{See SEC v. Texas Gulph Sulphur Co., 401 F.2d 833, 850 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).} Although this test provides some degree of certainty, its underlying assumption that the market will react to the disclosure of all material facts is fallacious, rendering its utility as a test for materiality de minimis. However, application of this test may be justified where liability is sought to be imposed under rule 10b-5 for nondisclosure by insiders. \textit{See ALI Fed. Sec. Code §§ 1303(a)--1303(c) (Tent. Draft No. 2, 1973).}
  
  A more promising approach, proposed in a case involving section 11 of the Securities Act, 15 U.S.C. § 77k (1970), would measure materiality in terms of whether a particular fact would actually be considered important by a specified percentage of a corporation's shareholders. \textit{Feit v. Lesaco Data Processing Equip. Corp., 332 F. Supp. 544, 571 (E.D.N.Y. 1971) (dictum).} This percentage would vary according to the disclosure required by the relevant regulatory provision. \textit{Id.} Such a formulation might provide management with somewhat ascertainable standards upon which it could rely in initially determining its disclosure obligation and would remove much of the jury's discretionary power to make a determination as to materiality. Indeed, Judge Weinstein's decision in \textit{Feit} found that a mathematical measure of materiality would afford a measure of certainty to litigants by permitting the application of "mathematical models buttressed by valid sampling techniques" to the quantitative results of surveys in the securities markets. \textit{Id.} In a similar vein, Professor Kripke has maintained that a more reliable conception of materiality can be developed by examining the work of behavioral scientists, economists, and statisticians. \textit{Kripke, supra note 70, at 1066–67. However, the instant decision cannot be faulted for failing to adopt a statistical approach to materiality, since it is highly unlikely that the judicial power to construe the meaning of statutes and administrative rules could be read so broadly as to encompass a power to draw the kind of fixed lines which such an approach would necessitate.}
  
  \textsuperscript{72} The Court indicated that there is a range of relevance extending from facts of "dubious significance," 96 S. Ct. at 2132, to facts of "obvious importance." \textit{Id.} at 2135 n.15.
  
  \textsuperscript{73} At one point, the Court directly indicated that it perceived the choice among various standards of materiality as involving a balancing process. It asserted that an adequate definition of materiality depends upon "the proper balance between the need to insure adequate disclosure [of information] and the need to avoid the adverse consequences of setting too low a threshold . . . ." 96 S. Ct. at 2133 n.10 (emphasis added).
fact would be considered important by a reasonable investor, it is important not only to examine the significance of that fact standing by itself, but also to focus upon all of the relevant information.\textsuperscript{74} Where disclosure of the fact in question would not "substantially alter" this "total mix" of available information, the fact may not be deemed material.\textsuperscript{75} Hence, in considering whether a particular fact is material, it will be incumbent upon the courts and members of corporate management to explore the entire range of facts having any bearing upon the transaction. By viewing the qualitative and quantitative aspects of this information as a whole, the relative importance of any particular fact, and hence its materiality, emerges more clearly than would be the case if the question were approached merely by focusing upon the abstract importance of the fact itself.

The obvious import of the \textit{TSC Industries} decision is its resolution of a manifest conflict between the circuits as to the proper definition of materiality for the purposes of rule 14a-9.\textsuperscript{76} In its broader ramifications, however, the Court's decision can be expected to eliminate similar inter-circuit conflicts as to the meaning of the term "material" in other areas of the securities laws where that concept is significant.\textsuperscript{77} Although the Supreme Court's test of materiality was limited to cases arising under section 14(a),\textsuperscript{78} the probability exists that this formulation will be applied by the courts to each of the antifraud provisions of the securities laws.\textsuperscript{79} If the courts seek to expand application of the \textit{TSC Industries} formulation of materiality, however, they should do so with recognition of the fact that the \textit{TSC Industries} standard was developed specifically within the proxy solicitation context,\textsuperscript{80} and that it may not be desireable, as a policy matter, to apply this standard to other areas of federal securities regulation. As has been frequently recognized, the various sections of the securities laws

\begin{footnotes}
\textsuperscript{74} See 96 S. Ct. at 2132-33.
\textsuperscript{75} Id. at 2133 (emphasis added).
\textsuperscript{76} While such a resolution has the salutary effect of providing certainty as to the proper definition of materiality, the utility of the standard to courts, attorneys, litigants, and corporate management is likely to be de minimis unless the standard is applied with explicit recognition of the logic underlying its development. See notes 67-75 and accompanying text supra. Unless such a scrupulous application is developed, the only possible value of the Court's resolution of the inter-circuit conflict over materiality will be to afford the defendant in a rule 14a-9 case a slightly more favorable jury instruction. See note 34 supra.
\textsuperscript{77} For a discussion of the varied formulations of materiality which have been employed in various circuits with respect to different sections of the federal securities laws, see notes 25-27 & 30 and accompanying text supra.
\textsuperscript{78} Id. at 2132. For the text of section 14(a), see note 8 supra.
\textsuperscript{79} Strong support for this conclusion lies in the fact that, to support its own formulation, the Court cited cases which had defined materiality for purposes of virtually all of the antifraud sections of the securities laws. Id. at 2132 n.3. Moreover, in the past, most of the decisions which had considered a definition of materiality in areas other than section 14(a) had looked to \textit{Mills}, a section 14(a) case, to support their definitions. This practice cannot reasonably be expected to change. For an overview of the cases basing a definition of materiality upon \textit{Mills}, see note 30 supra.
\textsuperscript{80} Indeed, the Court limited its consideration of materiality to rule 14a-9. See 96 S. Ct. at 2128, 2132.
\end{footnotes}
require different amounts of disclosure in different contexts to effectuate different policies. Hence, materiality, as a key measure of the factual disclosure obligation, may need to be measured by a test of greater or lesser stringency than the TSC Industries standard, depending upon the context in which the concept is sought to be applied.

In view of these problems, the proper formulation of a standard of materiality for each of the other areas of the federal securities laws should seek to incorporate the underlying rationale of TSC Industries rather than necessarily adopting the explicit language of its "substantial likelihood" test. In seeking to expand the application of TSC Industries, the courts should require disclosure of a fact in a particular context upon a showing that its degree of relevance to a transaction overbalances the risk that disclosure in that context would defeat, rather than further, the purpose and policy of the rule which itself requires disclosure in that context.

The Supreme Court's consideration of materiality in TSC Industries has provided a clear definition of the meaning of this important concept for purposes of rule 14a-9. However, the utility of the Court's standard is


It has been suggested that there are basically four different contexts in which the securities laws require disclosure of material information and that the concept of materiality must be measured by reference to these contexts and the purposes for which the disclosure is required. H. Bloomenthal, supra note 68, at § 9.21(2)(a). As set out by Bloomenthal, these contexts include:

1. false or misleading statements in registration statements and other documents filed with the Commission;
2. false or misleading statements made by the seller of securities in face-to-face transactions outside of formal disclosure documents;
3. false or misleading statements made in unstructured disclosures rather than as part of a filing by one not purchasing or selling securities; and
4. the absence of disclosure in a context in which a party has a duty to disclose. Each of these categories may have subdivisions — for example, filed documents include not only '33 and '34 Act registration statements and '34 Act reports but proxy and tender offer statements. The non-disclosure category can include non-disclosure in the absence of insider trading or during a period of time in which insiders are trading. Id. (footnotes omitted). Bloomenthal goes on to state: "It does not necessarily follow that the concept of materiality differs in each of the situations described, but appropriate analysis would suggest that any attempt to generalize the concept be measured against its possible application in each context." Id.

82. See note 16 supra.

83. See note 81 supra.

84. The Court itself suggested that it used a balancing analysis as a rationale supporting its articulation of the "substantial likelihood" test. See note 73 supra. Moreover, the Court's opinion clearly suggests that there were three essential elements to be weighed in this balancing process: the context in which disclosure is required; the policy behind requiring disclosure in that context; and the relative importance of the continuum of facts relevant to the transaction at issue. For a discussion of these factors and the Court's analysis thereof, see notes 41-45 & 72-75 and accompanying text supra.

85. See note 76 and accompanying text supra.
likely to be undermined unless its application is undertaken only with reference to the thoughtful policy analysis underlying its development.\textsuperscript{86} Careful scrutiny of the rationale supporting the Court's decision is especially important in determining to what extent the \textit{TSC Industries} standard should be extended to other areas of the federal securities laws.\textsuperscript{87}

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\textsuperscript{86} See notes 67-75 and accompanying text \textit{supra}.
\textsuperscript{87} See notes 77-84 and accompanying text \textit{supra}.